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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: Docket No. 96-115

Dear Ms. Salas:

The Association of Directory Publishers hereby submits the attached material and is forwarding a copy of it to the following individuals in the Common Carrier Bureau and Office of General Counsel.

Please direct any questions regarding this notification to Michael Finn or David Goodfriend, counsel for The Association of Directory Publishers, at (202) 328-8000.

Sincerely,

Michael F. Finn

Enclosure

cc: Richard Welch
James D. Schlichting
William A. Kehoe, III
Patrick Donovan
Jay M. Atkinson
Douglas Galbi
David A. Konuch
Tanya Rutherford
Dorothy Attwood
Blaise A. Scinto

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List ABCDE

Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20036-3384
202 328 8000

Telex: RCA 229800
WU 89 2762
Fax: 202 887 8979

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I. Introduction and Summary.

Section 222(e) of the Communications Act ("Act"), 47 U.S.C. § 222(e), mandates that local exchange carriers ("LECs") provide their subscriber list information ("SLI") -- name, address, telephone number, and business classification -- to telephone directory publishers at "reasonable" rates. It is bedrock Commission precedent that a reasonable rate is one based on cost. Given the Commission's long history of using cost as the touchstone for calculating a reasonable rate, Congress' use of the term "reasonable" in Section 222(e) is presumed, absent a contrary indication, to signify that SLI prices are to be cost-based. Thus, unless Congress expressly provides otherwise -- and it did not -- the traditional definition of "reasonable" continues to control the agency's actions. Moreover, even if the Commission were to ignore Congress' use of its own terminology, courts consistently have favored cost-based rates under the "reasonable" standard. In short, Congress' use of "reasonable" rates in Section 222(e) obligates the Commission to set SLI rates that are cost-based.

II. The Commission Consistently Has Interpreted "Reasonable" Rates to Be Cost-Based Rates.

Since the inception of the Act, the Commission repeatedly has interpreted a reasonable rate to be one that is based on cost: "ascertainment of the actual cost of providing services underlies the requirement that rates be just, reasonable, and nondiscriminatory."[1] The number of Commission decisions illustrating this point are too great to present here.[2] Instead, several illustrative examples show that the Commission's use of cost as the touchstone of reasonable rates is so deeply rooted as to become a term of art.

A. The AT&T Seven-Way Cost Study.

In 1965, responding to concerns over rate increases, the Commission asked AT&T to submit what has since been called the "Seven-Way Cost Study." The study addressed, among other things, AT&T's rate of return for several services which were in direct competition with services offered by other carriers. In the roughly ten years following that study, AT&T repeatedly filed significant rate increases, prompting the Commission to suspend the revised tariffs and engage in further inquiries into the underlying costs attributable to AT&T's services.[3]

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1 See AT&T Long Lines Dept., *Memorandum Opinion and Order*, 61 FCC 2d. 587, ¶ 66 (1976). See also id. at ¶ 70 ([I]t is manifest that costs have played a predominant role in determining whether rates are just and reasonable under our statutory standards."); ¶ 72 ("the recognition of costs as providing primary underlying support for determining the lawfulness of rates and rate structures has been established").

2 See, e.g., Material to be Filed in Support of 1998 Annual Access Tariff Filings, *Tariff Review Plans*, DA 98-546, at ¶ 36 (rel. Mar. 25, 1998) (under small company rules for access tariff filings, "a LEC is required to propose rates based on cost"); 1993 Annual Access Tariff Filings, *Memorandum Opinion and Order*, CC Doc. Nos. 93-193, 94-65, at ¶ 24 (Rel. April 17, 1997) (discussing permissible recovery of LECs' common line costs).

3 See AT&T Long Lines Dept., *Memorandum Opinion and Order*, 61 FCC 2d. 587, ¶¶ 11-23 (1976); *Second Memorandum Opinion and Order*, 64 FCC 2d. 971 (1977); *Second Order on Reconsideration*, 67 FCC 2d. 1441 (1978).

