

**The History & Rules of Setting Phone Rates in America
—The FCC’s ‘Big Freeze’ & Cross Subsidies**

Written in conjunction with:

The Hartman Memorandum

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local service, while “interstate” services only paid 25%. These interstate services can include special access and broadband internet services. On top of this, FCC rules, created in 2001, required that cost allocations be ‘frozen’ to reflect the year 2000, making the dumping of expenses into local service even worse. That was 16 years ago.

The FCC has a series of current proceedings pertaining to special access services. The FCC had kicked issues about special access down the road since 2002 when then-AT&T (circa 1985-2005) filed a complaint – now 14 years ago. In 2015, the FCC released new data claiming that special access was \$45 billion in revenues in 2013; the majority, 60%, of the revenues are still based mostly on the existing copper wires. (‘Common wisdom’ has claimed that customers dropped their phone service copper lines. As we discuss elsewhere, special access lines are not counted as ‘access lines’, even though their have been major increases in these lines and services.)

Since the 1990’s, special access profits went through the perverbial roof. Consumer Federation of America (CFA) found about \$20 billion in annual overcharging on special access.¹ The New Networks Institute’s (NNI) findings, using a diferent methodology, not only confirmed the CFA’s findings; but, using Verizon NY 2015 annual report data, found that access services (including special access) had an Earnings Before Interest, Taxes, Depreciation, and Amoritization (EBITDA or profits) of 66%.

The FCC claims it can create ‘just and reasonable’ rates by using mathematical formulas to create new ‘model’ special access rates. Unfortunetely, actual financial information from Verizon NY annual reports shows that there are massive cross subsidies of special access services and almost all fiber-optic build-outs, including those for wires to the cell sites for Verizon Wireless. This directly contradicts the FCC’s models, which do not take into account any actual financial information.

History of Phone Ratemaking supplies the details and history of the revenue and cost allocation rules, and the concept of the utility and a monopoly over the existing networks.

The Hartman Memorandum, the primary report, details how these rules have had direct impacts on customers and that the FCC cannot properly determine and create ‘just and reasonable’ rates for special access without a full investigation of the accounting rules and a cost study based on actual financial data.

¹ http://consumerfed.org/press_release/cfa-study-finds-special-access-market-concentration-cost-consumers-and-the-u-s-economy-150-billion-since-2010/

³ Also referred to as Public Utility Commissions (PUCs), Public Service Commissions (PSCs). Utility Regulatory Commissions (URCs), etc.

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There have been no audits by the FCC or the States of the affiliate transactions between and among Verizon, the state utility, and the other Verizon subsidiaries or lines of business, from Verizon Wireless and Verizon Online or Verizon special access services.

The FCC's cost allocation rules adopted in 2001 to reflect the year 2000 have never been properly examined. And the FCC's 75% to intrastate, 25% to interstate rule is also still in place. Moreover, the FCC has failed to acknowledge that special access services are part of the state utility and that the services have been cross subsidized where local service customers, including low income families, have had rate increases directly caused by the excessive cross subsidies, making local phone rates unjust and unreasonable as well.

Thus, the FCC must deal with the implications of how its rules have distorted the market and allowed for cross subsidies that harmed local phone customers, municipalities and competition in America.

In short, **The History of Ratemaking in America** and **The Hartman Memorandum** lay out both the history as well as the current impacts of the FCC's mal-formed rules, and the need for immediate investigations and cost analysis before the FCC can undertake creating just and reasonable rates for special access services.

NOTE: We focus on Verizon NY because New York is the only state with requirements to supply a detailed, public annual report. However, as we show, AT&T and CenturyLink use the same cross subsidy-based math to benefit the companies and not customers or their communities.

As shown by the 2015 Verizon NY annual report (and other states' data), the cross subsidies have made local service look unprofitable, which has been and continues to be used for multiple, bad, public policies. These losses are all artificial as they are not based on actual expenses, but a fabricated, convoluted series of rules that have been used to game the regulatory system by Verizon and the other incumbents.

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1.0 Introduction

The Communications Act of 1934 mandated that everyone in America was entitled to phone service, and this would be delivered to homes and offices, schools and libraries throughout America. Moreover, phone service would be delivered by a state-based utility that had a state-based (or city-based) franchise to offer phone service and the wires were based on copper wires.

1.1 Setting Rates in a Two-Regulator Monopoly Environment

Based on the recognition that the telephone industry was a monopoly, a telephone company could not be allowed to set its own rates for the monopoly services it provided. Due to the nature of telephone service, the telephone industry was regulated by both the FCC and the relevant state utility commissions³. The FCC regulated international services originating/terminating in the US, as well as interstate services within the US, e.g., interstate toll, commonly known as “long distance.” Therefore, the FCC regulated services that crossed state boundaries. State commissions regulated services that did not cross state boundaries, e.g., intrastate toll (sometimes called instate-long distance) and local service. Each state commission regulated the intrastate services within their state.

Each regulator approved the rates⁴ that would be charged for the monopoly services that it regulated. Since rates were based on costs, the issue was how much of the total costs used by a telephone company to provide monopoly services should be included in interstate rates and how much should be included in intrastate rates. However, the total of the telephone company revenues used in providing both interstate and intrastate monopoly services must be “fair” to the telephone company, and the ratepayers of both interstate and intrastate monopoly services.

Starting in the late 1940’s, the FCC, state commissions and the industry worked together to use tools to implement shared public policy goals, but by the mid 1970’s, this collaborative spirit fell apart. Instead, the FCC continually and consistently refused to work with the state commissions and in areas that required collaboration, the worked stopped altogether and this has continued to this day.

⁴ Simplistically, rate for service A = costs for service A / demand for service A.

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1.2 Confiscation

Because the rates of the telephone company were regulated and because the telephone companies are private companies providing a public service, if the rates were set too low, the regulator could be “taking” the telephone company’s property. “Takings” or confiscation is prohibited by the 5th amendment⁵ of the Constitution of the United States. Since rates were based on costs, each regulator had to know precisely their legal confiscation responsibility. In other words, each regulator had to know exactly the total costs its rates in total had to recover in order to avoid confiscation in its jurisdiction, i.e., interstate or intrastate.

