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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

July 2, 1996

Mr. William Caton
Secretary
Federal Communications Commission
Room 222
Washington, D.C. 20554

**RE: Ex Parte Communication in Docket 96-98**

Dear Mr. Caton:

Enclosed is a copy of a letter sent by me to John Nakahata, Special Assistant to the Chairman, with a copy of an Illinois Commerce Commission order which is also enclosed. Identical letters and copies of the order were sent to Mr. Bill Kennard, General Counsel; Mr. Joseph Farrell, Chief Economist; Ms. Pete Belvin, Sr. Legal Advisor to Commissioner Quello; Mr. Dan Gonzales, Legal Advisor to Commissioner Chong; Mr. Jim Casserly, Sr. Legal Advisor to Commissioner Ness, Mr. Stuart Kupinsky and Mr. Donald Stockdale, of the Common Carrier Bureau's Policy and Program Planning Divsion; Mr. David Sieradski of the Common Carrier Bureau's Competitive Pricing Division; and Suzanne Tetreault, Assisant General Counsel-Administrative Law. In addition, a copy of the Illinois order without the cover letter was provided to Richard Metzger, Deputy Bureau Chief of the Common Carrier Bureau.

Sincerely,

Richard L. Fruchterman, III
Director of Government Affairs

Enclosures

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July 2, 1996

John Nakahata
Special Assistant to the Chairman
Federal Communications Commission
1919 M Street, N.W.
Room 814
Washington, D.C. 20554

Dear Mr. Nakahata:

In case you have not already seen it, enclosed is a copy of the June 26, 1996, order of the Illinois Commerce Commission regarding LDDS WorldCom's petition for the right to combine unbundled network elements, including unbundled local switching, and AT&T's petition for wholesale services. Illinois is the first state to consider the combination of unbundled network elements and unbundled local switching in this fashion and they adopted the LDDS WorldCom approach, amended by staff, on a 4-1 vote. Because of the relevance of this decision to the FCC's implementation of sections 251(c)(3) and (c)(4) of the Telecommunications Act of 1996, I thought that you might be interested in the order.

The part of the order of most importance to WorldCom is the portion of the order addressing and endorsing the combination of unbundled network elements and the unbundled local switching element -- the local switch platform ("LSP").[1] The ICC's general discussion of those issues begins on page 55. Its conclusions begin on page 63 and run through page 66.

In its decision, the ICC:

- **ORDERED AMERITECH AND CENTEL TO PROVIDE UNBUNDLED LOCAL SWITCHING AS REQUESTED BY LDDS AND RECOMMENDED BY STAFF**

"Section 251(c)(3) clearly mandates the LDDS and Staff platform proposals. This section requires any and all network elements to be made available, in any combination, so that a new entrant can provide service, and that necessarily includes the provision of those elements on a

---

[1] "The unbundled LSP is all services and functionalities that are provided by a switch or end office. These services include: telephone number and directory listing; dialtone; announcements; access to operators, usage, and interexchange carriers; originating and terminating switching; custom calling features (call forwarding, call waiting, etc.); and CLASS features (call ID, call return, etc.)" [p. 58]

"total network" or platform basis." [p. 64] The Commission noted the Staff's observation that "[r]equiring the middle network element, the LSP, to be available unbundled, subject to being combined with either or both of the other two elements [loop and transport], would afford the greatest opportunity to develop competition in the local exchange markets." [p. 58]

- **FOUND THE PROVISION OF UNBUNDLED LOCAL SWITCHING TO BE TECHNICALLY FEASIBLE**

"The LSP is already part of the network architecture and, therefore, technically feasible." [p. 64] In addition, the ICC noted that "Centel agrees that the LDDS petition should be granted and will file a tariff according to the LDDS request as modified by Staff." [p. 61] Clearly at least one local exchange carrier agrees that the local switching platform is technically feasible.

- **REJECTED ARGUMENTS THAT SECTION 251(c)(3) REQUIRES A REQUESTING CARRIER TO PROVIDE SOME NETWORK ELEMENT OF ITS OWN TO COMBINE WITH THOSE OBTAINED FROM THE ILEC**

"Acceptance of these arguments would render the language [of Section 251(c)(3)] meaningless. An unbundled network element, by the very nature of unbundling, is subject to being combined with another carrier's network elements. There would be no purpose to the latter sentence of section 251(c)(3) mandating that incumbent LECs allow the combination of network elements if this were the interpretation. Furthermore, the section expressly requires that the unbundled network elements be made available to any telecommunications carrier. This is directly contrary to the limitation offered by Ameritech and MFS that network elements are available only to those telecommunications carriers which provide other network elements." [p. 64]

- **FOUND THAT ALLOWING A PURCHASING CARRIER TO COMBINE NETWORK ELEMENTS UNDER SECTION 251(c)(3) IS NOT REDUNDANT OF THE RESALE REQUIREMENTS OF SECTION 251(c)(4)**

"The federal Act clearly requires both offerings to be made available. These offerings were not required alternatively, but to be offered simultaneously. The intent of the federal Act is to make available the competitive tools which the carriers feel they need to employ their own marketing strategy and business judgment as to how to develop competition in the telecommunications marketplaces. The federal Act leaves it to the marketplace to resolve which is the best means available to develop competition." [p. 65]

- **HELD THAT THE PURCHASING CARRIER SHOULD RETAIN THE REVENUES FOR EXCHANGE ACCESS PROVIDED THROUGH LEASED NETWORK ELEMENTS**

