

1       **4.       General Problems with Approach and Inputs**

2  
3       *Common Costs*

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5       **Q.       Please turn to your discussion of common costs (Issues AE-0005; AE-0016; AE-0017).**  
6       **Would you begin by defining this costing concept?**

7       A.       Yes. Common costs are incurred when the same production process yields two or more  
8       outputs. They are often common to the entire output of the firm but can be common to just  
9       some of the outputs produced by the firm. Typical examples of common costs include salaries  
10       and other costs of the firm's upper level executives, regulatory and legal expenses, and audit  
11       expenses. An increase in production of any one good will tend to increase the level of common  
12       costs; however, the increase will not necessarily be proportional. The costs of producing  
13       several products within a single firm may be less than the sum of the analogous costs that would  
14       be incurred if each of the products were produced separately.

15               A firm that produces a single product sold in a single market incurs only direct costs.  
16       These include capital costs (cost of money, depreciation, income taxes) and all expenses  
17       exclusively attributable to a specific product or service. However, when the firm is engaged in  
18       producing multiple products or serving multiple markets, it normally also incurs common costs.  
19       Common costs are not directly attributable to a single service, yet they vary to some degree  
20       with the quantity of production of each service.

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22       **Q.       Would you please explain the Company's approach to common costs?**

23       A.       The Company created a common cost factor, which can be applied to the results of its  
24       TELRIC studies. It began the development of this factor by identifying the 1995 expenses  
25       associated with 13 specific ARMIS accounts on a total Company basis (including both

1 interstate and intrastate). SWBT classifies these accounts as Executive, Planning, General &  
2 Administrative, Network Operations-General Supervision, and Marketing and Service  
3 Expense. The Company assumed that only 12.83 % of its Executive, Planning, General &  
4 Administrative expenses were retail related, and removed them from its calculations. Similarly,  
5 the Company removed 92.6 % of Marketing and Service Expenses. Then SWBT added  
6 **Begin proprietary\*\*\*** **\*\*\*End proprietary** to its common costs as support  
7 assets costs associated with the Executive, Planning, General & Administrative salaries. SWBT  
8 then applied commission assessment and inflation factors to derive total wholesale common  
9 costs of \$86,687,735. SWBT then divided total wholesale common costs by total 1995  
10 expenses less total common costs (retail and wholesale). The result is a common cost factor of  
11 **Begin proprietary\*\*\*** **\*\*\*End proprietary** %.

12  
13 **Q. Do you have any concerns regarding the Company's approach to common costs?**

14 A. Yes. First, the Company's approach is based almost entirely upon its embedded data; hence,  
15 its estimates are not necessarily representative of the minimum level of common costs that  
16 would be incurred by an efficient carrier operating a forward looking network.

17 Second, SWBT has not adequately analyzed the differences between the level of  
18 common costs that it incurs as an integrated carrier providing services to retail and wholesale  
19 customers and the much lower level of common costs that would be incurred if it only rented  
20 unbundled elements. SWBT identified and removed certain retail costs that would be avoided if  
21 it only provided services to wholesale customers. SWBT calculated the ratio of retail marketing  
22 and services expenses to total expenses (12.83%), and removed that fraction from its common  
23 cost accounts. However, this procedure is not adequate to remove all of the common costs that  
24 should be excluded from UNE rates. SWBT has not identified the costs that would be avoided  
25 if it didn't provide any services (wholesale or retail) and merely rented unbundled network

1 elements. A firm whose sole business is renting unbundled elements would likely have a far  
2 lower level of network administration, and general and administrative overheads than one that  
3 integrates these elements in providing a wide array of services.

4 Third, the Company has not adequately adjusted its embedded common cost data to  
5 remove the type of overhead costs that will be incurred by the CLECs and should therefore not  
6 be loaded onto the UNE rates. If SWBT's common cost factor is used in pricing UNEs,  
7 CLECs will potentially be burdened with redundant layers of overhead—their own and that of  
8 SWBT.

9 Fourth, certain adjustments are appropriate to be consistent with my earlier  
10 recommendations. To the extent certain costs are removed from the labor cost loading, as I  
11 recommend, some of these costs might appropriately be added to the common cost factor.  
12 Also, the Company has applied inflation factors, which, as I explained earlier, is inappropriate.

13 Fifth, SWBT has applied a commission assessment factor to its common cost factor.  
14 This creates the potential for a double recovery of these costs, because a commission  
15 assessment factor is also included in the direct cost estimates. To the extent the common cost  
16 factor is applied to direct cost estimates that include a commission assessment adjustment, these  
17 costs will be overstated. The solution is to remove this element from the common cost  
18 calculations, and then to apply the resulting common cost factor to direct cost estimates that  
19 include a commission assessment adjustment.

20 Sixth, SWBT has failed to include the cost of equity in portions of its common cost  
21 factor development, yet it includes common equity costs in the direct cost estimates to which  
22 the common cost factor will be applied. This creates a serious mismatch, resulting in an  
23 overestimate of common costs. *The solution is to appropriately include equity costs in all*  
24 *aspects of the cost development, including the denominator of the common cost*  
25 *development calculations.*

1       **Q.    Have you developed a recommended alternative to SWBT's common cost**  
2       **calculations ?**

3       A.    Yes. Schedule 1 shows the results of my recommendations. First, I removed nearly all  
4       Marketing and Services expenses, since these are not required for UNEs. Second, I added  
5       General and Computer support asset costs to SWBT's estimate of common costs, including a  
6       return on these assets, since I recommend these items be removed from SWBT's labor rate  
7       calculations.

8                Third, I added SWBT's 1995 net income to the denominator of the common cost  
9       factor, as an estimate of equity costs. This adjustment is necessary for consistency if the  
10      common cost factor is going to be applied to cost estimates that include an estimate of equity  
11      costs (e.g. those derived using CAPCOST),

12              Fourth, I excluded the inflation adjustment from the numerator and the denominator of  
13      the common cost factor. Fifth, I removed the commission assessment factor from the numerator  
14      of the common cost factor.

15              Sixth, I removed 22 % of common and support asset costs from the numerator. This 22  
16      % factor provides a reasonable estimate of the portion of SWBT's common costs which must  
17      be removed before developing a reasonable common cost factor for UNE cost calculations.  
18      SWBT removed just 12.83%, which is too low. It is clear that a disproportionate share of  
19      SWBT's executive, planning and other common costs arise due to the fact that SWBT operates  
20      as a vertically integrated firm offering services in both retail and wholesale markets. Thus, it is  
21      necessary to make a downward adjustment to remove a portion of SWBT's common costs, in  
22      order to develop a common cost factor that can reasonably be applied in the context of  
23      unbundled elements. The 22 % factor is the ratio of SWBT's Marketing and Services expenses  
24      (including 80 % of its wholesale Marketing and Services expenses), to total expenses less

1 common costs and capital related expenses. Development of this percentage factor is shown on  
2 Schedule 1, page 2.

3           Seventh, I removed all common costs from the denominator, including SWBT's 1995  
4 Kansas support asset expenses. This was necessary to ensure that the resulting factor could  
5 appropriately be applied to the results of cost studies that do not include common costs. The  
6 net effect of this procedure is a common cost factor of approximately 16 %.