adopted, we allowed a rate increase that captured anticipated cost increases, including general inflation and increased labor costs. No such increases are being allowed here, inasmuch as the CCFs are based on 1995 expense levels without adjustment for cost increases.

Here, too, AT&T responds that New York Telephone has shown no new reason to credit its assertion that the application of historical CCFs to TELRIC investment amounts adequately captures available savings. It sees no basis for assuming we were unaware that the accounts being adjusted might include some non-direct labor expenses and dismisses as "quibbles" New York Telephone's arguments over the significance of the productivity precedents we cited, asserting that the Commission needs no guidance from the parties on how to construe its past decisions.

Because of the adjustments New York Telephone itself had made to the maintenance CCF, as described in Opinion No. 97-2, we were satisfied that the factor was sufficiently forward-looking to obviate application of the general 10% productivity factor. Nevertheless, we saw a need, also described in Opinion No. 97-2, for a labor productivity offset, and we chose a 2% figure in light of rate case precedent. (That no rate increases are being allowed here provides no basis for distinguishing those cases, which were cited only in connection with the proper magnitude of a labor productivity offset and not with respect to the circumstances under which such an offset might be warranted.) New York Telephone's petition offers no basis for modifying this result and is denied on this point.

Deaveraging of Carrying Charge Factors

New York Telephone contends that the decision to geographically deaverage link rates fails to reflect the differences among the zones with regard to expense relationships. As a result, it says, we have deaveraged investment but not expenses, and rates do not track geographically deaveraged costs as much as they might. It asserts we must correct this omission, especially if rates are deaveraged further.

In response, AT&T emphasizes that we deaveraged only loop rates and not rates for other elements, and it suggests that our gradualist approach may have led us to use statewide average CCF factors applicable not only to loop investments but to the investment underlying all other network elements as well. It notes that New York Telephone will be able to address itself to this issue in the forthcoming further consideration of deaveraging and sees no basis for taking any action on it now.

Sprint's response supports New York Telephone on this point.

The decision not to deaverage CCFs grew out of concerns that the record was weaker with regard to deaveraged expenses than with regard to deaveraged investment. For example, in allocating expenses among the four zones, New York Telephone employed internal reports that provided incomplete data. As AT&T suggests, this issue may be addressed in the next phase; no action is needed now.

DEPRECIATION LIVES

We determined that the depreciation lives to be used in estimating the cost of providing network elements should be those most recently set for New York Telephone in the triennial represcription process overseen by the FCC. We rejected New York Telephone's proposal to use shorter depreciation lives (and correspondingly greater depreciation costs) based on Generally Accepted Accounting Principles (GAAP). We agreed with the proponents of the Hatfield Model that the prescribed depreciation lives used in traditional regulation were the correct ones to be used here inasmuch as recent FCC represcriptions have become more forward-looking. But while the Hatfield proponents had used the depreciation lives prescribed by the FCC for Bell Atlantic's Maryland subsidiary, we agreed with New York Telephone that if prescribed lives are used, they should be those recommended by

this Commission for New York Telephone, consistent with the FCC's mandate, for intrastate purposes.[1]

In its petition for rehearing, New York Telephone reargues at great length its case in support of using the shorter GAAP depreciation lives rather than the traditional prescribed lives. It argues, among other things, that because prescribed lives are an incident of traditional cost-of-service regulation, they are inconsistent with the FCC's determination that the 1996 Act precludes the use of traditional cost-of-service regulation as well as with our own rejection of all other incidents of traditional cost-of-service regulation in favor of a forward-looking approach. Accordingly, it contends, the decision "results in a mismatch between a least-cost, forward-looking network and regulatorily prescribed depreciation rates that do not reflect the TELRIC network, but rather are overwhelmingly based upon historic[al] data going back decades."[2]

New York Telephone goes on to cite the FCC's observation that a TELRIC calculation requires treating depreciation in a manner that reflects the expected change in the economic or market value of the carrier's assets and that these considerations are not reflected in the represcription process, which postulates a regulated monopoly environment without competition. It cites as well, in this regard, a decision of the California Public Utilities Commission endorsing the use of GAAP lives for these purposes as well as a statement by the FCC, promulgated after the close of the record in this case, suggesting that incumbent LEC assets may be under-depreciated if

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[1] See, generally, Opinion No. 97-2, mimeo pp. 47-48. In reaching our decision, we acknowledged that New York Telephone was correct that if prescribed rates are used, they should be those for New York Telephone itself and not for Bell Atlantic's Maryland subsidiary. (Opinion No. 97-2, mimeo p. 48.) In its Petition for Rehearing, New York Telephone suggests that that change worked to its detriment inasmuch as it produced a level of depreciation generally even lower than that urged by the Hatfield proponents. (New York Telephone's Petition, p. 27.)

[2] New York Telephone's Petition, p. 28.

their prescribed useful lives exceed their economic lives and that prescribed lives are an inappropriate measure of the expected changes in the economic value of a carrier's investment. Pointing to a January 1997 statement by the FCC staff that "the depreciation schedules specified in a proxy model should be based on forward-looking costing principles and should reflect projected economic lives of investments rather than physical plant lives,"[1] it adds that our own cost manuals recognize that economic lives capture changes in economic value while prescribed depreciation lives do not.