"Having paid the incumbent LEC for the use of the network elements, the purchasing carrier is entitled to all revenues generated by local exchange, exchange access, and other telecommunications services it provides utilizing the purchased network elements. . ." "[O]nce

the incumbent LEC has received the cost-based price for the LSP, the purchasing carrier is entitled to the use of the network element and all revenues for services therefrom." [p. 65]

- **HELD THAT CUSTOM CALLING AND CLASS FEATURES SHOULD BE INCLUDED IN THE LSP NETWORK ELEMENT**

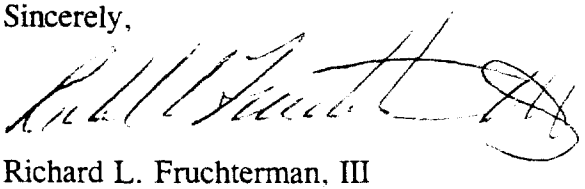
"Centel's request to exclude custom calling and CLASS features from the LSP network element is denied as being without basis and in direct violation of the federal Act's requirement that the network element includes the features, functions, and capabilities of the facility or equipment by definition." [p. 65]

- **FOUND THAT REQUIRING THE LSP WOULD PROMOTE LOCAL COMPETITION**

"The Commission finds that requiring Ameritech and Centel to make these unbundled network elements available [the LSP] will further our goal of promoting competition in the local exchange marketplace. Potential entrants to the local exchange marketplace would be provided the flexibility to design their own operational and marketing strategy to compete with the incumbent LEC and other carriers for end users of local exchange and other telecommunications services ... This will enable carriers to make decisions based on economic efficiency as to which network elements it should build, and which it should purchase from incumbent LECs or from competing other providers, free of any predetermined regulatory requirement. This will best foster the Commission's policies of allowing the competitive marketplace and economic considerations to substitute for regulatory oversight." [p. 64-65]

I hope this is helpful to your deliberations.

Sincerely,



Richard L. Fruchterman, III
Director of Government Affairs

Enclosure

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STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

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JUL 2 1996

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

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| AT&T Communications of Illinois, Inc.<br><br>Petition for a total local exchange wholesale service tariff from Illinois Bell Telephone Company d/b/a Ameritech Illinois and Central Telephone Company pursuant to Section 13-505.5 of the Illinois Public Utilities Act. | 95-0458 |
| LDDS Communications, Inc. d/b/a LDDS Metromedia Communications<br><br>Petition for a total wholesale network service tariff from Illinois Bell Telephone Company d/b/a Ameritech Illinois and Central Telephone Company pursuant to Section 13-505.5 of the Illinois Public Utilities Act. | 95-0531<br><br>consol. |

ORDER

DATED: June 26, 1996

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STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

| | | |
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| | : | 95-0531 |
| Petition for a total wholesale network service tariff from Illinois Bell Telephone Company d/b/a Ameritech Illinois and Central Telephone Company pursuant to Section 13-505.5 of the Illinois Public Utilities Act. | : | consol. |

ORDER

By the Commission:

On September 19, 1995, AT&T Communications of Illinois, Inc. ("AT&T") filed its petition for a total local exchange wholesale tariff from Illinois Bell Telephone Company ("Ameritech" or "the Company") and Central Telephone Company ("Centel") pursuant to Section 13-505.5 of the Illinois Public Utilities Act ("Public Utilities Act" or "PUA"). In its petition, AT&T stated that its request encompassed most existing Ameritech and Centel noncompetitive retail services as enumerated in the petition; operational and support requirements, including access to support systems that provide provisioning, billing or network maintenance data; the creation of appropriate administrative standards to ensure proper provisioning of services by Centel and Ameritech; and wholesale pricing of retail services as described in the petition.

On October 10, 1995, Centel filed a motion to extend the time period in which to consider AT&T's petition, or, in the alternative, to dismiss AT&T's petition. After this motion was duly briefed by the parties, the parties reached an agreement that was reflected in an agreed upon briefing schedule on December 8, 1995. Pursuant to this schedule, the parties extended the 180-day deadline (applicable to petitions filed pursuant to Section 13-505.5) to May 24, 1996.

On October 19, 1995, LDDS WorldCom, f/k/a LDDS Communications, Inc., d/b/a LDDS Metromedia Communications ("LDDS") filed its own petition requesting a total wholesale network service from Ameritech and Centel. While similar to the AT&T petition, LDDS also requested that switched access services be provided on a wholesale basis. Simultaneously, LDDS filed a motion to consolidate its petition with that of AT&T. This motion was briefed by the parties and on December 8, 1995, Hearing Examiner granted LDDS' motion, thereby consolidating Docket 95-0458 (the AT&T petition) and Docket 95-0531 (the LDDS petition).

On February 5, 1996, a hearing was held in this matter. At that time, the parties discussed the need to file additional testimony addressing the Federal Telecommunications Act of 1996 ("federal Act"). The Hearing Examiner granted leave for the parties to file supplemental direct and supplemental rebuttal testimony to address the potential impact of the federal Act on these proceedings. As a result, the parties agreed to continue the matter until March 18, 1996 and to further extend the date for Commission decision in this matter under Section 13-505.5 of the PUA until June 26, 1996.

On February 20, 1996, MFS Intelenet of Illinois, Inc. ("MFS") filed a Motion to Dismiss LDDS' petition in light of the federal Act. After hearing the responses and replies of the parties, the Hearing Examiner denied MFS' motion on April 4, 1996.