Rates were set to provide “just compensation” to the telephone companies by recovering all the costs of providing monopoly service, e.g., expenses and taxes. In addition, “just compensation” included the opportunity for the telephone company to earn a reasonable or fair profit. The needed profit level had to be determined by the relevant commission for the monopoly services it regulated. Because providing traditional telephone service was very investment-intensive, profit was calculated as a return on net investment.⁶ Each regulator could determine and apply a different “reasonable” rate of return. In addition, not every regulated service in a jurisdiction had to recover the same level of costs or earn the same return. This only applied to all services not individual services.

If the total jurisdictional costs plus the commission-authorized rate of return were not recovered in the rates set by the regulator for its jurisdiction, then the regulator would have to raise the rates for one or all services that it regulated in order to avoid confiscation or takings of the telephone company’s property. Conversely, if more than the total jurisdictional costs plus the commission’s authorized rate of return were recovered in the rates set by the regulator for its jurisdiction, then the regulator could lower the rates for one or all service that it regulated in order to avoid the telephone company from making monopoly profits. The reductions seldom happened, however.

The fact that the services provided by telephone companies were regulated by two regulators added another dimension. As discussed, it was critical that each regulator knew exactly the total costs its rates in total had to recover in order to avoid both confiscation of telephone property and monopoly profits in its jurisdiction, i.e., interstate or intrastate.

⁵ Takings clause – “... nor shall private property be taken for public use, without just compensation.”

⁶ Revenue requirement is defined as expenses + taxes + return on net investment where the expenses, taxes, gross investment and reserves are the costs. The return is determined by the respective regulator. Net investment = gross investment – reserves. For this paper, the terms costs and revenue requirements are used interchangeably.

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1.3 The Need for Jurisdictional Separations

If there were separate interstate and intrastate networks and operations, the task of determining interstate and intrastate costs of the providing telephone company would be a lot easier. In that case, each regulator would be responsible for 100% of the costs associated with their stand-alone network and operations. However, such is not the case.

In reality, however, there is a single network that is used for providing both interstate and intrastate services. Therefore there needs to be some way of determining how much of the total costs of the telephone company are the confiscation responsibility of each of the two regulators so that interstate costs + intrastate costs = total costs. If interstate costs + intrastate costs = more than total costs, this would provide telephone companies monopoly profits and be unfair to captive rate payers. Conversely, if interstate costs + intrastate costs = less than total costs, then this would be an illegal takings and unfair to the telephone company.

The only chance that interstate costs + intrastate costs = total costs is if both regulators use the same cost allocations. The allocations are contained in the Separations Manual⁷. The Manual allocates the investment, expenses, taxes, revenues and reserves of the telephone company between the FCC (interstate) and state commissions (intrastate).⁸ While the Separations Manual rules require many detailed calculations, e.g., categories⁹, the Separations Manual was designed to develop only two numbers - total interstate cost and total intrastate cost.

In other words, regarding the costs of a telephone company, the Separations Manual determines the legal size of both the FCC's jurisdiction and the relevant state commission's jurisdiction. Once the costs have been separated between interstate and intrastate, the FCC could then set interstate rates and the state commission can set intrastate rates in order to prevent confiscation and monopoly profits.

⁷ Today codified in 47 CFR 36 Jurisdictional Separations Procedures; Standard Procedures for Separating Telecommunications Property Costs, Revenues, Expenses, Taxes and Reserves for Telecommunications Companies

⁸ In general, the Separations Manual calculates, for example, the interstate allocation for a particular investment and then calculates the intrastate allocation of that particular investment by subtracting the calculated interstate amount from the total amount of that particular investment. (Intrastate = Total – Interstate) This guarantees that Interstate + Intrastate = Total.

⁹ Defined in the Glossary of the Separations Manual as “a grouping of items of property or expense to facilitate the apportionment of their costs among the operations and to which, ordinarily, a common measure of use is applicable.” For example Account 2410 Cable and Wire Facilities is divided into various categories for loop and trunk.

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1.4 Preemption

Since the Separations Manual allocates costs as recorded in an accounting system, it is also critical that both regulators use the same accounting system. Clearly, if each regulator defined accounts differently, interstate costs + intrastate costs equaling total costs would be impossible. The accounting manual that the Separations Manual relies on is the Uniform System of Accounts for Telephone Companies¹⁰.

Therefore, in order to make sure that interstate costs + intrastate costs = total costs, both regulators are required to use both the Uniform System of Accounts (Part 32) and the Separations Manual (Part 36). Technically and legally, the state commissions are preempted by the FCC and must use only Parts 32 and 36 to determine the extent and size of their jurisdictions.

1.5 Separations Theory and Common Costs

Unlike most industries, since both interstate and intrastate services utilize the same network, many, if not most of a telephone company's costs are common or joint costs. While usage might seem a reasonable way to separate the interstate and intrastate portions, usage is not the only correct way to allocate common or joint costs, besides there are many different usage measurements, e.g., minutes, capacity, etc.

Per cost accounting principles, there is no one universally accepted way to assign common or joint costs between multiple users or services. Because common or joint costs make up such a large portion of a telephone company's costs, how these common or joint costs are allocated is critical to each regulator and to the rate payers.

1.6 Separations as a Public Policy Tool

Since there is no "correct" way to allocate common or joint costs, using the Separations Manual to accomplish certain objectives would be no more or no less reasonable than any other allocation methodology. So long as everyone agreed on the same objectives, the next step was relatively easy - developing a formula that accomplished that objective. This system worked well so long as the FCC and states (and industry) had the same objective.

¹⁰ Today codified in 47 CFR Part 32

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1.7 Universal Service as a Public Policy that was “Good for All Concerned”

Since it was virtually impossible to make or receive a long distance call without local service, it was understood by AT&T¹¹ that the growth and value of long distance service was directly related to the household penetration of local service¹². Pricing local service too high would have a detrimental effect on interstate (FCC) and intrastate long distance service, since the value of toll service was related to the number of local subscribers that could make or receive calls. So it would be financially advantageous for AT&T to have the state commissions approve local rates that were low enough so that it allowed local service to be affordable to most if not all¹³.