Recognizing that the First Report and Order stated that prescribed rates were a reasonable starting point for a TELRIC analysis, New York Telephone suggests we mischaracterized that statement as a presumption in favor of using prescribed lives and contends, in any event, that it met its burden of showing why business risks justify departing from the prescribed lives. It argues, among other things, that prescribed lives do not attempt to estimate the lives of a new "reconstructed" network that must be assumed in a TELRIC study; that prescribed lives often are unrealistically long, as shown by the frequency with which regulators have to deal with depreciation reserve deficiencies; and that even though the FCC and state regulators have made asset lives shorter in an effort to reflect technological and competitive changes (the factor we cited in reaching the conclusion that the process had become sufficiently forward-looking to be used here), their primary emphasis continues to be on past retirement practices and historical data and mortality analyses. And the FCC's simplification of its represcription process, New York Telephone insists, was intended to reduce regulatory burdens but not to change the depreciation methods applied, which continue to rely on historical booked data. Noting that the FCC has announced its intention to

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[1] New York Telephone's Petition, p. 31, citing a document by the FCC staff entitled "The Use Of Computer Models For Estimating Forward-Looking Economic Costs: A Staff Analysis" (released January 9, 1997) ¶61.

institute a further proceeding to explore such issues as the degree to which increased competition and technological change warrant modifying depreciation policies, New York Telephone points out that that proceeding has not yet been instituted and that the represcription process remains largely unchanged.

New York Telephone contends as well that the 1995 New York represcription also was grounded in historical data and made only a very limited attempt to reflect changes to those data. As a result, it takes account of a network that is "not the newly constructed network that the TELRIC construct calls for."[1] It notes that at the time of the represcription, there was no way for staff to anticipate the 1996 Act, the FCC's rules thereunder, and our actions since 1995 to encourage competition. New York Telephone notes that each succeeding represcription has adopted lives shorter than its predecessor and takes this, as well, as evidence that the represcription process has been a poor predictor of the future.

Finally, New York Telephone renews its argument that GAAP-based lives are the ones properly used and disputes the opinion's statement that adopting them here would unduly inflate the cost of network elements. It contends that the GAAP lives were developed after an examination of technology trends and of New York Telephone's infrastructure deployment strategies and that they are the lives it has used for financial reporting purposes since it discontinued the use of the traditional regulatory accounting practices prescribed by Financial Accounting Standards Board (FASB) Statement No. 71. Further, it contends, a thoroughgoing TELRIC analysis would have used lives even shorter than those based on GAAP inasmuch as it would be the assumed TELRIC network that was being depreciated and not the entire embedded base of New York Telephone investments. It therefore regards its proposed depreciation lives as conservative; points to the FCC staff's suggestion, in the analysis previously quoted, that depreciation rates filed by

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[1] New York Telephone's Petition, p. 35.

incumbent LECs for financial purposes may be appropriate for costing; and asserts that the New York Commission and its staff also "have consistently recognized the appropriateness of GAAP-based accounting as the telecommunications market becomes increasingly competitive."[1]

Citing various observations in Opinion No. 97-2, MCI responds that New York Telephone has simply failed to rebut what MCI characterizes as the "strong" presumption in favor of using prescribed depreciation rates in the TELRIC analysis.[2] It adds that New York Telephone departs from its use of historical costs only where, as here, the effect of the departure would be to have New York Telephone's competitors subsidize its other business goals.[3]

AT&T responds in greater length and specificity. It contends generally that New York Telephone has simply repeated its earlier arguments and offered, as its only new assertion, a misrepresentation of the FCC's current position on depreciation. More specifically, it insists that the prescribed lives are sufficiently forward-looking to be used for TELRIC purposes. It contends that the FCC's statement on under-depreciation cited by New York Telephone merely describes the circumstances in which under-depreciation <u>could</u> occur and invites comments on whether under-depreciation <u>in fact</u> has occurred; AT&T has submitted comments in that FCC proceeding purporting to demonstrate that the represcription process has not resulted in underdepreciation.[4] AT&T contends as well that the past reserve

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[1] New York Telephone's Petition, p. 38.

[2] As we found, there is a presumption in favor of using prescribed rates and New York Telephone has not rebutted it. Nevertheless, MCI may overstate the FCC's position in the First Report and Order by characterizing it as a <u>strong</u> presumption.

[3] MCI's Response, p. 12.

[4] It cites, among other things, Bell Atlantic having paid $33.3 billion for NYNEX assets having a net book value of only $19.8 billion, suggesting over-depreciation, not under-depreciation. (AT&T's Response, p. 33.)

deficiencies cited by New York Telephone were created before the FCC began to use forward-looking projection life prescription; that New York Telephone's focus on plant retirements is inappropriate and suggests a misunderstanding of the real world; and that the claim that prescribed lives rely unduly on the past is a criticism previously voiced and rejected. Characterizing as wishful thinking New York Telephone's suggestion that a new prescription now would result in shorter lives than those set in 1995, AT&T notes that New York Telephone did not file for an annual update in 1996 or 1997; that by 1995, we had already recognized the potential effects of competition; and that the 1996 Act's emphasis on resale and use of unbundled network elements by New York Telephone's competitors, along with various other factors, could result in newly represcribed rates being, if anything, longer than those prescribed in 1995.