The following parties have intervened or entered an appearance in this proceeding: AT&T; LDDS; Ameritech; Centel; Southwestern Bell; Mobile Systems, Inc. d/b/a Cellular One - Chicago ("Cellular One"); Citizens Utility Board ("CUB"); GTE North Incorporated ("GTE"); LCI International Telecom Corporation ("LCI"); Cable Television and Communications Association of Illinois ("CATV"); the People of Cook County ("Cook County"); Illinois Consolidated Telephone Company ("ICTC"); USN Communications, Inc. ("USN"); TC Systems - Illinois, Inc. ("TC Systems"); The Illinois Independent Telephone Association ("IITA"); The Telecommunications Resellers Association; MFS; the Attorney General of the State of Illinois (the "AG"); Consolidated Communications, Inc. ("CCI") and PCS Primeco. In addition, the Staff of the Commission appeared in this proceeding.

Hearings were held in this proceeding before a duly authorized Hearing Examiner on October 10, December 4, 1995, February 5, and March 18-20, 1996.

The record was marked "Heard and Taken" by the Hearing Examiner on March 20, 1996. The record of this proceeding consists of the testimony of: seven witnesses for Staff; five witnesses for AT&T; one witness for LDDS; nine witnesses for Ameritech; two

witnesses for Centel; one witness for GTE; one witness for MCI; two witnesses for TC Systems; one witness for MFS; one witness for CUB; one witness for Cellular One; and one witness for the IITA. These witnesses will be identified where appropriate.

Initial briefs were filed in this proceeding by AT&T; LDDS; Ameritech; Staff; MFS Intelenet; TC Systems; CUB; ICTC; the IITA; Cellular One; MCI; Centel; and the Telecommunications Resellers Association. Reply briefs were filed by AT&T; LDDS; Ameritech; Centel; Staff; MFS; Teleport; CUB; CCI; MCI; and the Telecommunications Resellers Association.

Briefs on Exceptions and replies thereto were filed by Ameritech, AT&T, LDDS, Staff, Centel, CCI, CUB, TC Systems, MCI and MFS and were given due consideration in this order.

## I. INTRODUCTION

Both the AT&T and LDDS petitions were filed pursuant to Section 13-505 of the PUA which provides as follows:

> 13-505.5. Request for new noncompetitive services. Any party may petition the Commission to request the provision of a noncompetitive service not currently provided by a local exchange carrier within its service territory. The Commission shall grant the petition, provided that it can be demonstrated that the provisioning of the requested service is technically and economically practicable considering demand for the service, and absent a finding that provision of the service is otherwise contrary to the public interest. The Commission shall render its decision within 180 days after the filing of the petition unless extension of the time period is agreed to by all the parties to the proceeding.

AT&T is requesting, pursuant to Section 13-505.5 of the PUA, that the Commission require Ameritech and Centel to file separate wholesale tariffs for the following: (a) all existing Ameritech and Centel retail services; (b) operational and support requirements; (c) administrative standards for quality of service assurance; and (d) wholesale pricing. AT&T has provided a methodology for calculating a wholesale price which results in approximately a 35% discount off of the existing retail rates for Ameritech and Centel. AT&T petition at 2-5. AT&T further requests that the wholesale tariffs be applicable to all of Ameritech's and

Centel's exchanges in the state. AT&T's petition also requests that Ameritech and Centel provide automatic routing for certain services and access to Advanced Intelligent Network ("AIN") services.

The LDDS petition differs from the AT&T petition in that under the LDDS "platform" proposal, the new entrant would be able to acquire the underlying network elements or functionalities in a manner that allows the new entrant to freely combine elements and provide service.

LDDS requests that the basic components of the local exchange network, i.e., the loops, the switch, and local call termination, be made available to carriers for purchase so these elements may be combined and utilized to provide local exchange, exchange access, and other telecommunications services. In contrast to AT&T which seeks the ability to purchase Ameritech's and Centel's retail services at a wholesale price for the purpose of resale, LDDS requests a different option, to be able to purchase the underlying network, facilities, equipment, and related support, to enable LDDS to design and offer its own local exchange, exchange access, and other services. Similar to the AT&T request, LDDS seeks access to the use of the incumbent local exchange carrier's "LEC's" operational interfaces and support systems for data transfer and administrative requirements, to ensure the proper and high-quality provisioning of local service at parity with the service the incumbent LECs provide themselves.

Staff, in turn, has developed a version of the network platform approach which focuses on unbundling of the Local Switching Platform ("LSP"). Both LDDS and AT&T have endorsed Staff's proposal and support Staff's recommendation that the LSP be pursued in a follow-on proceeding. MCI also has supported the platform proposal and has offered further definition of the local switching component.

There was considerable disagreement between the petitioners and Ameritech and Centel regarding the legality of AT&T's and LDDS' requests under Section 13-505.5 of the PUA. With the passage of the federal Act, the issue of the legality of the petitions has become inconsequential. There is now no question that the incumbent LECs -- Ameritech and Centel in this instance -- have the duty to provide wholesale rates for their retail services under the federal Act. There is also no question that Ameritech and Centel have a duty to provide network elements on an unbundled basis. Ameritech and Centel agree that they are required to do so. Accordingly, the issues addressed in this Order will, for the most part, involve legal interpretations of specific language in the federal Act.

## II. THE STRUCTURE OF WHOLESALE/RETAIL PRICES

### A. Introduction

More than any other issue in this proceeding, our Commission's decisions with respect to the pricing of wholesale service will have profound effects on the local exchange market. The price set for wholesale local exchange services will dictate whether competitors choose to enter the local exchange market via resale, as a facilities-based carrier, or not enter the market at all. The Commission must decide this matter in such a manner that best serves the public interest while balancing the interests of various market participants.