Both the FCC and state commissions recognized that the growth of their respective toll services was directly related to the number of subscribers that could make and/or receive toll calls. Therefore, it was also in the best interest of growing toll services that household penetration of local service was increased by making local service affordable.

In the 1950's and 1960's there were technological savings primarily in the long distance arena. Local service was primarily the same technology as in the 1940's. Interstate was especially advantaged, e.g., microwave. Historically when AT&T's interstate earnings became too high, e.g., interstate costs declined, AT&T was “encouraged” to lower interstate rates. On the state side, there was no offsetting decrease in intrastate costs, which in fact were increasing yearly, e.g., wages. The individual Bell local telephone company would have to go in for a state rate case to request a rate increase. It might take upwards of a year for the state commission to raise rates that provided less than what was requested. So, on the whole, AT&T would see a rate reduction in interstate (loss of revenue), and respond with a constant fight for rate increases in intrastate revenue.

1.8 Rate Making in the States – Pre Divestiture

For state commissions, local rate increases of even 10 cents were very difficult politically. Therefore, when faced with approving an increase in state rates, state commissions generally first favored increases in any intrastate services other than local, e.g., intrastate toll, business, etc. As stated above, the FCC was decreasing interstate toll rates. This caused toll rate disparity where the rates for an interstate toll call were considerably less than an intrastate toll call of the same duration and mileage. This became a bigger problem after Divestiture.

¹¹ For purposes of this paper, AT&T stands for the pre-divestiture American Telephone and Telegraph Company. AT&T stands for the post divestiture long distance company split from AT&T.

¹² It was not until the 1950's that household penetration for telephone service reached 50%.

¹³ This was also one of the reasons given to replace 16 party service with 1 party service, since on a 16 party line only 1 of the 16 parties could make/receive a toll call at a time.

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1.9 Changing the Separations Manual as an Alternative

An alternative to the above scenario was to reallocate costs between the interstate (FCC) and state commission jurisdictions via changes in the Separations Manual. As a result, if more costs were allocated to interstate, AT&T's interstate return would decline and a rate reduction was not needed and if intrastate costs declined, AT&T's local operating companies would have a higher intrastate return and not need to go in for a rate case. So, from AT&T's financial perspective, this was a win-win.

1.10 Steps Required to Change the Separations Manual

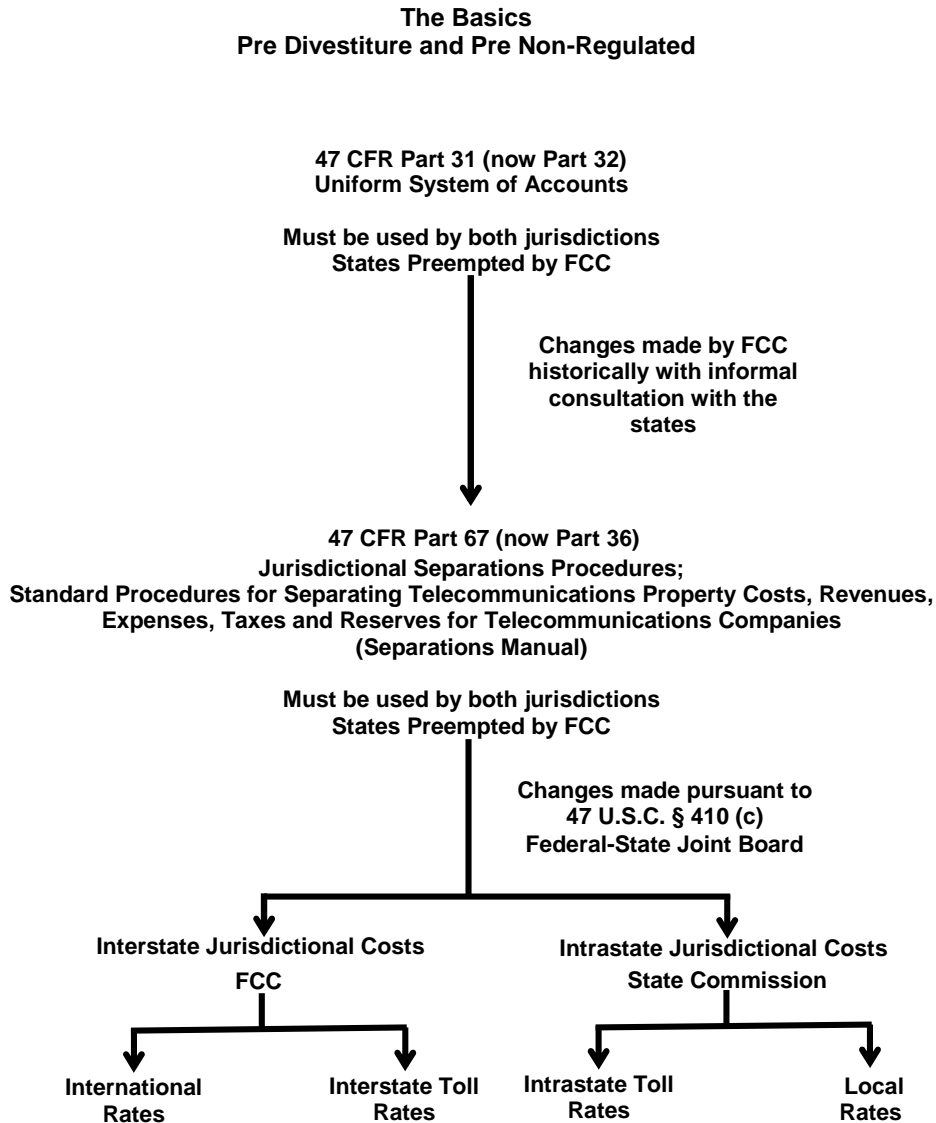
1. The FCC refers a particular issue to the Federal-State Joint Board comprised of 4 state commissioners nominated by the National Association of Regulatory Commissioners (NARUC) and 3 of the 5 FCC commissioners.
2. The Joint Board develops and votes on a recommendation.
3. The Joint Board's recommendation is forwarded to the FCC for approval by the full FCC.