Finally, AT&T sees no basis for reconsidering New York Telephone's claim that GAAP-based lives should be used for a TELRIC study. It emphasizes the tentative nature of the "isolated viewpoint"[1] in the FCC staff report cited by New York Telephone. It adds that at the time of the hearings, no jurisdiction had adopted New York Telephone's witness' proposed depreciation approach for a TELRIC study and that, since then, several have specifically rejected it.

Although New York Telephone has treated this issue at length, it has offered little new and shown no error in our fully explained decision to use prescribed lives. Its petition on this point is denied.

COST OF CAPITAL

Introduction

We used as a modeling input an overall cost of capital of 10.2%, reflecting a cost of equity of 12.1% and a debt/equity

[1] AT&T's Response, p. 38.

ratio of 40%/60%.[1] We reached that result largely on the basis of an analysis of the proxy group of telecommunications firms advocated by AT&T, but with an adjustment of those firms' historical debt/equity ratio from 45%/55% to 40%/60% "in order to bring it, and the resulting overall cost of capital, within the range of those that might characterize a communications firm such as NYNEX operating in the competitive environment we are endeavoring to promote."[2] We also modified AT&T's analysis by rejecting its use of a multi-stage growth model for purposes of its discounted cash flow (DCF) analysis, seeing no need to depart from our traditional use of a single growth model. New York Telephone takes issue with various aspects of this decision.

As in the case of depreciation lives, New York Telephone asserts in general that our analysis here departed little from traditional rate case methods and thus fails to be adequately forward-looking for a TELRIC analysis. More specifically, it contends that the cost of capital takes inadequate account of increased risk and thus cannot be said to satisfy the FCC's mandate that the cost of capital to be used for TELRIC purposes be "risk-adjusted."[3] AT&T responds generally that New York Telephone, for the most part, simply reiterates old arguments and that its one novel point (noted below) lacks any basis.

Proxy Group

Turning first to the question of which comparable companies should be studied, New York Telephone renews its arguments in favor of its own proxy group, comprising the Standard and Poor's (S&P) Industrials. Acknowledging that many of those firms operate in markets that are more competitive than

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[1] See generally Opinion No. 97-2, mimeo pp. 38-40. Page 40 erroneously states the overall cost of capital to be 12.1%; an errata notice corrected that to 10.2%.

[2] Opinion No. 97-2, mimeo p. 39.

[3] First Report and Order, ¶702.

those in which it now operates, New York Telephone nevertheless contends that they represent a proper proxy group because the FCC has said that a TELRIC analysis "simulates the price for network elements in a competitive market,"[1] and it maintains that "for purposes of a TELRIC analysis, all costs that go into the analysis should be the costs that would prevail in a competitive market."[2] New York Telephone notes that the Massachusetts commission has adopted this view.

New York Telephone reiterates as well its view that the AT&T proxy group, comprising the regional Bell holding companies and four other telephone holding companies, improperly carries forward into a TELRIC analysis an approach to cost of capital that may have been proper under traditional regulation but that is inappropriate for TELRIC purposes. Moreover, it contends, even if the proxy group were reasonable, it would have been necessary to adjust the data to recognize the assertedly higher level of competition faced by New York Telephone.

New York Telephone goes on to suggest, for the first time, that if we are unwilling to use the S&P Industrials as the proxy group, we at least base our decision on a wider group of telecommunications companies than only the parents of ILECs, in order to truly mirror telecommunications competition and provide a proper price signal to competitors trying to decide between building their own systems and renting network elements. Noting that AT&T's rebuttal testimony included in the proxy group the three largest interexchange telecommunications companies (AT&T, MCI, and Sprint), New York Telephone suggests that they be included in the analysis in order to make it more representative and truer to the purpose of TELRIC. It calculates that making this change, and leaving in place all other aspects of our analysis, would increase the cost of equity from 12.1% to 12.4% and the overall cost of capital from 10.2% to 10.4%. It

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[1] Ibid., ¶635.

[2] New York Telephone's Petition, p. 40.

calculates as well that applying our DCF method to updated data results in a cost of equity of 12.8%, for both our proxy group and New York Telephone's newly-proposed enlarged proxy group.

In response, AT&T maintains that New York Telephone has shown no reason to depart from the conclusions that financial markets consider the average company in the S&P Industrials to be riskier than telephone companies and that the proper measure of comparable risk is provided by other telephone companies, such as those included in AT&T's proxy group. It adds that New York Telephone's witness made no attempt to show how any of the S&P Industrials are comparable to New York Telephone, nor has it been shown that New York Telephone faces a higher level of competition and a correspondingly greater risk than the other local exchange companies included in the proxy group.