The Commission is cognizant of the fact that if the wholesale price is set artificially high, then competitors may be discouraged from entering the local exchange market, even if they could provide retail components more efficiently than the incumbent LEC. As a result, the incumbent LEC would not face competitive pressure to reduce retail cost, and more efficient providers of retail services would not be able to provide them. Conversely, if the wholesale price is set artificially low, then competitors would be discouraged from becoming facilities-based competitors, even if they could provide facilities-based services more efficiently than the incumbent LEC. As a result, these services would be provided in an inefficient manner. In addition, the low wholesale price would have a negative impact on the amount of investment made by the incumbent LECs in their underlying local network.

A properly established wholesale/resale market would require all firms to compete on their ability to provide retail local exchange services, while preserving any efficiencies to the extent present. Any decision by a reseller to enter the local exchange market should be dependent on its ability to compete in that market based on the societal cost of providing the retail component of local exchange service. Such retail competition will occur if other carriers can be more efficient at providing the retailing function of providing local exchange service.

The Commission is of the opinion that a properly established wholesale/resale market would place competitive pressure on both the incumbent LECs, as well as new entrants into the local exchange market. This pressure would be exerted in terms of price, cost, and service quality. In addition, a properly established wholesale/resale market would preserve any possible efficiencies to be gained from situations where there may be natural monopoly conditions in the underlying network of local exchange service. However, the Commission also is cognizant that new technology and innovation in the actual service provisioning will take place only as facilities based competition evolves -- although pure resale

competition should not be written off just because it may not be as beneficial as facilities-based competition. Wholesale/resale competition will put competitive pressure on both retail rates and quality of service. Wholesale/resale competition is also a first step in an evolving marketplace that will eventually involve more facilities-based competition.

### B. The Pricing Standard and Cost Basis for Wholesale Services

The Commission's interpretation of Section 252(d)(3) of the federal Act is the single most important issue before the Commission in this docket. This section provides as follows:

> (d) PRICING STANDARDS
>
> ...
>
> (3) WHOLESALE PRICES FOR TELECOMMUNICATIONS SERVICES- For the purposes of section 251(c)(4), a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

As discussed below, the interpretation of this Section varies markedly.

AT&T

With respect to the pricing standard and the Cost Basis for Wholesale Services, AT&T contends the federal Act provides specific direction on how the prices for wholesale services are to be set and prescribes a methodology for establishing the LECs' cost basis for wholesale prices. As such, AT&T contends that the record in this docket contains adequate information for the Commission to order specific wholesale prices.

AT&T witness Dr. Selwyn presented a method of measuring avoidable costs based on accounting data for retailing functions. This approach yielded a discount of 25% from retail prices (plus an additional incentive discount of up to 10% for operational interfaces that are not yet at parity with the LEC's own retailing operations.) Dr. Selwyn testified further that this method is fully consistent with the language of the federal Act. AT&T concedes that this method was general in nature because it develops only one percentage equally applicable to all services; the

approach was proposed by AT&T for use until more detailed cost analyses could be completed.

The final position of AT&T in this regard, based upon the completed record in this docket, is that a service-specific development of wholesale prices can be achieved. Specifically, AT&T endorses the pro rata contribution methodology presented by Staff, discussed below, implemented at the rate element-specific level and with certain additional service cost adjustments. Dr. Selwyn's analysis does, however, provide corroboration of the overall result reached under Staff's method.

With respect to whether Staff's method should be applied on a "individual service element" basis or a "service family" basis, AT&T maintains that a method which uniquely treats individual service elements is superior to a method which applies discounts broadly to entire service families. An individual service element approach avoids unnecessary and undesirable variation in the contribution margin between the corresponding wholesale and retail versions of the same service. Such an approach, AT&T contends, is also consistent with the federal Act, which describes the wholesale rate calculation methodology for "the telecommunications service requested...". Section 252(d)(3) of the Act. (Emphasis added).

Regarding additional service cost adjustments, AT&T agrees with a number of the adjustments advocated by Staff. With respect to maintenance expense, AT&T endorses Staff's adjustment to offset Ameritech's claim that maintenance expense will be higher in a wholesale environment. AT&T also agrees with Staff's proposed adjustment of maintenance expense and Account 6623 (Customer Service Expenses).

In addition, AT&T contends that in certain instances Staff's adjustments did not go far enough and that additional adjustments in Ameritech's cost data were needed to arrive at a correct and reasonable wholesale discount. First, with respect to uncollectible expenses, AT&T proposes to remove the varied and unrepresentative collection of customer types considered by Ameritech and, rather, to base the calculation on actual experience with interexchange carriers ("IXC"). AT&T explains that given the nature and qualifications of resellers that will be certificated, the result will be uncollectible expense more in line with experienced with IXCs. Second, as to advertising expenses, AT&T contends that these expenses should be removed entirely, in that it is neither necessary nor appropriate for Ameritech to advertise and promote essential monopoly wholesale services to informed resellers who have no option but to rely on such inputs in order to provide their own services. While Ameritech may choose to advertise to its captive customers, recognizing remaining advertising expenses essentially amounts to charging customers for the privilege of

being captive. Third, with respect to joint and administrative costs, AT&T contends that several major areas of cost would be avoided in a large-scale shedding of retail activity by the incumbent LEC. Examples of these costs include buildings, vehicles, computer equipment, furniture and artwork, personnel and other assets and functions supporting retail operations.

