

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

2
3 *Labor Costs*

4
5 **Q. Please discuss the Company’s labor costs (Issues AB-0003; AB-0004; AB-0007;**
6 **AE-0021). How has SWBT calculated the labor rates used in its cost studies?**

7 A. SWBT provided us with a “Cost Factor Support Binder” which purportedly contains the
8 calculations of its labor rates. This binder indicates that the Company began with the average
9 hourly wage/salary costs for various categories of workers, as of the end of 1995. The
10 Company then applied various loadings to each labor rate, to calculate the “directly assigned”
11 labor rate for each class of worker.

12 Upon further review, it appears that the labor rates developed in its Cost Factor
13 Support Binder were used in some, but not all, of SWBT’s studies. Notably, although SWBT
14 used the Cost Factor Support Binder labor rates in its non-recurring bop study, it developed its
15 recurring loop costs using 1996 Outside Plant Broad Gauge Unit Costs (Broad Gauge Report).
16 This source includes a different set of labor rates, based upon a different set of calculations.
17 While there appear to be some similarities, the wage/salary rates and loading categories are not
18 identical to those appearing in SWBT’s Cost Factor Support Binder. The specific loadings in
19 the Broad Gauge Report are: Overheads, MV (motor vehicles) and Special Tools, Engineering
20 and Other. In contrast, the specific loading factors in the Cost Factor Support Binder are:
21 wage increase (to estimate average wages as of the end of 1996); break time; paid absence;
22 premium time; benefits; social security; support assets; other expenses; secretarial support; and,
23 supervision. We were unable to perform a more detailed analysis of the similarities and
24 differences between these two sources. SWBT provided some supporting documentation for

1 the labor rates appearing in its Cost Factor Support Binder, but none for the labor rates in its
2 Broad Gauge Report.

3
4 **Q. Are there any potential problems with SWBT's labor cost calculations?**

5 A. Yes. In the context of a long run economic cost study, the appropriate standard is the level of
6 labor costs that would be incurred by an efficient firm operating in long run equilibrium.
7 SWBT's internal labor costs are only relevant to the extent they are consistent with this
8 benchmark. Unfortunately, to the extent the Company provided supporting documentation for
9 its labor rates, this material was entirely focused on internal costs.

10 In the context of maintaining, expanding and rearranging an existing network, SWBT's
11 internal labor costs might be reasonably consistent with the relevant long run equilibrium
12 benchmark. However, in the context of the labor activities required to construct a new network
13 for a TELRIC study, SWBT's internal costs might not provide a very good estimating basis.
14 Just as the internal labor costs of the Hyatt hotel chain might not provide a good indicator of the
15 labor costs of a contractor constructing a new hotel, SWBT's internal labor costs might not
16 provide a good indicator of the cost of constructing a new network. If outside contractors can
17 construct outside plant facilities more economically than the Company, this lower cost level
18 should be reflected in the TELRIC calculations. A TELRIC study should appropriately focus on
19 the minimum level toward which costs will trend in long run equilibrium, not the specific and
20 unique costs of a particular carrier operating under a specific union contract, or with a particular
21 level of overheads.

22 Stated differently, to be consistent with the basic premise of a long-run cost study, it is
23 reasonable to use labor costs for outside plant construction that are representative of the lowest
24 price that would be received from a qualified contractor in a competitive bidding process.