Eventually, the Separations rules were changed so that neither the FCC nor states got all of the benefits from lower costs due to technology, e.g., operators replaced with switches. As stated above, this worked well financially for AT&T and the independent local telephone companies, increased household local penetration, and increased toll usage. This cooperation worked well for 20 years or so, but ended in the 1970's.

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2.0 The Basics – A Diagram

The diagram below shows the process of determining the jurisdictional costs for both the FCC and state commissions when times were simpler, mainly before Divestiture and before the addition of a process for non-regulation.



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2.1 The Mechanics

The accounting (Part 32) and jurisdictional separations (Part 36) rules are codified in the Code of Federal Rules and Regulations (CFR). The FCC preempted the states for both of these processes. So legally and administratively, the states had to follow the Uniform System of Accounts (Part 32) and the Separations Manual (Part 36).

Part 36 requires a federal-state joint board recommendation before any changes become effective, although the FCC is not required to follow the recommendation. Part 32 requires no such a process or consultation with the state commissions, although historically the FCC consulted informally with the states.

As shown above, separations carves out the costs for both the FCC and state commissions. These costs are then used to determine the confiscation liability of the respective commission. The respective commission must set rates so that the revenues derived from the sum of all of their services recovers the total costs as determined by separations.

Historically, these allocated jurisdictional costs are used by the FCC and state commissions to set rates, where simplistically

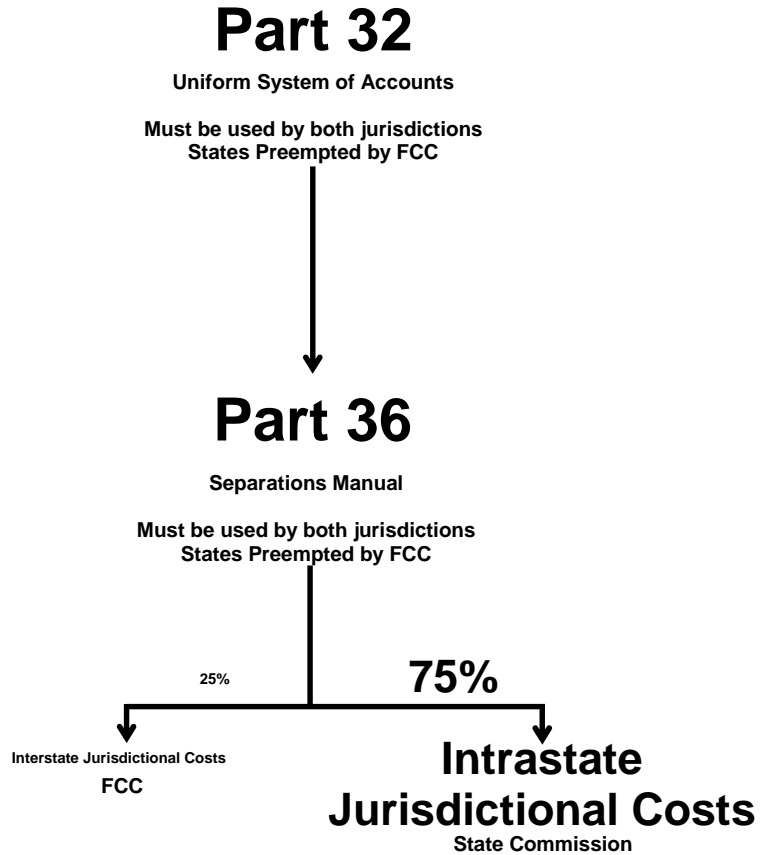
$$\text{Rates} = \frac{\text{Costs}}{\text{Demand}}$$

See Appendix I for the math.

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2.4 The Basics – Jurisdictional Size

The Basics
Relative Size of FCC and State Jurisdictions
Based on Costs
(Relative Size Shown by Type Size)
Approximate relative size of each jurisdiction (costs per Part 36)
for an average individual Bell Operating Company or the sum of
all Bell Operating Companies for year 2000



Note: The sum of the interstate jurisdictional costs for all of the states of the Bell Operating Companies and/or a Regional Bell Operating Company was larger than the intrastate jurisdictional costs of any single state.

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3.0 These Times They Are A-Changin'

"By 1980, the traditional penetration measure (residential lines divided by the number of households) reached 96%, while the number of households reporting that they had telephones in the 1980 census was 92.9%"¹⁴. To some, this indicated that universal service had been accomplished.

Long Lines, the interstate division of AT&T, had long argued that interstate toll rates were subsidizing the local service provided by the local telephone companies, including the Bell Operating Companies. Prior to Divestiture, interstate rates as filed by Long Lines contained all of the interstate costs of the local telephone companies¹⁵ as allocated by the Separations Manual. There were no explicit interstate access charges, rather these costs were included in AT&T's interstate toll rates.

Interstate long distance competition began in the 1970's. AT&T, Long Lines in particular, felt that the competitors were not paying the same for "access to the local telephone networks" as they did, thus putting Long Lines at a competitive disadvantage.¹⁶ Therefore AT&T was not interested in continuing to allocate more costs of the local telephone companies to the interstate jurisdiction in order to keep local rates lower than they otherwise might have been. The historic revenue advantage of allocating more intrastate (local loop) costs to interstate via changes in the Separations Manual became increasingly less attractive. AT&T became less willing to "help" the state commissions come up with formulas to modify the Separations Manual unless it was in the correct direction, i.e., less to interstate.

3.1 Divestiture - 1984

At around the time of Divestiture, the FCC no longer wanted to work with the states on any Joint Board separations issue that would increase costs allocated to the interstate jurisdiction as had been done in the past. The FCC (and the post-divestiture AT&T) now believed that interstate rates were the most important issue.

¹⁴ "Telephone Penetration by Income by States" released January 1998 by Alexander Belinfante, Industry Analysis Division Common Carrier Bureau Federal Communications Commission, pages 2, 7-15. There were significant differences by state and income.