As for New York Telephone's new suggestion to expand the proxy group to include AT&T, MCI, and Sprint, AT&T sees no record evidence to support the claim that doing so would send the proper price signal with regard to building versus renting. It suggests as well--more importantly in its view--that doing so might unlawfully discriminate among the types of potential entry into the local exchange market, contrary to the 1996 Act's prohibition on such discrimination. Nor does AT&T see any evidence supporting the assertion that an expanded proxy group would be truer to the purposes of TELRIC. Asserting that the proxy group we adopted explicitly includes other local exchange carriers subject to the same market opening rules as New York Telephone, AT&T notes that its witness included the major long distance carriers in his rebuttal testimony proxy group only as an experiment that illustrated the invalidity of New York Telephone's proposed reliance on the S&P Industrials.

MCI similarly acknowledges that New York Telephone no longer operates in a totally risk-free environment but sees no basis for regarding it as subject as the same risks as the S&P Industrials. It adds that insofar as New York Telephone's cost of capital is higher than it was in the past, the increase flows from the risks New York Telephone has assumed in providing

advanced technology services and that New York Telephone's shareholders, not its competitors, should bear the risk of that expansion. It suggests, finally, that the Bell Atlantic merger could be expected to reduce New York Telephone's risks and cost of capital.

The arguments here for the most part reiterate those presented in the case-in-chief and establish no basis for concluding that the proxy group we used failed to produce an overall return within the range of reason or was otherwise improper. The new suggestion to include three long-distance companies in the proxy group has not been shown so likely to produce a more reasonable result as to warrant rehearing on its account. Moreover, the 20-basis point increase in cost of capital that New York Telephone calculates to flow from that change would increase the loop price by only about ten cents; and, as noted, recalculation of the rate of return on the basis of updated data as of May 7, 1997 shows the change in proxy group to produce no difference at all.[1] In sum, there is no need to grant rehearing on this point.

Capital Structure

With regard to the capital structure, New York Telephone similarly asserts that the 40%/60% debt/equity ratio, while better than the historical 45%/55% ratio urged by AT&T, fails to reflect market values in the coming competitive environment. It characterizes the ratio as "a backward-looking, accounting concept that measures the book values of debt and equity on [New York Telephone's] historical financial records" and thus violates the FCC's mandate that network element prices

[1] More precisely, the change in proxy group produces a change in return so small as to be lost in rounding. This reference to updated data, it should be noted, is intended only to demonstrate the minimal effect of the change in proxy group. It does not imply any need to update; as in traditional rate cases, the return is set as of the time of the decision and should not be updated at the time requests for rehearing are considered.

not be based on booked accounting costs.[1] It renews its argument in favor of a debt/equity ratio of 25%/75%, which it regards as reflecting market values with respect to both the Commission's proxy group and the more comprehensive one New York Telephone now suggests.

New York Telephone calculates that applying that capital structure to its recalculated equity cost of 12.8% and an updated cost of debt (next discussed) results in an overall cost of capital of 11.6%. Using those data and applying New York Telephone's DCF method rather than ours, it says, produces a cost of equity of 13.1% and a cost of capital of 12.0%.

Here, too, AT&T responds that New York Telephone simply reiterates rejected arguments. It notes our explicit statement that we were adopting a 40%/60% debt equity ratio not as a backward-looking exercise but as an effort to reflect the forward-looking, real-world capital structure. It adds that New York Telephone's witness failed to show that the average S&P Industrials capital structure reflects what New York Telephone's financial managers would attempt to achieve on a going-forward basis and that a supplier of unbundled network elements should be significantly less risky, and consequently more leveraged, than the average telephone holding company and certainly than the average S&P Industrials company.

AT&T is correct; New York Telephone has offered no new arguments warranting rehearing.

Cost of Debt

We used a cost of debt of 7.3%, representing the average (as of December 31, 1996) of Moody's composite rate for Aa rated debt and S&P's composite rate for A rated debt. Noting that this figure is below both New York Telephone's proposed 7.9% cost and AT&T's proposed 7.7%, New York Telephone contends it has no support in the record and suggests it reflects the aberrational effects of a short-term phenomenon inasmuch as the

[1] New York Telephone's Petition, p. 43.

bond market at the end of 1996 was at its lowest point in the last 12 months. Averaging the figures as of April 1997, the latest month available, produces a cost of debt of 7.8%, and New York Telephone urges use of that figure.

AT&T responds that the cost of debt must be determined as of some date certain and that New York Telephone has shown no basis for changing the data points we used. It charges New York Telephone with attempting to pick selectively from post-record market data in order to use a data point that would increase the cost of capital.

AT&T is correct; there is no need to update the cost of debt, which must be determined as of some time certain. In any case, increasing the cost of debt from 7.3% to 7.8%, as New York Telephone proposes, would increase the link rate by only about five cents.