1 There is no reason to assume that the Company's internal labor costs and overhead loadings
2 are equivalent to that minimum cost level

3 To investigate this issue further, we reviewed information provided by the Company in
4 response to discovery regarding outside contractors. For instance, according to its Cost Factor
5 Support Binder, the Company's Craft 1 labor rate is **Begin proprietary*** ***End**
6 **proprietary** per hour, including the various loadings I mentioned earlier. Its Broad Gauge
7 Report does not contain the identical category. However, the labor rate for placing and splicing
8 cable (which would be similar to the Craft 1 category) is approximately **Begin proprietary*****

9 *****End proprietary** per hour including Overheads and MV and Special Tools, but
10 excluding engineering. The direct (wage and salary) cost component in both the Cost Factor
11 Support Binder and the Broad Gauge Report seem to be reasonable (less than \$30 per hour)
12 and fairly consistent with (albeit somewhat higher than) the outside contractor prices. However,
13 SWBT's studies use labor rates that are quite high, because they include relatively high levels of
14 fringe benefit and overhead costs. The latter cost components aren't necessarily consistent with
15 the level of labor costs that would be incurred by an efficient firm constructing or operating a
16 network in long run equilibrium

17
18 **Q. How do SWBT's labor rates compare to labor rates developed by other LECs?**

19 A. In recent years, I have reviewed many cost studies prepared by incumbent LECs. SWBT's
20 loaded labor rates are quite a bit higher than the analogous labor rates that I recall being used in
21 other jurisdictions. I cannot provide the details of these other studies because they are subject
22 to proprietary agreements similar to the one that protects SWBT's labor cost estimates. It is my
23 impression, however, that the discrepancy in labor cost levels is largely a function of differences
24 in the loadings which are added to the direct labor costs—particularly the overheads which
25 SWBT includes in its calculations.

1 **Q. How do SWBT’s labor rates compare to the analogous labor costs that are incurred by**
2 **SWBT when it hires outside contractors?**

3 A. The loaded labor rates used in SWBT’s studies are quite a bit higher than the analogous rates
4 that are being charged by outside plant contractors. Again, it appears that the primary reason
5 for this discrepancy is the high level of loadings included in SWBT’s labor cost development.
6 The outside plant contractors undoubtedly incur fringe benefit and overhead costs, which are
7 reflected in the rates they charge. However, it appears that their benefits and/or overheads are
8 considerably lower than those incurred by SWBT.

9 During the discovery process, SWBT provided copies of several contracts between the
10 Company and outside contractors for various work activities related to outside plant
11 construction (e.g cable installation). [See Response to BJA IR 7.27]. Most of the activities
12 contemplated by these contracts are priced on a per unit basis. For example, the contracts
13 specified the cost per foot of placing cable under various scenarios. To calculate the implied
14 cost per hour of labor involved in this work, one can divide the contract price per unit by an
15 estimate of the time it takes to perform the activity.

16 For example, for placing cable in a pre-existing trench, the contract cost per foot ranges
17 from **Begin proprietary*** ***End proprietary**, depending upon the specific
18 contractor and the geographic location of the work. In its Broad Gauge Report, SWBT
19 estimates that it takes an average of **Begin proprietary*** ***End**
20 **proprietary** per foot to place cable in an existing trench. Therefore, the contractor rates equate
21 to a per-hour labor cost for placing cable that ranges from **Begin proprietary*****

22 *****End proprietary** with a midpoint of **Begin proprietary*** ***End**
23 **proprietary** per hour. The contract prices include all relevant loadings, including the cost of
24 motor vehicles and other equipment used in placing the cable. In comparison, the comparable
25 labor rates used in SWBT’s studies (including all relevant loadings) are noticeably higher:

1 **Begin proprietary*** ***End proprietary** for the Craft 1 category, according to the
2 Cost Factor Binder, or approximately **Begin proprietary*** ***End proprietary** for
3 cable placement labor, according to the Broad Gauge Report.
4

5 **Q. Did these contracts contain any explicit hourly rates?**

6 A. Yes. Certain activities in the contracts were priced at an hourly rate. These hourly rates ranged
7 from **Begin proprietary*** ***End proprietary** depending upon the
8 contractor and the location of the work. Additional charges would apply for the use of
9 specialized motor vehicles. Even with this caveat, however, it is apparent that these hourly rates
10 are substantially less than the hourly labor rates used by the Company in its cost studies.
11