¹⁵ This included the interstate costs of both Bell and independent telephone companies.

¹⁶ That efficient economic theory required that the "cost causer" should pay for all the common/joint costs was developed. According to AT&T, the "cost causer" for the LOCAL loop was obviously the LOCAL rate payer. Therefore any other service utilizing the local loop, especially interstate long distance, should only have to pay the incremental costs to the local loop to provide that service. Since the incremental cost to the local loop for interstate long distance service appeared to be zero, the amount allocated to interstate via separations should likewise be zero.

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One outcome of Divestiture was that the costs of the local telephone companies allocated to interstate by separations became explicit. These interstate costs were used to calculate interstate access charges, which were charged to interstate long distance carriers (interexchange carriers) rather than being buried in the costs underlying the pre Divestiture interstate toll rates filed by AT&T

Since AT&T was still rate regulated, the FCC (and AT&T) understood that lowering the interstate access rates of the local telephone companies (local exchange carriers),¹⁸ in particular the newly created Regional Bell Operating Companies (RBOCs) caused AT&T's interstate toll prices to decline. The unregulated interexchange carriers (IXCs) lowered their interstate toll rates in order to match the reductions in AT&T's regulated interstate toll rates.

3.2 "Cost Causer" and Economically Efficient Rates

There are those who feel that the FCC made the decision that it was easier and more importantly much quicker than working through the mandatory federal-state joint board process, to lower interstate access rates by making the default "cost causer" local customer¹⁹ pay for more of the interstate portion of the local loop by imposing interstate "subscriber line charges" (SLCs). Interstate SLCs lowered interstate access rates paid by the long distance carriers, thus causing interstate toll rates to decline.

This was a double hit on state commissions. The decrease in interstate access rates caused interstate toll rates to decline which exacerbated the toll rate disparity issue. This put more pressure on intrastate access rates and intrastate toll rates. More importantly to the state commissions, interstate SLCs looked and tasted like a local rate increase, since interstate SLCs could not be avoided even if no interstate toll calls were made or received in a given month²⁰.

¹⁸ Abbreviated LEC. After the 1996 rewrite of the Communications Act, the term Incumbent Local Exchange Carrier or ILEC was used and is still used today.

¹⁹ That efficient economic theory required that the "cost causer" should pay for the all common/joint costs was developed. The clear "cost causer" for the LOCAL loop was obviously the LOCAL rate payer. Therefore any other service utilizing the local loop, especially interstate long distance, should only have to pay the incremental costs to the local loop to provide that service. Since the incremental cost to the local loop for interstate long distance service was zero, the amount allocated to interstate via separations should likewise be zero.

²⁰ Interstate SLCs were recovering costs allocated to the interstate jurisdiction through separations. Therefore the FCC had wide latitude on how it chose to recover these interstate costs. It was legally irrelevant that interstate SLCs looked like an increase in local rates.

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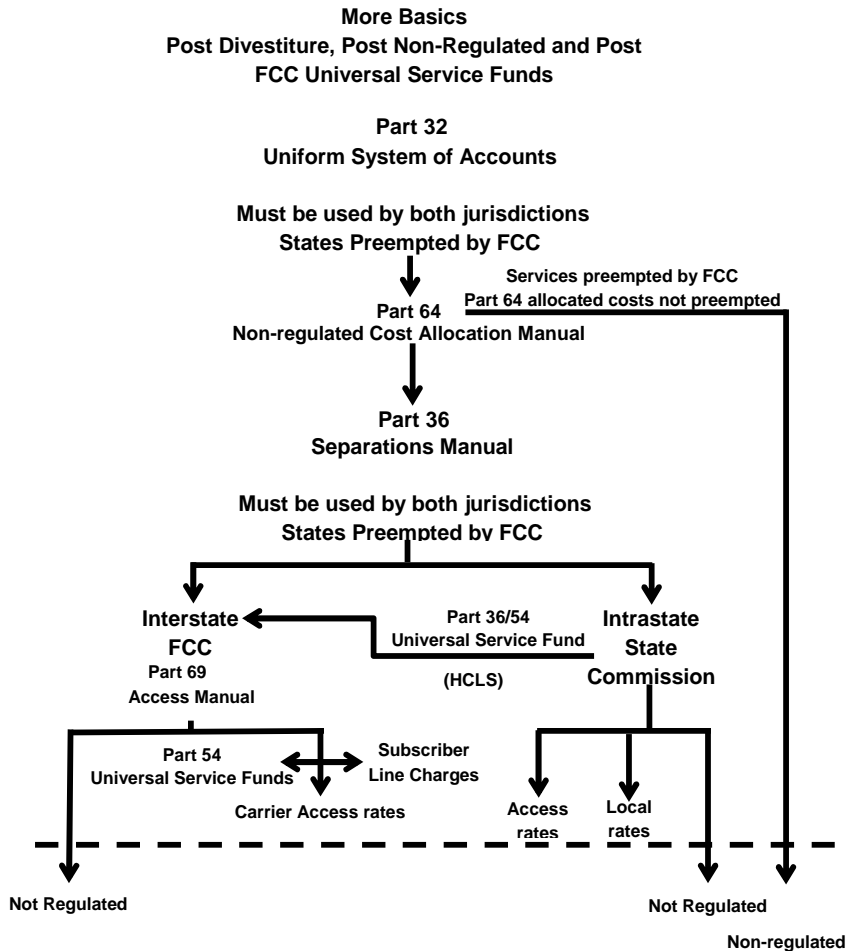
3.3 State Commissions Pressured to Approve Intrastate Access Rates that Mirror Interstate Access Rates

In the years after Divestiture, many state commissions were pressured to have intrastate access rates mirror interstate access rates. Because of toll rate disparity prior to Divestiture and the continued desire of the state commissions to keep local service rates low, the initial intrastate access rates were considerably higher than the corresponding interstate access rates. The same economic efficiency arguments used on and by the FCC were now focused on the state commissions with more than passing success.