DCF Method

We rejected, as unnecessary and contrary to precedent, proposed adjustments by New York Telephone to reflect quarterly dividends and flotation costs. In its petition, New York Telephone contends that the precedents, more than a decade old, reflect traditional approaches and that the adjustments are now needed inasmuch as they reflect factors that investors consider in assessing competitive firms. It maintains that competitive firms must consider the cost of quarterly payment of dividends and of floating capital, particularly equity, and that to set network element rates that omit the cost of floating capital is to favor firms that choose to rent those elements from New York Telephone as against firms that must float capital in order to build their own facilities. It asserts that "including these costs, both flotation costs and the costs of quarterly payment of dividends, fulfills the aim of emulating the cost of a competitively provided network, under TELRIC."[1]

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[1] New York Telephone's Petition, p. 47.

AT&T responds that New York Telephone's claims have already been rejected and that its new arguments are extra record. It sees no relevance in what it characterizes as New York Telephone's speculation about flotation costs for potential competitors.

Once again New York Telephone has shown no error of fact or law, nor has it presented any new arguments warranting rehearing.

FORWARD-LOOKING COST SAVINGS

MCI and MFS contend that we failed to give adequate recognition to anticipated future efficiency gains. MCI asserts that "the Commission has repeatedly determined, in service quality reviews and otherwise, that [New York Telephone] is not operating in an efficient manner."[1] Citing New York Telephone's claims at the hearings that there were no further efficiency gains to be reflected in a TELRIC study, MCI contends that Opinion No. 97-2 noted the parties' opposing positions on this matter but did not rule on it. Pointing in particular to recent press coverage of possible efficiency gains resulting from the Bell Atlantic-NYNEX Merger, it asks that the record be opened on this point and that an informed decision be made.

MFS similarly complains that we did not adequately address the issue of whether merger savings, which New York Telephone characterized as speculative, should be reflected. Noting that the merger is now on the verge of being consummated, it contends that the consolidated operations resulting from the merger will diminish duplicative common costs and that steps must be taken to insure that the resulting efficiencies are passed on to purchasers of unbundled loops. It urges that the matter be considered in the continued phase of the proceeding now contemplated for deaveraging.

New York Telephone responds that the extent and nature of merger-related savings remain uncertain and that any such

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[1] MCI's Petition p. 27.

savings that may materialize are better taken into account through a revised TELRIC analysis later than through speculation now. It also reiterates its claim, raised in its own petition for rehearing, that Opinion No. 97-2 reflects speculative productivity savings lacking any basis in the record and that it would be wrong to compound that error by reflecting additional productivity here.

The parties seeking rehearing have shown no basis for changing our treatment of forward-looking cost savings. They have been reflected to a degree in the productivity adjustments, and may be considered further, in future proceedings, as and if they develop.

DIGITAL LOOPS

During the proceeding, MFS had requested that we set rates for two types of digital lines, referred to as asymmetrical digital subscriber lines (ADSL) and high-bit-rate digital subscriber lines (HDSL). We determined that ADSL and HDSL were not among the elements under review here and added that "MFS, if it wishes to raise issues relating to them, may do so, in the first instance, through renewed negotiations with New York Telephone regarding its interconnection agreement. If those negotiations do not resolve the issue promptly, MFS may apprise us, and we will consider what further action may be needed."[1]

In its petition, MFS contends that this approach allows New York Telephone to evade the terms of its interconnection agreement with MFS, in which, MFS says, New York Telephone contractually bound itself to provide cost support for ADSL and HDSL so that rates could be set in this proceeding. New York Telephone failed to produce that support, and MFS contends that it can now prolong negotiations and leave the matter unresolved. It asks that we apply the rates for the digital loops that were considered (referred to as "two-wire conditioned" and "four-wire conditioned" loops, both of them components of the Integrated

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[1] Opinion No. 97-2, mimeo p. 82.

Services Digital Network (ISDN)) to ADSL and HDSL on an interim basis and that we direct New York Telephone to submit cost support for permanent ADSL and HDSL rates in the continued phase of this proceeding.

MFS also challenges what it sees as the tacit decision to set the rates for digital (ISDN) loops on the basis of an all-fiber-feeder construct that results in digital loop rates that are nearly double the voice-grade loop rates. Renewing its claim that the use of fiber for digital loops is particularly inefficient, it asserts that we failed to address its evidence to that effect. It contends that the resulting rates also are discriminatory, inasmuch as New York Telephone continues to provide the majority of its own digital loops over copper and will go on doing so at the same time as it charges competitors the assertedly inflated costs of a fiber-based digital loop. It asks that we declare the two-wire conditioned and four-wire conditioned loop rates to be interim, that we examine digital loop rate issues further in the continued phase of the proceeding, and that we allow parties to supplement the record and brief these issues again.