12 **Q. Can you explain why SWBT's estimated labor rates are so high?**

13 A. The primary problem seems to be the loadings used by the Company. While the contractors
14 obviously incur various fringe benefit and overhead costs analogous to those incurred by
15 SWBT, the level of these costs is apparently quite a bit lower than the loadings that SWBT is
16 including in its cost studies. With regard to the Labor Rates developed in the Cost Factor
17 Support Binder, I am particularly concerned about the Support Asset and Benefit loading
18 factors. With regard to the Broad Gauge Report, I am particularly concerned about the
19 “overhead” loading factor.
20

21 **Q. Can you explain the problems associated with the support asset loading factors?**

22 A. For purposes of calculating its labor rates, SWBT classifies support assets into three categories:
23 General Support Assets, Computers, and Autos. General Support Assets include land,
24 headquarters, furniture and office equipment. Computers includes general purpose computers
25 (including main frames and personal computers). The category labeled “Autos” includes motor

1 vehicles and garage work equipment. SWBT takes the embedded level of these support asset
2 costs and adds them to its labor rates based upon a percentage factor. The effect is to increase
3 the direct level of wages and salaries by more than **Begin proprietary *** **End**
4 **proprietary** %.

5 There are at least three problems with this procedure. First, these costs are being
6 treated as if they were directly attributable to specific labor activities, yet they are more
7 appropriately classified as common overheads. Second, the embedded level of common
8 overheads being incurred by SWBT may exceed the long run efficient level which is
9 appropriate for inclusion in a TELRIC study—particularly in the context of construction costs for
10 a new network. Third, to the extent these costs are recovered from competitors who rent
11 UNEs, there is a risk that they will be inappropriately burdened with common overhead costs
12 of SWBT which are analogous to, and redundant to, common overhead costs that the CLEC
13 will internally incur. This problem can best be avoided if all common costs are dealt with
14 together, at the end of the study process, where adequate steps can be taken to ensure that the
15 UNE rates do not include an excessive level of common overhead.

16 Parenthetically, there may be an inconsistency between the manner in which SWBT
17 develops its support asset labor loading factors and the application of these factors in its
18 studies. SWBT's workpapers indicate that the Company developed separate support asset
19 factors for different classes of employees. For operator services and directory assistance
20 employees, SWBT developed a factor which only includes General Support Assets, thereby
21 excluding Autos and Computers. For service representatives, SWBT developed a higher factor
22 that includes both General Support Assets and Computers. For all other workers, SWBT
23 developed an even higher factor which includes all three categories of support assets. The effect
24 of this procedure was to increase the resulting percentage factor for the other workers, thereby
25 ensuring that, for instance, the cost of Autos is spread across the employees falling outside the

1 service representative, operator services and directory assistance categories. However, in
2 developing the loaded labor rate for at least one type of service representative, the Company
3 used the highest support asset factor rather than the one that excludes Autos. [See, e.g., Cost
4 Factor Support Binder, Report LBR09, Document 97-SCCC-149-GIT].

5
6 **Q. Do you have any other concerns about the labor cost calculations?**

7 A. Yes. Dave Dittmore will testify about some specific problems associated with SWBT's benefit
8 factors. In particular, he questions the inclusion of SWBT's Transitional Benefit Obligation
9 expenses in its TELRIC calculations. These are embedded costs incurred by SWBT that are
10 historic in nature. Removal of these costs from SWBT's labor calculations would reduce the
11 hourly rates, moving them closer to the contractor labor rates I discussed earlier.