The Commission consolidated these inquiries regarding multiple services into a single docket which fundamentally addressed whether AT&T's rates were lawful under the Act.[4] In making such determination, the Commission stated that:

> [t]he importance of costs has long been recognized in our determination of the lawfulness of rates of telecommunications services. It thus follows that our determination of the lawfulness of the rate levels of the major interstate service categories at issue herein, must be justified in relation to the cost of furnishing the particular service.[5]
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> * * *
>
> We emphasize that ascertaining relevant costs is essential to our primary ratemaking responsibilities under the Act-- the determination of whether rates are just, reasonable, and not unduly discriminatory.[6]

The Commission adopted the fully distributed cost ("FDC") method to determine AT&T's underlying costs and, by extension, the "zone of reasonableness" within which rates could be considered "reasonable" under the Act.[7] In so doing, the Commission observed that, while imperfect, the FDC method would be "consistent with long-standing Commission policy which recognizes the central role of costs in determining the lawfulness of rates. . . ."[8] In sum, the Commission held that the Act's "reasonable" rate requirement obligated the agency to

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4 AT&T Long Lines Dept., *Memorandum Opinion and Order*, 61 FCC 2d. at ¶ 27.

5 Id. at ¶ 67.

6 Id. at ¶ 73.

7 Id. at ¶ 184.

8 Id.

examine exhaustively AT&T's underlying costs in order to determine whether AT&T's rates satisfied the reasonableness requirement.

B. Rate of Return Regulation.

One method by which the Commission has ensured that rates are "reasonable" has been to prescribe a carrier's rate of return. As noted by the D.C. Circuit, "[r]ate of return regulation is based directly on cost."[9] According to the court, rate of return regulation, in theory, duplicates the tendency of perfectly competitive markets to drive prices down to cost.[10]

Under rate of return methodology, the calculation of a permissible rate begins with an estimation of the operating costs and the addition of the cost of capital. These inputs are then analyzed under the following equation:

$$\mathbf{R = C + r(I)}$$

(where R = total revenue requirement, C = operating costs, r is the rate of return, and I = the rate base.)[11]

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9 National Rural Telecom Ass'n. v. FCC, 988 F.2d 174, 177 (D.C. Cir. 1993) ("NRTA").

10 Id. at 178.

11 Illinois Bell Telephone v. FCC, 988 F.2d 1254, 1258-59 (D.C. Cir. 1993) ("Illinois Bell") (affirming Commission rate prescriptions).

The rate of return equation may be stated another way:

$$\mathbf{R = E + (V\text{-}d)r}$$

(where R = revenue requirement, E = annual expense, V = gross investment, d = depreciation, and r = rate of return).

The rate of return method is inherently tied to cost in several respects. Operating costs, C, are expressly used to determine the revenue requirement, R, and there is a direct correlation between the two. That is, if operating costs increase, so too must revenues. Moreover, the Commission derives the rate base, I, from historical costs.[12] Finally, rate of return, r, is determined using the cost of debt and the cost of equity capital.[13]

The Commission repeatedly has adjusted the means of calculating regulated entities' rate bases and allowable expenses because "these areas are crucial to [the Commission's] assessment of a carrier's rates under a rate of return method . . . and because carriers are allowed to recover their recognized expenses from ratepayers."[14] Thus, the rate of return method is inherently tied to cost. By using this method to determine whether common carriers are complying with the Act's "reasonable"

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12 Id. The direct correlation between permissible rates and cost led to so-called "gold-plating" by regulated entities, prompting the Commission to adopt incentive-based regulation, Price Caps, discussed in the following "Price Caps" section.

13 See 47 C.F.R. §§ 65.301-306.

14 Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Base and Net Income of Dominant Carriers, *Report and* Order, 3 FCC Rcd 269, ¶ 3 (1987), *Order on Reconsideration*, 4 FCC Rcd 1697 (1989); see also Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Services, *Order*, 5 FCC Rcd 7507 (1990), *Memorandum Opinion and* Order, 6 FCC Rcd 7193 (1991), aff'd sub nom Illinois Bell, 988 F.2d 1254 (D.C. Cir 1993).

rate requirement, the Commission has equated "reasonable" rates with cost-based rates.[15]

C. **Price Cap Regulation.**

In 1990, the Commission began to move away from rate of return regulation and toward the "Price Cap" method of regulating rates for the largest LECs.[16] The Commission did so in recognition of certain inefficiencies created by rate of return regulation, particularly LECs' incentives to increase underlying costs in order to justify rate increases.[17] In adopting Price Caps, the Commission maintained its belief that costs were the statutory touchstone of the reasonable rate standard.