In response, New York Telephone sets forth what it characterizes as the relevant portion of its interconnection agreement with MFS and asserts, on that basis, that it has no contractual obligation to provide cost support for ADSL or HDSL. It notes that even the offering of ADSL is made contingent on successful completion of a technical trial and resolution of various other issues and that consideration of costs and rates for ADSL and HDSL would be premature. Rejecting MFS' suggestion that it is evading the terms of the agreement, New York Telephone contends that it is in fact MFS "that is attempting an end run around the provisions of the interconnection agreement."[1]

With respect to ISDN costs, New York Telephone acknowledges that copper loops can reduce costs for what is

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[1] New York Telephone's Response, p. 40.

termed basic rate ISDN.[1] But it contends that introducing copper loops into the forward-looking network to reduce costs for ISDN customers would increase costs for non-ISDN customers, contrary to the overall forward-looking efficiency required by a TELRIC analysis. It asserts that requiring all customers to bear increased costs to support lower rates for a much smaller number of ISDN customers is consistent neither with the FCC's First Report and Order nor with what it considers to be sound regulatory policy.[2] Turning to MFS' allegation of unfair discrimination (in that New York Telephone will continue to provide the majority of its own digital loops over less expensive copper), New York Telephone states that this is not the only instance of a disparity between forward-looking TELRIC costs and actual provisioning practices and that in most instances, New York Telephone's continued use of its embedded plant requires it to bear higher costs than those reflected in the TELRIC analysis. It maintains that MFS and the Hatfield sponsors should not be allowed to pick and choose, in effect requiring New York Telephone to base prices on forward-looking technology when it is cheaper and on embedded technology when it is cheaper.

With respect to ADSL and HDSL, New York Telephone has responded persuasively to MFS's petition. Consideration of costs and rates for services provided using these technologies is not now necessary, and the applicability of these technologies in the forecast network is unproven. If and when ADSL and HDSL are about to be deployed commercially, New York Telephone will of

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[1] ISDN exists in two principal transmission formats: basic rate and primary rate. Basic rate permits the transmission of two standard 64 kilobyte per second (kbps) voice or data channels and a 16 kbps data channel. Primary rate ISDN permits the transmission of 23 standard 64 kbps channels and one 16 kbps channel. Primary rate ISDN links can be connected with digital switches through a standard IDLC connection. Basic rate ISDN presents various technical considerations that render the use of a copper interface more efficient.

[2] New York Telephone's Response, p. 42.

course be expected to fulfill its obligations to offer such services on a wholesale basis.

As for ISDN costs, New York Telephone is correct that MFS's proposal, considered alone, would unfairly increase costs for the majority of customers in order to benefit a minority. But that does not end the inquiry. New York Telephone's study assumed that in the context of a forward-looking fiber network, basic rate ISDN links and ports could be offered only via costly UDLC connections and set the price on that premise. Recent technological developments reported by New York Telephone itself[1] suggest, however, that before long, perhaps within a year, it will be feasible to provision basic ISDN via IDLC connections, thereby reducing its cost. Consistent with its forward-looking approach, New York Telephone will be required to price basic ISDN accordingly, thereby addressing, in part, MFS's legitimate concerns and simultaneously enhancing New York Telephone's incentive to pursue vigorously the development of IDLC connections for basic ISDN. Specifically, New York Telephone should recalculate on this basis, and submit for approval, the rates for (1) two-wire conditioned digital links; (2) the basic rate ISDN port; and (3) four-wire analog links. (Two-wire analog and four-wire conditioned links already are costed on the basis of IDLC; thus, the effect of this change would be to use IDLC for all links.) To that extent, MFS's petition is granted.

OVERALL PRICE LEVEL

Citing our observation that

> the major cities [loop] price is low enough to avoid discouraging competitive market entry in the denser urban markets where it is likely to develop soonest, and the price in other areas is not so high as to be disruptive to the development of competition there[,][2]

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[1] See New York Telephone's Initial Brief, pp. 70-71.

[2] Opinion No. 97-2, mimeo p. 130.

AT&T asserts that these "are essentially words of prayer, not words of analysis of anything in the record of this proceeding"[1] and that the record supports the opposite conclusion, that the loop rates will foreclose facilities-based competition incorporating loop resale. AT&T complains that we have set the highest major cities loop rate in the country, higher than the statewide average rate in various states and far above the rates in assertedly comparable cities. The rural loop rate, meanwhile, is only eight cents below the existing rate, which has not permitted the development of competition.

AT&T sees this decision as part of a recent pattern, in which the Commission has combined "pro-competitive rulings establishing the operating arrangements, terms and conditions that would foster competition, with rates that preclude competitors from translating any of the structural arrangements into actual competitive alternatives for consumers."[2] It cites in this regard the Rochester Telephone Open Market Plan and New York Telephone's PRP, in both of which, it claims, we took the lead in adopting pro-competitive structural provisions but then compromised our own efforts by setting rates (in one instance a wholesale discount; in the other, access charges) that assertedly had the effect of precluding the very competition we sought to encourage.

AT&T sees the current decision as continuing that pattern. It praises the landmark pro-competitive structural changes but warns that the rates set here are even more anti-competitive than those set under the Rochester Telephone Open Market Plan. It charges that the rates are unlawful as well, and notes, ominously, that "the Commission still has time to correct these fundamental errors of both fact and law--which

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[1] AT&T's Petition, p. 2.