12 I would also note that SWBT treats engineering costs as a loading factor that is added
13 to its labor rates. This factor alone accounts for **Begin proprietary*** **End**
14 **proprietary** % of SWBT's total estimated cost per hour. The implied costs associated with the
15 Engineering is significant enough that these functions should be separately and directly
16 estimated. While engineering is obviously required to design and construct a network, "loading"
17 the craft labor rates with an engineering factor doesn't necessarily result in a reasonable
18 estimate of engineering costs. In particular, I am concerned that the extent of engineering effort
19 required for various jobs is unlikely to vary in exact proportion to the amount of craft labor
20 required for those jobs. Thus, for example, the Company estimates that splicing of aerial cable
21 takes longer than splicing of buried cable due to the extra time required to set up aerial
22 platforms and to tag cable pairs. While this may be true, it doesn't necessarily follow that the
23 engineering effort will be greater for aerial cable than for buried cable, in direct proportion to
24 this difference in craft labor. But that is the implied relationship behind the Company's method
25 of "loading" engineering costs in proportion to craft labor requirements.

1 **Q. What are your recommendations regarding SWBT's labor rates?**

2 **A.** I recommend that they be substantially reduced.

3 First, with regard to all of its labor rates, I recommend that SWBT remove overtime
4 and premium time loadings, as agreed to by SWBT in response to issue AB-0001. Second,
5 with regard to the labor rates developed in SWBT's Cost Factor Support Binder, I
6 recommend the rates be recalculated to remove all TBO costs and all Support Asset costs.
7 Having removed the Support Asset costs from the labor rates, it would be reasonable to
8 include an appropriate portion of these costs in the "common cost" factor development.

9 Third, with regard to the labor rates developed in SWBT's Broad Gauge Report, I
10 recommend that the TBO costs, if any, be removed, along with the entire category of
11 "Overhead" expenses. Alternatively, a more reasonable cost per hour could be substituted for
12 the one developed in the Broad Gauge Report. Based upon the outside contractor rates
13 mentioned earlier, as well as my general knowledge of the industry, I believe a loaded rate of
14 approximately \$40 to 50 per hour would be reasonable. Regardless of which specific approach
15 is used, I recommend that the hourly labor rates be reduced below the level reflected in the
16 Company's cost studies. To the extent the Commission is concerned with ensuring that a
17 reasonable share of the Company overhead costs are recovered through the UNE rates, this
18 can most appropriately be accomplished in the context of the "common cost" factor that is
19 applied at the end of the study process.

20 Parenthetically, I would note that it is not unreasonable to load motor vehicle and
21 garage work equipment costs onto the relevant hourly rates. This is the approach used in the
22 Broad Gauge Report. Similarly, these costs are included in the rates paid to outside
23 contractors. Accordingly, I have treated these differently than the other Support Asset costs,
24 and do not recommend moving them into the "common" cost category.

1 I recommend that the Commission require Engineering costs be separately estimated in
2 future cost filings, so that these costs can be examined in greater detail. However, for purposes
3 of this proceeding, I am not recommending any specific changes to the Company's Engineering
4 loadings.

5
6 **Q. Have you quantified the effect of these recommendations on SWBT's labor rate
7 calculation?**

8 A. Yes. I performed some illustrative calculations for one class of employee. Specifically, I
9 recalculated the labor rate appearing in SWBT's Cost Factor Support Binder for its Class 1
10 worker. As I mentioned earlier, the rate calculated by SWBT is **Begin proprietary *****

11 ***** End proprietary** After removing all support asset costs except for motor
12 vehicles and garage work equipment, and excluding TBO costs from the benefit factor, the
13 loaded labor rate decreases to **Begin proprietary ***** ***** End proprietary**

14 We did not receive the Broad Gauge Report until very late in our review process, and
15 SWBT did not provide us with any supporting documentation for these labor rates or loading
16 factors. However, once the "Overheads" loading factor is removed, the hourly rates drop to a
17 more reasonable level. For instance, the hourly cost associated with cable placement is **Begin
18 proprietary ***** ***** End proprietary** per hour including Overheads and MV and
19 Special Tools, which fall within my recommended range. To the extent SWBT is incurring some
20 additional "overhead" costs that the Commission believes should be reflected in the UNE
21 prices, it is preferable to deal with these costs in the context of the common cost recovery
22 factor, rather than adding them to the labor rates.

23