A further and important area of cost adjustment needed according to AT&T is the removal of implementation and additional ongoing costs in connection with the provision of wholesale services. AT&T argues that the federal Act speaks only of "costs that will be avoided" and makes no mention of any new or additional costs that might be incurred. Allowing such costs to be "netted" against costs "that will be avoided" would be tantamount to reverting to rate of return regulation and a scheme of guaranteed cost recovery. AT&T recommends that any "one time" costs incurred by the incumbent LEC for start-up modifications to systems to accommodate the provision of wholesale services, to the extent they are recognized at all, be recovered from all retail providers, including the incumbent LEC, in proportion to each provider's share of the retail market.

Staff

Staff takes the position that various interpretations of Section 252(d)(3) are possible based on the phrases "excluding the portion thereof attributable to" and "on the basis of." Staff contends that "on the basis of" is not the same as "equal to."

Staff's interpretation of the federal Act allows the Commission full latitude in setting wholesale prices beyond the minimum requirement of retail price less avoided cost. It recommends that the Commission set the wholesale price equal to the retail price less net total assigned cost ("TAC") of retail functions less a pro rata share of contribution attributable to the avoided retail costs. This approach attributes a pro rata share of contribution to the avoided retail functions. "Contribution" is the difference between the retail price and the Long Run Service Incremental Cost ("LRSIC"). Staff defines common costs as the costs that are common to a carrier that are not directly attributable to any particular service. Joint costs meanwhile, are the costs of a service that occur in the production of two or more services. Staff also agrees with the Company's definition of Total Assigned Costs ("TAC"), which is the LRSIC of a service plus administrative and shared costs belonging to a particular group of services. TAC can also be explained as the LRSIC of a group or family of services.

Staff argues that Section 252(d)(3) allows states latitude in setting wholesale rates. It further argues that, historically,

federal legislation has set forth general guidelines or requirements and requires regulatory agencies to expand on those guidelines. Staff contends that the language "on the basis of" and "attributable to" demands regulatory guidance. As an example, Staff cites Ameritech's position that the federal Act would allow identifiable incremental costs to be included in the calculation of avoided costs because "on the basis of" does not mean "equal to" and, also, "other regulatory policy objectives" permits it to recover its costs of providing a service.

Staff has agreed that recurring incremental costs should be included in determining the wholesale price for policy reasons, not because specific language contained in the federal Act mandates the recovery of incremental costs to provide wholesale services. The phrase, "[o]ther regulatory policy objectives" also support Staff's pro rata share of contribution method. Staff states that the incumbent LECs cannot have it both ways: argue that the federal Act supports recovery of incremental costs of providing wholesale services, but not the allocation of a pro rata share of contribution to the avoided costs. Staff contends that if the federal Act can be interpreted to permit recovery of incremental costs of providing wholesale services (which Staff supports), then the same arguments support Staff's proposed pricing methodology of assigning a pro rata share of contribution to the avoided costs. The Commission also may interpret the term "attributable" to permit the attribution of a pro rata share of contribution to the avoided retail functions. This is the method Staff used to allocate, or attribute, a portion of shared cost to wholesale and retail services in order to calculate the wholesale price of individual services.

Staff argues that there are two policy reasons why the Commission should adopt its proposed pricing methodology. The first reason is economic efficiency. Staff asserts that simply setting the wholesale price equal to the retail price less directly assigned avoided cost would not allow for effective competition in the retailing of local exchange service. Specifically, there would be insufficient margins between retail prices and wholesale prices for the reseller to compete, because the cost that a reseller has in providing retail service would be greater than the directly assigned "avoided cost" of the incumbent LEC. Staff asserts that it has been stated by AT&T and other new LECs that the range of discounts offered by Ameritech on a net avoided costs basis would not allow them sufficient margins to recover their retailing costs of providing local exchange service. Providing resellers of local exchange service an opportunity to compete where economically feasible will promote efficiency.

Staff argues for equity as the second reason. Staff contends that by excluding a pro rata share of contribution in the

determination of wholesale rates, wholesale customers would pay a greater mark-up on incremental cost than would retail customers.

Staff asserts that the mathematical formula for calculating wholesale prices can be written in a manner that sets the wholesale price equal to the retail price less net avoided cost, less a pro rata share of contribution. For example, the general formula for Staff's methodology is as follows:

$$P(w) = TAC(w) + [[P(r) - TAC(r)] * TAC(w) / TAC(r)].$$

This equation can be rewritten in the following manner:

$$P(w) = P(r) - [TAC(r)-TAC(w)] - [P(r)-TAC(r)] * [1-TAC(w)/TAC(r)].$$

ICC Staff Ex. 1.03 at 9-10.

In addition, Staff contends that this method of calculating wholesale rates furthers the goal of the federal Act in promoting competition and opening the local telecommunications market.

Staff maintains that its proposed wholesale pricing methodology for wholesale local services is based on the wholesale TAC, which includes shared costs and the LRSIC of the service and sets an appropriate relationship between wholesale and retail rates. Staff states that resellers will choose to enter the local exchange market via resale based on their ability to compete more efficiently against the LEC's retail services. Facilities-based carriers are making decisions to enter the local exchange market based on the existing rate structure of the incumbent LECs, which may be inefficient, as well as the cost of providing local service and demand. Under Staff's pricing methodology, the wholesale price is set relative to the retail price which will not bias entrants in their decision to enter the resale market or the facilities-based market. Staff argues that since the incumbent LEC would receive the same percentage mark-up on wholesale services as retail services, the wholesale LEC would have the same incentive to invest in its underlying network on a wholesale basis as it does on the current retail basis.