[2] Ibid., p. 4.

could cost New York consumers $400 million annually--before any federal court proceedings."[1]

MCI similarly alleges that the rates we set for links are among the highest in the country and that the major cities rate is "patently excessive" in comparison with loop rates in assertedly comparable cities. Sprint also compares the loop rate to those set in other jurisdictions and suggests the high loop rate may preclude it from offering local service in New York. NYCHA, in its response, endorses AT&T's observations regarding the alleged pattern in our decisions and asserts that New York Telephone, which faces no real competition, is charging prices so high as to jeopardize New York's business climate. It comments that since April 1, it has begun to see proposals to serve large business customers that "fix one rate for loops/lines in 24 of the 25 largest cities in the country--and a separate, higher rate for New York."[2]

In response, New York Telephone characterizes AT&T, MCI, and Sprint as offering self-serving, result-oriented arguments growing out of their interest, like that of all consumers, in securing the lowest possible prices for the products they must purchase. It sees no basis for assuming that loop prices in New York City should be lower than elsewhere, citing, among other things, the high costs of construction in New York City and the congestion costs that may offset economies of scale. It warns against artificially low element prices that would encourage uneconomic market entry and prevent New York Telephone from recovering its costs, thereby endangering the quality of the network, or that might discourage true facilities-based competition by reducing the incentive to invest in alternative structure. It characterizes the complaint that the approved rates are "just 'too high' [as] an affront to the

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[1] Ibid., p. 7.

[2] NYCHA's Response, p. 2.

substantial effort and attention devoted to this process by scores of individuals over many months."[1]

Notwithstanding the parties' arguments, we remain satisfied that we have fairly and reasonably resolved the issues in this case and that the rates we have set, which are fully consistent with the 1996 Act, suitably advance our goal of encouraging the development of local service competition. Insofar as further rate deaveraging may be warranted in pursuit of that goal, we have already noted our intention to consider it, along with other pertinent matters, in the ensuing phase of the proceeding.

CONCLUSION

For the reasons described above, the rate for digital elements should be modified to reflect the use of IDLC connections in providing basic ISDN. In all other respects, all petitions for rehearing are denied.

The Commission orders:

1. The petition for rehearing of MFS Intelenet of New York, Inc. is granted to the extent described in the foregoing opinion and is otherwise denied.

2. Within 30 days of the date of this opinion and order, New York Telephone Company shall submit tariff amendments consistent with the foregoing ordering clause.

3. All other petitions for rehearing of Opinion No. 97-2 are denied.

4. These proceedings are continued.

By the Commission

(SIGNED) JOHN C. CRARY
Secretary

[1] New York Telephone's Response, p. 5.

ACRONYMS USED IN THIS OPINION[1]

ADSL	Asymmetrical Digital Subscriber Line. It can provide voice and wideband applications to residences over a single copper pair.
ARMIS	Automated Reporting Management Information System. A financial report filed by ILECs with the FCC.
BLS	United States Bureau of Labor Statistics
CCF	Carrying Charge Factor. A device for converting investments into recurring expense levels.
CSA	Carrier Serving Area.
DLC	Digital Loop Carrier.
GAAP	Generally Accepted Accounting Principles.
HDSL	High-Bit-Rate Digital Subscriber Line. It can convert two copper pairs into a higher-capacity link.
IDLC	Integrated Digital Loop Carrier. One of two ways (the other is Universal DLC) by which DLC loops can interface with a digital switch.
ILEC	Incumbent Local Exchange Carrier. The LEC, formerly a monopoly, that has historically served in a particular area.
ISDN	Integrated Services Digital Network. An advanced technology that permits end-to-end transmission of signals in digital format.
LEC	Local Exchange Company.
NRC	Non-Recurring Charge.
PRP	Performance Regulatory Plan. The regulatory plan approved for New York Telephone in Case 92-C-0665.
SCIS	Switching Cost Information System. A model, maintained by Bellcore, for pricing switches.
SONET	Synchronous Optical Network. A system for deploying high capacity fiber optic systems.

[1] Omitted from this list are some commonly used acronyms representing the names of parties or government agencies.

TELRIC	Total Element Long Run Incremental Cost. A term coined by the FCC for its adaptation of the TSLRIC costing standard to the costing of network elements.
TFP	Total Factor Productivity.
TSLRIC	Total Service Long Run Incremental Cost. A costing construct that attempts to determine the cost of providing the entire increment of a service demanded by the firm's customers.
UDLC	Universal Digital Loop Carrier