A pre-divestiture argument was also used. The network was not designed to recognize state boundaries. So from a network standpoint there is no difference between interstate and intrastate toll/access costs. Therefore, there should be no difference between interstate and intrastate access rates.

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4.0 More Basics – Post Divestiture, Post Nonregulated, Post Federal USF Programs



4.1 The Mechanics in an Increasingly More Complex World

As shown above, separations carves out the costs for both the FCC and state commissions. These costs are then the responsibility of the respective commission.

The respective commission may choose to deregulate a particular service in its jurisdiction but the only way to discharge their “takings” liability for the associated costs for that deregulated service is to allocate costs to that service. Once those costs have been allocated to deregulated, the respective commission is no longer responsible for those costs.

The company wants as few costs as possible allocated to its non-regulated services in order to make the non-regulated services as profitable as possible as soon as possible. That objective

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may or may not be shared by the commission where the costs that do not get allocated to non-regulated remain to be recovered in rates of regulated services

An underlying principle of separations is that costs follow revenues. This was important in determining which rates should be used for a service that was offered in both jurisdictions and looked identical, e.g., private line/special access services.²¹

If a service is sold under an interstate tariff, regardless if it actually looks like an intrastate service, the revenues will be interstate and therefore the costs per separations will also be interstate. Interstate revenues will change. Since separations studies were done annually, historically changes in interstate usage, e.g., minutes, miles, number of loops (message, private lines/special access) were likewise reflected in costs annually.

An extended freeze of separations factors and/or setting rates of services in the other commission's jurisdiction requires a reconciliation so that the costs follow revenues. This does not mean that costs follow revenues on a dollar for dollar basis. But historically there should be some recognizable relationship between costs and revenues since costs allocated to a particular regulator (intrastate) become the responsibility of that regulator (intrastate) to set (intrastate) rates to recover those allocated (intrastate) costs.

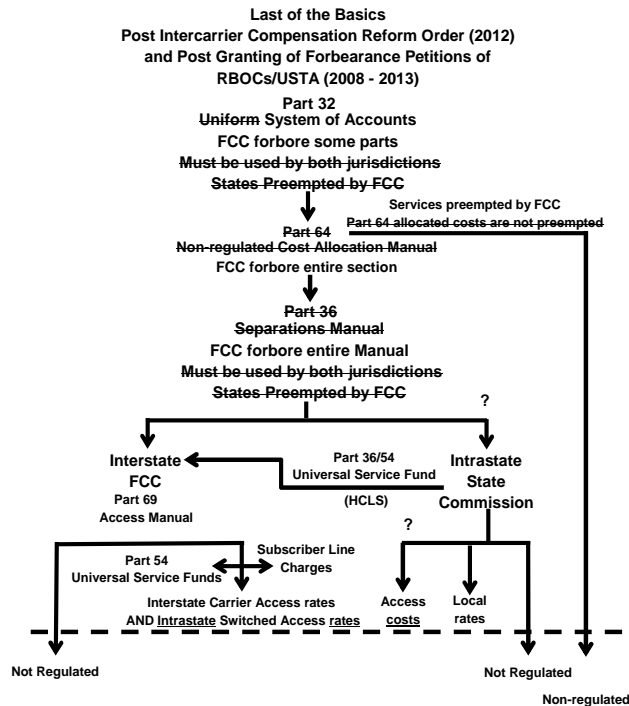
SEE Appendix II for the math. 4.2 The Math in an Increasingly More Complex World

²¹ A private line/special access circuit wholly within a particular state may actually be able to connect to or be part of an interstate network, thereby making the wholly intrastate private line/special access circuit able to be purchased from an interstate tariff.

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5.0 The New Regime (Post Forbearance and Intercarrier Compensation Reform)

Forbearance from the cost accounting rules, most notable Part 36, occurred in 2008 for the three remaining price cap BOCs²² - AT&T, Verizon²³ and Qwest (now CenturyLink).



5.1 The Mechanics after Forbearance and the Interconnection Compensation Reform Orders

Now as a result of FCC forbearance, there are no separations rules and almost no accounting rules that apply to the FCC. Applying the preemption principle backwards, there are no separations rules and almost no accounting rules that apply to the state commissions either.

As for the Interconnection Compensation Reform Order, the FCC unilaterally took over the responsibility for intrastate switched access rates and left intrastate switched access costs in the state jurisdiction. The FCC’s argument was that access is access. However, that is not how it fits into the traditional cost–revenue structure as discussed above.

²² *Petition of AT&T Inc. for Forbearance under 47 U.S.C. § 160 from Enforcement of Certain of the Commission’s Cost Assignment Rules*, WC Docket Nos. 07-21, 05-342, Memorandum Opinion and Order, 23 FCC Rcd 7302, para. 1 n.2 (2008) (*AT&T Cost Assignment Forbearance Order*)

²³ There was no order for Verizon’s request – it was automatically granted because the FCC had not acted in time.

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If the FCC wanted to have these costs reallocated to its jurisdiction, the FCC would have to convene a federal-state Joint Board and ask for its recommendation. To further complicate any move in this direction, most state commissions did not have an explicit calculation of intrastate access costs. The guiding principle followed by many, if not most state commissions was that intrastate access rates should mirror interstate access rates.

In addition, in its forbearance orders, the FCC indicated that “in any event, any jurisdictional separations reforms currently being considered would not apply to carriers, such as AT&T, that have secured forbearance from the Commission’s jurisdictional separations rules.”²⁴

These actions by the FCC to order rates for intrastate switched access services and forbearing from all Part 36 Separations Manual rules now and in the future, clearly indicate that the FCC believes that separations no longer calculates the two numbers that must be used by both jurisdictional regulators to determine the extent of each regulator’s jurisdiction.

Therefore, the state commission is no longer required to use separations results as the starting point in determining its jurisdictional confiscation liability.

See APPENDIX III for the math 5.2 The Math after Forbearance and the Interconnection Compensation Reform Orders

6.0 Separations Freeze

Historically, separations costs moved in a relationship to demand and therefore revenues, albeit this was a loose relationship. This relationship was codified in the Separations Manual with usage based factors. Costs moved in relationship to relative usage,²⁵ not necessarily linear.