Staff's proposed pricing methodology will result in an average discount of 20.07% if the methodology is applied to an individual service level and a 16.63% discount if applied to the family service level. Most of the avoided costs are found in the TAC or shared and administrative costs levels of a group or family of services and are shared among those services contained in the family. In order to calculate a pro rata share of contribution to subtract out of the avoided costs, one must allocate those shared

costs based on a factor. Staff believes that it is reasonable to use relative LRSICs to perform such an allocation. This proposal is the same method that is used by the Commission to calculate the aggregate revenue test for services classified as competitive to determine if the competitive services are recovering their share of facilities and expenses. See 220 ILCS 5/13-507. Staff recognizes that any time shared or common costs are allocated to an individual service level some degree of arbitrariness is involved because those costs are "common" or "shared."

Staff contends that calculating wholesale prices based on its assignment of a pro rata share of contribution at the family level removes the arbitrariness of allocating the avoided shared costs, administrative costs, and contribution to individual services. However, it argues that such a method ignores the retail to LRSIC relationship that is currently embedded in the retail rate structure. This is because resellers will be induced to purchase services in an inefficient manner because the wholesale price will not correspond to the retail rate structure. This will result in both under- and over-utilization of resources, depending on the LRSICs of wholesale services. However, under Staff's proposed method of assigning shared costs, common costs, and contribution to the individual service level, resellers will pay the same percentage mark-up that currently exists on retail services, allowing for efficient competition.

Staff recommends that the Commission require Ameritech to calculate wholesale prices based on Staff's pricing methodology of relative wholesale and retail TAC studies, including applying Staff witness Webber's cost adjustments for an individual service level.

As support for its interpretation of Section 252(d)(3), Staff argues that the incumbent LECs should not be allowed to pick and choose what, if any, cost will be avoided on a wholesale basis. If the incumbent LECs were allowed to make such a decision, then there would be no reason for state commissions to set wholesale rates. Staff asserts that the incumbent LECs would just state what cost they would avoid and set wholesale prices. Under this scenario, the incumbent LECs would set the wholesale rates equal to or above the retail rates in order to protect their local exchange market. Clearly, it is not the intent of the federal Act to forestall local exchange competition.

Staff disagrees with Ameritech's contention that the wholesale prices should not be determined based on the volume and term discounts in the retail rates. Any discounts included in the retail rate structure must be applied to the wholesale rates, otherwise the wholesale rates would not be calculated "on the basis of" the retail rates. Section 252(d)(3). Staff sees no reason why Ameritech would be required to run the usage data through its

system twice in order to apply the retail volume discounts or, if that is the case, why that would be a reason not to offer wholesale volume discounts in accordance with the requirements of the federal Act.

In an effort to ensure that Centel's wholesale discounts reflect avoidable retailing costs on a service-by-service basis, Staff recommended that Centel's discounts (in percentage terms) be set equal to those discounts offered by Ameritech until the appropriate studies are completed. In support of this recommendation, Staff stated that its wholesale pricing plan was designed to ensure that discounts are reflective of avoided costs on a service-by-service basis and that this interim solution would be more consistent with its pricing structure than Centel's flat rate proposal.

In the event that Staff's interim pricing proposal is rejected, Staff states that Centel's FDC cost studies be modified before the flat rate discount is applied.

Ameritech

Ameritech argues that wholesale rates should be based on "avoided costs": that is, retail rates less the marketing and other costs which the incumbent carrier will avoid when providing service to resellers on a wholesale basis, rather than to end users on a retail basis. It contends that use of an avoided cost test will ensure that competition is efficient. Because retail rates are discounted by the amount of the incumbent carrier's retailing costs, avoided cost pricing ensures that only competitors which can provide the retail function equally or more efficiently than the incumbent carrier are encouraged to enter. Ameritech also contends that avoided cost pricing ensures that incumbent LECs can continue to invest in infrastructure, because it preserves the existing level of contribution from the incumbent LECs' services needed to cover other operating costs. Finally, Ameritech states that avoided cost pricing methodology ensures that there is no net change in the competitive relationships among the various providers in the marketplace.

Ameritech states that it has taken the position that the federal Act codifies this pricing methodology. Mr. David H. Gebhardt, Vice President Regulatory Affairs for Ameritech testified that Ameritech, has determined its month-to-month wholesale rates by applying this methodology. The marketing, billing, collection and other retail costs incurred by the Company, less new costs incurred to provide service on a wholesale basis, were identified and subtracted from existing retail rates. Thus, the Company's proposed rates are discounted by the amount of retail costs which it will avoid. Mr. Gebhardt stated that the average,

month-to-month discount resulting from the Company's methodology is 6.8%. Ameritech later modified its position to reflect acceptance of a Staff cost adjustment which resulted in an overall discount of 8.47%.

Ameritech opposed Staff's recommendation to discount rates further to achieve a pro rata level of contribution on wholesale services. Ameritech stated that the financial effect of Staff's pro rata approach was substantial. The bulk of the difference between the Company's proposed discount rate and Staff's proposed discount rate of 16.63% - 20.07% is directly attributable to this pro rata pricing formula. The Company stated that contribution is not profit, but rather is cost recovery. Mr. Gebhardt explained that, because LRSIC studies identify forward-looking costs that are incremental to individual services based on the most efficient technologies, LRSIC costs do not come close to recovering the Company's total costs of operation. The Company's costs not covered in LRSIC studies fell into three categories: (1) shared costs; (2) common costs; and (3) residual. He explained that the Company's rates have traditionally been set to generate "contribution" above LRSIC levels to permit it to recover its total costs of operation.