Specifically, Price Cap regulation allows the Commission to establish a rate ceiling for a "basket" of services, thereby granting the LEC discretion to price services within a basket, provided the sum of prices within a basket does not exceed the ceiling. The LEC retains a portion of its earnings resulting

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15 See, e.g., Beehive Telephone Company, *Order Designating Issues for Investigation*, CC Doc. No. 97-249, at ¶¶ 2-4 (Rel. Mar. 13, 1998) (small carrier subject to rate of return regulation must file cost-of-service studies; Commission found rates unreasonable where reported costs too high).

16 See Policy and Rules Concerning Rates for Dominant Carriers, *Second Report and Order*, 5 FCC Rcd 6786 ¶¶ 1, 21 & 26. (1990) ("Price Cap Order"); *Report and Order and Order on Further Reconsideration and Supplemental Notice of Proposed Rulemaking*, 6 FCC Rcd 4524 (1991); *Memorandum Opinion and Order on Second Further Reconsideration*, 7 FCC Rcd 5235 (1992); aff'd sub nom. NRTA, 988 F.2d 174 (D.C. Cir. 1993).

17 Such concern is further proof that rate of return regulation is cost-based.

from increased efficiencies (i.e., lower underlying costs).[18] The Price Caps periodically are updated to ensure that the Price Cap formulas comport with market realities.[19] The Commission surmised that this system would create an incentive to lower costs.[20]

Price Caps are not a departure from cost-based ratemaking. First, in establishing the initial baseline for the Price Caps, the Commission used then-existing rates established under the rate of return methodology.[21] Thus, cost-based methodologies underlie the original Price Caps. Second, in establishing the formula to calculate future Price Cap levels, the Commission included "exogenous costs," reasoning that by setting price limits based on "changes in input costs," the Commission would ensure that prices would remain within a "zone of reasonableness."[22] Third, the Commission's periodic revisions of the Price Caps requires an examination of actual costs.[23] Given the above, it should be uncontroverted that Price Cap regulation

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18 Id. at ¶¶ 3, 7, 11.

19 Id. at ¶ 2.

20 Id. at ¶ 22.

21 LECs subject to Price Cap regulation were to use July 1, 1990 rates as a basis for their first Price Cap filing. Id. at ¶ 17.

22 Price Cap Order at ¶¶ 48-49.

23 See NRTA, 988 F.2d at 178.

is a cost-based regulation.[24]

D. Post-1996 Act Tariff Filings.

The Commission has continued to interpret the Act's reasonable rate requirements to mandate cost-based rates. For example, in June of 1997, certain incumbent local exchange carriers ("ILECs") filed tariffs for their 1997 access charges. Suspecting unlawful rates, the Common Carrier Bureau suspended the tariffs and initiated an investigation to determine whether the ILECs' practices under the new Access Charge Reform Order[25] and Other Billing and Collection Order[26] comported with the statutory reasonable rate standard.[27]

The Commission concluded that certain ILECs had engaged in "unreasonable practices" in violation of the Act and in response to this the Commission prescribed "just and reasonable solutions . . . ."[28] Particularly relevant was the requirement that certain ILECs change their cost estimates. For example, the Commission originally had allowed ILECs to amortize equal access expenses but, under Price Caps, it allowed these amortized costs

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24 Price Cap Order at ¶ 401. The Commission concluded that its Price Cap plan was lawful because, inter alia, the plan "reflects cost changes. . . ." Price Cap Order at ¶ 402.

25 Access Charge Reform, *First Report and Order*, 12 FCC Rcd 15982 (1997).

26 Amendment of Part 36 of The Commission's Rules, *Report and Order*, 12 FCC Rcd 2679 (1997).

27 1997 Annual Access Tariff Filings, *Memorandum Opinion and Order*, FCC 97-403 at ¶¶ 1, 2 (rel. Dec. 1, 1997) ("Access Tariff Order").