The transition of the separations of the loop from a usage based allocator to a flat 25% allocation factor to interstate started in 1984.²⁶ This “flat” allocator philosophy culminated in the freezing of separations factors and categories in 2001²⁷ using 2000 as the base year.

²⁴ Petition of US Telecom for Forbearance Under 47 U.S.C. § 160(c) from Enforcement of Certain Legacy Telecommunications Regulations, et al., Memorandum Opinion and Order and Report and Order and Further Notice of Proposed Rulemaking and Second Further Notice of Proposed Rulemaking, 28 FCC Red 7627 (2013) (“US Telecom Forbearance Order”), footnote 151.

²⁵ Relative usage is interstate minutes/(interstate minutes + intrastate minutes) For example, if intrastate usage increased 1%, interstate usage increased 5% and total usage increased 3%, the intrastate usage factor would increase by more than 1% and interstate relative usage would increase by less than 5%.

²⁶ Amendment of Part 67 of the Commission’s Rules and Establishment of a Joint Board, CC Docket No. 80-286, *Decision and Order*, 96 FCC 2d 781 (1984).

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In the chart below the year 2000 is the base year. Freezing separations categories percentages and allocation factors at the 2000 levels allows virtually no change in the allocation of costs between the jurisdictions. The jurisdictional costs were “frozen” at the percentages effective in 2000, mainly 25% interstate and 75% intrastate. Total costs were assumed to grow 2% per year. On the other hand jurisdictional revenues were not “frozen”. Because of the growth in such interstate services as interstate special access and the much slower increase in intrastate revenues, in the chart below, interstate revenues are shown to increase 5% each year and intrastate revenues increase 1% each year. This is just an example, but the results are startling over 15 years.

Year	Assumptions	<<<<<<<< Costs >>>>>>>>			<<<<< Revenues >>>>>			Revenues - Costs		(Rev - Costs)/Costs	
		Total	Interstate	Intrastate	Total	Interstate	Intrastate	Interstate	Intrastate	Interstate	Intrastate
	Growth	2%				5%	1%				
2000	Base Year	\$ 1,000,000	\$250,000	\$750,000	\$ 1,000,000	\$250,000	\$750,000	\$0	\$0	0.00%	0.00%
	Frozen %		25%	75%							
2001		\$ 1,020,000	\$ 255,000	\$ 765,000	\$ 1,020,000	\$ 262,500	\$ 757,500	\$ 7,500	(\$7,500)	2.94%	-0.98%
2002		\$ 1,040,400	\$ 260,100	\$ 780,300	\$ 1,040,700	\$ 275,625	\$ 765,075	\$15,525	(\$15,225)	5.97%	-1.95%
2003		\$ 1,061,208	\$ 265,302	\$ 795,906	\$ 1,062,132	\$ 289,406	\$ 772,726	\$24,104	(\$23,180)	9.09%	-2.91%
2004		\$ 1,082,432	\$ 270,608	\$ 811,824	\$ 1,084,330	\$ 303,877	\$ 780,453	\$33,269	(\$31,371)	12.29%	-3.86%
2005		\$ 1,104,081	\$ 276,020	\$ 828,061	\$ 1,107,328	\$ 319,070	\$ 788,258	\$43,050	(\$39,803)	15.60%	-4.81%
2006		\$ 1,126,162	\$ 281,541	\$ 844,622	\$ 1,131,164	\$ 335,024	\$ 796,140	\$53,483	(\$48,482)	19.00%	-5.74%
2007		\$ 1,148,686	\$ 287,171	\$ 861,514	\$ 1,155,877	\$ 351,775	\$ 804,102	\$64,604	(\$57,413)	22.50%	-6.66%
2008		\$ 1,171,659	\$ 292,915	\$ 878,745	\$ 1,181,506	\$ 369,364	\$ 812,143	\$76,449	(\$66,602)	26.10%	-7.58%
2009		\$ 1,195,093	\$ 298,773	\$ 896,319	\$ 1,208,096	\$ 387,832	\$ 820,264	\$89,059	(\$76,055)	29.81%	-8.49%
2010		\$ 1,218,994	\$ 304,749	\$ 914,246	\$ 1,235,690	\$ 407,224	\$ 828,467	\$102,475	(\$85,779)	33.63%	-9.38%
2011		\$ 1,243,374	\$ 310,844	\$ 932,531	\$ 1,264,336	\$ 427,585	\$ 836,751	\$116,741	(\$95,779)	37.56%	-10.27%
2012		\$ 1,268,242	\$ 317,060	\$ 951,181	\$ 1,294,083	\$ 448,964	\$ 845,119	\$131,904	(\$106,063)	41.60%	-11.15%
2013		\$ 1,293,607	\$ 323,402	\$ 970,205	\$ 1,324,982	\$ 471,412	\$ 853,570	\$148,011	(\$116,635)	45.77%	-12.02%
2014		\$ 1,319,479	\$ 329,870	\$ 989,609	\$ 1,357,089	\$ 494,983	\$ 862,106	\$165,113	(\$127,503)	50.05%	-12.88%
2015		\$ 1,345,868	\$ 336,467	\$ 1,009,401	\$ 1,390,459	\$ 519,732	\$ 870,727	\$183,265	(\$138,675)	54.47%	-13.74%

In the base year and year 1, costs = revenue. By year 15 of the freeze (2015), in the interstate jurisdiction, revenues exceeded costs by \$183,265. In the intrastate jurisdiction, costs exceeded revenues by \$138,675. In other words interstate profit went up by \$183,265 or +54.47% when compared to the growth in interstate costs, and intrastate profit went down 138,675 or -13.74% when compared to the growth in intrastate costs.

It is little wonder that the FCC and the RBOCs were not anxious to stop the freeze after its initial time six-year time frame. The freeze continues, as of now, until 2017.

Conclusion: This history was written as a prequel to understanding The Hartman Memorandum’s findings and conclusions. It also serves as reference for those who want to understand the complicated and broken ratemaking process in America.