Ameritech contended that Staff's pro rata methodology was not consistent with the plain terms of the federal Act. Section 252(d)(3) of the federal Act requires that wholesale prices be established by subtracting avoided costs from retail rates. Mr. Gebhardt testified that mathematically, this preserves the absolute amount of contribution produced by wholesale rates, not the pro rata amount. As Ameritech witness Dr. MacAvoy also testified, proper application of the avoided cost pricing leaves intact the contribution levels generated by the incumbent carrier's retail rates.

Ameritech also contended that Staff's argument that contribution can be considered "attributable" to marketing, billing, collection and other costs avoided by the LEC was wrong as a matter of fact and law. Mr. Gebhardt testified that contribution is recovered in rates in varying proportions based on past regulatory pricing decisions designed to achieve a wide range of policy objectives, not in any fixed relationship. Ameritech pointed out that common and residual costs are not considered "attributable" to services under relevant economic principles or the Commission's cost of service rule. The Company also pointed out that this Commission has consistently rejected costing and ratemaking policies like Fully Distributed Costing which allocate common and residual costs to services in fixed proportions, citing the Commission's order on remand in Docket 89-0033.

Ameritech stated that Congress clearly intended that avoided cost pricing directive have meaning and that, if Congress had intended the latitude which Staff claims, Section 252(d)(3) would have been written entirely different. In Ameritech's view, the effect of Staff's interpretation is to write the clear direction provided in Section 252(d)(3) out of the statute.

Ameritech also contended that Staff's pricing approach was contrary to the public policy objectives outlined by Staff and the other parties to this proceeding. Mr. Gebhardt and Dr. MacAvoy explained that it encourages entry by inefficient competitors by making entry attractive for competitors which provide the retail function less efficiently than the incumbent carrier. Although Staff contended that prorating contribution was necessary because the IXCs needed additional margin with which to compete, the Company noted that the IXCs had presented no data whatsoever on their expected retail costs or substantiated in any manner that additional discounts were required to cover those costs.

Ameritech also argued that Staff's approach would bias the playing field in favor of resellers. Ameritech contended that, under Staff's approach, resellers will be able to subscribe to wholesale services at large discounts with virtually no financial or operating risks. In contrast, facilities-based carriers, companies like MFS and TC Systems, must make investments in equipment in blocks of capacity and cannot downsize if their share of the marketplace is slow to materialize. Ameritech further noted it would enter into volume and term agreements with resale carriers that would provide substantially higher discounts (e.g. 15-20%) under volume and term agreements. Under these arrangements, however, the Company explained that the reseller is accepting higher operating and financial risks that are more comparable to those faced by facilities-based carriers.

Ameritech argued that there is no basis for Staff's view that it would be inequitable for resellers to pay the same absolute amount of contribution as retail end users. Resellers and their end users benefit from the continued operation of Ameritech's network just as much as Ameritech's end users. Therefore, resellers should pay an equal amount to support it: not less. Ameritech also contended that loss of contribution will diminish its incentive and ability to invest in its network.

Finally, Ameritech contends that Staff's methodology will operate in precisely the same fashion as a disallowance in a rate proceeding. Assuming for the sake of argument that resellers are successful in obtaining 30% of the local exchange marketplace, Ameritech estimated that its revenues would be reduced $54 million annually merely as a result of Staff's pricing formula. The Company contends that the Commission does not have the authority

under either traditional regulatory principles or the terms of the Alternative Regulatory Plan to reduce the Company's cost recovery in this manner to achieve "equity" objectives, citing Citizens Utilities Board v. Illinois Commerce Comm'n., 166 Ill.2d 111; 651 N.E.2d 1089, 1099. The Company argued that, for this pricing methodology to be lawful, the Commission would have to permit exogenous change treatment under the Company's Alternative Regulation Plan. Mr. Gebhardt testified that this would simply shift the cost burden from the reseller's end users to Ameritech' end users, for which there was no equitable justification. Thus, the Company contended that Staff's approach raised as many fairness issues as it purported to resolve.

Ameritech also opposed AT&T's request for an additional 10% discount based on the assumption that the quality of the provisioning and operational relationships between resellers and incumbent LECs will be inadequate. Ameritech contended that Section 252(d)(3) does not authorize additional discounts in the form of advance penalties. The Company also stated that it did not believe that there would be differences between the services provided by resellers and Ameritech, respectively, that will be observable to end users or have competitive consequences in the marketplace. Ameritech suggested that any carrier who believes that the Company's new operational interfaces are inadequate can present that view to the Commission through traditional avenues (e.g., a complaint) where all the relevant facts and circumstances can be examined. The Company also supported Staff's suggestion that this issue be dealt with in a rulemaking proceeding.

Centel

Although Centel has agreed to perform the necessary LRSIC studies in order to implement properly the wholesale pricing methodology ordered by the Commission, the studies will not be completed by the conclusion of this proceeding. If Centel is unable to complete these studies by the time it begins to offer its wholesale services, the Commission must adopt an interim pricing methodology.

Centel recommended that it be allowed to use the results of its Fully Distributed Cost ("FDC") study as the basis for an across the board discount which would applied to its current retail rates as an interim wholesale rate structure. Once Centel completes the necessary LRSIC studies, it proposes to a wholesale pricing approach very similar to Ameritech's position, i.e. a wholesale rate equal to the wholesale LRSIC plus retail contribution.