		Equipped Lines 12/31/94	Working Lines June 95	Book Amount 12/31/94	Working Line Calculation Book Amount 12/31/94	Investment Per Equipped Line	Investment Per Working Line
77th St -- RSC	1	979	--	327,750	--	$334.78	--
Armonk -- RSC	2	5,600	5,817	420,365	420,365	$75.07	$72.26
Ballston Spa -- 5RSM	3	9,815	9,565	3,240,650	3,240,650	$330.17	$338.80
Chittenango -- SRSC	4	4,494	4,281	1,409,325	1,409,325	$313.60	$329.20
Clintondale -- 5RSM	5	3,111	3,025	1,027,250	1,027,250	$330.20	$339.59
Eden -- 5RSM	6	3,023	2,896	998,200	998,200	$330.20	$344.68
E 79th St. -- D100	7	39,389	43,460	11,775,885	11,775,885	$298.96	$270.96
Greenwich Co. -- 5RSM	8	8,480	--	2,800,000	--	$330.19	--
Greenwich Co. -- 5ES	9	39,077	37,062	11,851,700	11,851,700	$303.29	$319.78
Guilderland -- D100	10	28,776	26,895	8,602,920	8,602,920	$298.96	$319.87
Hauppauge -- 5ORM	11	765	--	262,500	--	$343.14	--
Holley -- RSC	12	3,325	3,383	1,113,660	1,113,660	$334.94	$329.19
Hunter -- SRSC	13	1,551	1,374	486,450	486,450	$313.64	$354.04
Jamaica -- RSC	14	1,251	--	419,175	--	$335.07	--
Jordan -- SRSC	15	4,252	3,947	1,333,425	1,333,425	$313.60	$337.83
Latham -- 5ES	16	21,951	20,012	6,657,700	6,657,700	$303.30	$332.69
Lewiston -- RSC	17	4,241	4,285	1,000,000	1,000,000	$235.79	$233.37
Maine -- RSC	18	1,629	1,575	545,790	545,790	$335.05	$346.53
Melville -- 5ORM	19	485	--	166,250	--	$342.78	--
Middleport -- 5RSM	20	2,320	2,349	766,150	766,150	$330.24	$326.16
Newfane -- 5RSM	21	3,547	3,544	1,171,100	1,171,100	$330.17	$330.45
North Collins -- 5RSM	22	2,121	2,074	700,350	700,350	$330.20	$337.68
Orchard Park -- 5RSM	23	9,982	10,079	3,295,950	3,295,950	$330.19	$327.01
Pittstown -- SRSC	24	1,199	1,129	376,050	376,050	$313.64	$333.08
Portchester -- D100	25	31,918	30,097	10,140,240	10,140,240	$317.70	$336.92
Springville -- 5RSM	26	4,882	4,755	1,612,100	1,612,100	$330.21	$339.03
Stanfordville -- 5RSM	27	1,319	1,328	435,400	435,400	$330.10	$327.86
Syra. S. Salina -- 5ES	28	17,078	14,636	5,179,650	5,179,650	$303.29	$353.90
Troy 4th St. -- D100	29	35,459	30,720	10,600,815	10,600,815	$298.96	$345.08
Utica -- 5ES	30	58,755	50,815	17,819,900	17,819,900	$303.29	$350.68
Wappingers Fls -- 5ES	31	15,109	13,899	4,582,550	4,582,550	$303.30	$329.70
Westerlo -- SRSC	32	1,183	1,097	370,875	370,875	$313.50	$338.08
Wingdale -- 5RSM	33	2,218	2,166	732,200	732,200	$330.12	$338.04
Alby Washington -- 5ES	34	51,234	44,001	15,538,950	15,538,950	$303.29	$353.15
Amherst -- 5ES	35	35,542	32,219	10,779,650	10,779,650	$303.29	$334.57
Clarksville -- SRSC	36	909	825	284,970	284,970	$313.50	$345.42
Fairview -- SRSC	37	590	--	184,920	--	$313.42	--
Kerhonkson -- 5RSM	38	3,891	3,845	1,284,850	1,284,850	$330.21	$334.16
Ticonderoga -- RSC	39	3,613	3,195	350,641	350,641	$97.05	$109.75
Tratman Ave -- 5ES	40	25,440	--	7,715,750	--	$303.29	--
Tuckahoe -- D100	41	41,500	35,504	10,600,000	10,600,000	$255.42	$298.56
Yonkers - D100	42	78,500	68,751	8,010,100	8,010,100	$102.04	$116.51
Total -- Original 33 Switches		369,284	336,265	112,222,325	108,246,650	$303.89	$321.91
Total -- All 42 Switches		603,924	518,788	166,224,041	154,675,446	$275.24	$298.15
Total -- 41 Switches (Excluding Yonkers)		525,424	450,037	158,213,941	146,665,346	$301.12	$325.90
Total -- 38 Switches (Excluding Yonkers, Armonk, Lewiston & Ticonderoga)		517,570	442,557	156,863,300	145,314,705	$303.08	$328.35

Note: Equipped Lines and Investment Amounts are from the 2/5/95 Depreciation Represcription Report.

Note: Working Lines are from the June 1995 NYNEX Access Service Planning Guide. Seven switches were dropped from the investment per working line calculations since working lines for those switches were not listed in the Planning Guide.

Explanation for the 5.72% Reduction in Switch Prices

* Staff relied upon the annual per line switch prices for RHCs from the McGraw Hill study (Exhibit 144) in order to develop the 5.72% factor.

* Table 3-37 in section 3.5 of the McGraw Hill study (exhibit 144) lists per line digital switch prices for the RHCs for 1994 through 1999.

* The RHC per line switch prices were $105, $102, $99 and $96 for 1994, 1995, 1996 and 1997, respectively.

* Staff estimated a $108.18 per line switch price for 1993, by increasing the 1994 per line figure of $105 by 2.9429%. 2.9429% was the average decrease in switch prices for the RHCs from 1994 through 1997.

* The decrease in RHC switch prices from $108.18 per line in 1993 to $102 per line in 1997 is 5.7159%.