²⁷ Jurisdictional Separations and Referral to the Federal-State Joint Board, CC Docket No. 80-286, *Report and Order*, 66 Fed. Reg. 33202 (2001).

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APPENDIX I

2.2 Relationship between Rates, Revenues and Costs in a 100% Regulated World

Using regulated interstate rates, revenues and costs for interstate service A as an example:

1. *Interstate rate for service A* = Interstate costs for service A / Demand for service A
2. Interstate revenue for service A = *Interstate rate for service A* * Demand for service A
3. Substituting for *interstate rate for service A*
 - a. Interstate revenue for service A = (Interstate costs for service A / Demand for service A) * Demand for service A
4. Interstate demand for service A cancels out leaving
 - a. Interstate revenue for service A = Interstate costs for service A
5. In a perfect world:
 - a. Total interstate revenue = Sum of revenue from all interstate services
 - b. Total interstate costs = Sum of costs for all interstate services
 - c. Applying "Interstate revenue for service A = interstate costs for service A" from step 4a above to all interstate services
 - i. Total interstate revenue = Total interstate costs

The above relationships also apply to regulated intrastate rates, revenues and costs.

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APPENDIX II

2.3 The Math

(**Bold** indicates processes where the state commissions have been preempted by the FCC)

1. Total interstate toll revenues + Total interstate international revenues = Total interstate revenues
2. Therefore, Total interstate toll costs + Total interstate international costs = **Total interstate costs (Part 36)**
3. Total intrastate toll revenues + Total intrastate local revenues = Total intrastate revenues
4. Therefore, Total intrastate toll costs + Total intrastate local costs = **Total intrastate costs (Part 36)**
5. **Total Interstate costs (Part 36) + Total Intrastate costs (Part 36) = Total costs (Part 32)**

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Appendix III

4.2 The Math in an Increasingly More Complex World

(**Bold** indicates processed where the state commissions have been preempted by the FCC)

Revenue side

1. Total interstate access revenues (Part 69) + Total interstate Subscriber Line Charges (Part 69) + Total Interstate USF (Part 54) + Total interstate non-access costs (Part 69) + Total interstate USF (HCLS) = **Total Interstate revenues (Part 36)**
2. Total intrastate long distance revenues + Total intrastate access revenues + Total intrastate local costs + Total intrastate non-regulated costs – Total interstate USF (HCLS) = **Total Intrastate revenues (Part 36)**
3. **Total Interstate revenues (Part 36) + Total Intrastate revenues (Part 36) = Total subject to separations revenues (Part 36)**
4. **Total subject to separations revenues (Part 36) + non-regulated revenues (Part 64) = Total revenues (Part 32)**

Cost Side

1. Total interstate access costs (Part 69) + Total interstate non-access costs (Part 69) + Total interstate USF (HCLS) = **Total Interstate costs (Part 36)**
2. Total intrastate long distance costs + Total intrastate access costs + Total intrastate local costs + Total intrastate non-regulated costs – Total interstate USF (HCLS) = **Total Intrastate costs (Part 36)**
3. **Total Interstate costs (Part 36) + Total Intrastate costs (Part 36) = Total subject to separations costs (Part 36)**
4. **Total subject to separations costs (Part 36) + non-regulated costs (Part 64) = Total costs (Part 32)**

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APPENDIX IV

5.2 The Math after Forbearance and the Interconnection Compensation Reform Orders (**Bold** indicates processes where the state commissions have been preempted by the FCC)

Non-Forborne Local Exchange Carriers (Interconnection Compensation Reform Only)

Revenue Side

1. Total interstate access revenues (Part 69) + Total interstate Subscriber Line Charges (Part 69) + Total Interstate USF (Part 54) + Total interstate non-access costs (Part 69) + Total interstate USF (HCLS) + **Intrastate switched access revenues** = **Total Interstate revenues (Part 36)**
2. Total intrastate long distance revenues + Total intrastate access revenues - **Intrastate switched access revenues** + Total intrastate local costs + Total intrastate non-regulated costs – Total interstate USF (HCLS) = **Total Intrastate revenues (Part 36)**
3. **Total Interstate revenues (Part 36) + Total Intrastate revenues (Part 36) = Total subject to separations revenues (Part 36)**
4. **Total subject to separations revenues (Part 36)** + non-regulated revenues (Part 64) = **Total revenues (Part 32)**

Cost Side

1. Total interstate access costs (Part 69) + Total interstate non-access costs (Part 69) + Total interstate USF (HCLS) = **Total Interstate costs (Part 36)**
2. Total intrastate long distance costs + **Total intrastate access costs** + Total intrastate local costs + Total intrastate non-regulated costs – Total interstate USF (HCLS) = **Total Intrastate costs (Part 36)**
3. **Total Interstate costs (Part 36) + Total Intrastate costs (Part 36) = Total subject to separations costs (Part 36)**
4. **Total subject to separations costs (Part 36)** + non-regulated costs (Part 64) = **Total costs (Part 32)**

Forborne Local Exchange Price Cap Carriers Plus Interconnection Compensation Reform

Revenue Side

1. Total interstate access revenues + Total interstate Subscriber Line Charges (Part 69) + Total Interstate USF (Part 54) + Total interstate non-access costs + **Intrastate switched access revenues** = Total Interstate revenues

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2. Total intrastate long distance revenues + Total intrastate access revenues - *Intrastate switched access revenues* + Total intrastate local costs + Total intrastate non-regulated costs – Total interstate USF (HCLS) = Total Intrastate revenues
3. Total Interstate revenues + Total Intrastate revenues = Total interstate + intrastate revenues
4. Total interstate + intrastate revenues + non-regulated revenues = Total revenues

Cost side

1. Total interstate access costs + Total interstate non-access costs = Total Interstate costs
2. Total intrastate long distance costs + *Total intrastate access costs* + Total intrastate local costs + Total intrastate non-regulated costs = Total Intrastate costs
3. Total Interstate costs + Total Intrastate costs = Total interstate + intrastate costs
4. Total interstate + intrastate costs + non-regulated costs (Part 64) = Total costs