CUB

CUB advocates a pricing approach consistent with Staff's recommendation to attribute a pro rata share of contribution to the avoided retail functions, whereby the maximum wholesale price of each local exchange service be set equal to the wholesale to TAC ratio plus a pro rata contribution level attributed to the wholesale functionalities.

MFS

MFS contends that the Commission should reject AT&T witness Dr. Kaserman's proposal to strip the contribution embedded in retail rates that exceed retail LRSIC. MFS states that the resale pricing methodology under the federal Act does not eliminate contribution from retail rates because contribution is not an avoided cost. MFS contends that contribution represents cost recovery for joint and common costs of the incumbent LEC's multiple services. Joint and common costs are costs that are attributable to more than one service and, in the interest of efficiency, are recovered proportionately from all of these services. MFS argues that disallowing recovery of these costs in the rates for a multiservice carrier would cause the services to be produced at a higher cost by separate firms or not produced at all, both of which would reduce consumer welfare. MFS further argues that contribution is not avoided merely because the LEC sells some of its services at wholesale. Thus, MFS maintains, the Commission lacks the power to discount retail rates beyond the avoided cost level.

TC SYSTEMS

TC Systems argues that the federal Act clearly limits the Commission's discretion in setting a price for local resold services. TC Systems cites Section 252(d)(3) of the federal Act, which mandates that the wholesale rates will be set by the Commission "on the basis of retail rates charged to subscribers for the telecommunications service requested excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier." This language, according to TC Systems, means the federal Act does not allow the Commission to set the wholesale rate based on any other methodology than avoidable costs. TC Systems then points out to the Commission that Staff's pro rata share of contribution methodology is not identified as an appropriate local wholesale pricing mechanism in the federal Act, and therefore cannot be adopted by the Commission as its local wholesale pricing standard. TC Systems also contends that the only lawful local wholesale pricing standard that can be used is an avoided cost methodology, as was advocated by TC Systems in this proceeding. According to TC

Systems, nothing in the federal Act confers upon the Commission the discretion to set a discount level based upon pro rata contribution. Section 252(d)(3) of the 1996 Law refers to "avoided costs," not avoided contribution. Hence, on its face, TC Systems argues that Staff's proposal is illegal, and adoption by the Commission of the pro rata share of contribution methodology would be per se reversible error. According to TC Systems, the Commission should instead adopt a discount strictly based upon avoided cost.

Commission Conclusion

The federal Act grants State commissions the authority and discretion to properly set the wholesale rates. A plain reading of Section 252(d)(3) of the federal Act indicates that this section does not, in and of itself, set the wholesale price for the State commissions:

> (d) PRICING STANDARDS
>
> ...
>
> (3) WHOLESALE PRICES FOR TELECOMMUNICATIONS SERVICES- For the purposes of section 251(c)(4), a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

(emphasis supplied.)

The single most litigated issue in this proceeding concerns the interpretation of this Section. There is great dispute among the parties as to the scope of the Commission's authority in setting the wholesale rate. Essentially the issue is: whether the Commission can set a pricing methodology for wholesale rates or did Congress establish the methodology, and our role as a State Commission is only to fill in the blanks in the equation provided?

This Commission is of the opinion that if Section 252(d)(3) was meant to set the wholesale rate for the Commissions, then Congress would have used the words "equal to" rather than the words "on the basis of." Instead the Act plainly sets forth the basis for determining a wholesale rate. The word "basis" has a much different definition than the word "equal."

The American Heritage Dictionary, Second College Edition, (1982) defines the word "basis" as the following:

> 1. A supporting element; foundation. 2. The chief component of something. 3. The essential principle.

Similarly, Websters New World Dictionary, Second College Edition, (1985) defines "basis" as:

> 1. the base, foundation , or chief supporting factor of anything. 2. the principal constituent of anything 3. the fundamental principle or theory, as of a system of knowledge.

Both definitions clearly indicate that when one uses the word "basis," one contemplates that there can be more -- another "element" or "factor" or "component." The words "on the basis of," therefore, are to be interpreted as meaning that a State commission must decide the wholesale pricing methodology to be used. This methodology can incorporate other elements as well as the elements listed in Section 252(d)(3) -- namely billing, collection, marketing, etc. By using the word "basis," Congress granted State commissions latitude in setting a proper wholesale rate.

The Commission agrees with Staff witness Jennings that in removing the avoided retail costs in reaching a wholesale rate, a pro-rata share of contribution pertaining to avoided retail functions must also be removed. This is an additional "element" or "factor" or "component" that this Commission has the authority and discretion to consider under the federal Act.

Mr. Jenning's methodology is consistent with Section 252(d)(3) because it is based upon the concept of removing avoided costs from the retail price to reach a wholesale price and it places competitive pressure on the incumbent LEC. The incumbent LEC is no longer entitled to the entire amount of the contribution. The contribution that the incumbent currently receives is based upon it providing a full array of services, including the retail function. With the incumbent LEC providing fewer services, there must some reduction in the amount of contribution that it receives.

Rejecting Staff's proposal would lead to an unreasonable result that would be inconsistent with the federal Act, as well as this Commission's policy of promoting competition. If a pro-rata share of contribution pertaining to avoided retail functions is not removed in setting a wholesale rate, the incumbent LEC would be immune from any competitive pressure.

Competitive pressure on both the incumbent LECs, as well as new entrants into the local exchange market, is key to a properly established wholesale/resale market. Such pressure would be exerted in terms of price, cost, and service quality. This competitive pressure ensures that market participants will be as