28 Access Tariff Order at ¶ 4.

to be included in the traffic sensitive basket. When the Commission reformed access charges, it required these costs to be removed from any rate calculations because the amortization period had lapsed.[29]

In the Access Tariff Order, the Commission sought once and for all to remove "amortization costs in a manner that results in just and reasonable rates"[30] and to "ensure that ratepayers are not paying charges based upon costs that have already been fully recovered."[31] Thus, as recently as 1997, the Commission endeavored to have rates accurately reflect costs in order to comply with the statutory "reasonable" standard.

III. By Using the Term "Reasonable" in Section 222(e), Congress Is Presumed To Have Known And Applied The Commission's Long-Standing Construction of "Reasonable."

The discussion above demonstrated that Commission precedent equates a reasonable rate under the Act with a cost-based rate. Given the long line of Commission decisions, Congress' requirement that SLI rates be "reasonable" reflects its desire that such rates be based on cost.

As held by the Supreme Court, Congress' "failure to repeal or revise [a] statute in the face of such administrative interpretation is persuasive evidence that that interpretation is the one intended by Congress."[32] Consequently, the fact that

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[29] Access Tariff Order at ¶¶ 103-105.

[30] Id. at ¶ 112.

[31] Id. at ¶ 103 citing Access Charge Reform Order at ¶ 302.

[32] CBS v. FCC, 453 U.S. 367, 385 (1981)(quoting Zemel v. Rusk, 381 U.S. 1, 11 (1965)).

Congress did not repeal or revise the "reasonable" standard in Section 222(e) confirms the Commission's numerous decisions that a reasonable rate is a cost-based rate.

This conclusion is bolstered by the fact that Congress did not alter the "reasonable" standard in Section 222(e) when enacting the Telecommunications Act of 1996. It is well established that:

> [Where] Congress is presumed to be aware of an administrative or judicial interpretation of a statute[,] [it] adopt[s] that interpretation when it re-enacts a statute without change. . . . So too, where . . . Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute.[33]

Congress, by not interfering with the term "reasonable" in Section 222(e), endorsed the Commission's view that a "reasonable" rate is a cost-based rate.[34] That conclusion is supported by the Supreme Court, which has said that:

> [Where] an agency's statutory construction has been 'fully brought to the attention of the public and the Congress,' and the latter has not sought to alter that interpretation although it has amended the statute in other respects, then presumably the legislative intent has been <u>correctly discerned</u>.[35]

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33 <u>Lorillard v. Pons</u>, 434 U.S. 575, 580-81 (1978).

34 Where Congress desired to amend the Commission's interpretation of "reasonable," it did so explicitly. <u>See</u>, <u>e.g.</u>, 47 U.S.C. § 252(d)(1)(A)(i) (reasonable rate under this provision shall be cost-based but "determined without reference to a rate-of-return or other rate-based proceeding").

35 <u>North Haven Bd. of Educ. v. Bell</u>, 456 U.S. 512 (1982) (emphasis added); <u>see</u> <u>Lindahl v. OPM</u>, 470 U.S. 768 (1985) (30 year judicial gloss on statutory section gives rise to presumption that judicial standard has been embodied into

Thus, Congress intended the term "reasonable" in Section 222(e) to incorporate the Commission's long-standing view that a "reasonable" rate is a cost-based rate. A Commission departure from this interpretation would run counter to its own historical course. More importantly, it would mark a deviation from Congress' expectation and justified reliance in passing both the 1996 Act[36] and Section 222(e).[37] Specifically, Congress intended the Commission to continue interpreting its authorizing statute to enable new competitors to obtain vital subscriber list information at reasonable rates based on cost in order to generate vigorous competition in the directory publishing market.[38]

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the section by Congressional amendment of statute without amendment of section in question).

36 The 1996 Act was enacted "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition . . . ." S. Conf. Rep. No. 104-230, at 1 (1996).

37 Congress, in enacting Section 222(e), recognized that LECs' prices for SLI were too high. See H.R. Rep. No. 204, 104th Cong., 1st Sess. at 89 (1995) (House report accompanying H.R. 1555) ("some LECs have charged excessive and discriminatory prices for subscriber listings").

38 ADP recognizes that passive Congressional acquiescence -- as opposed to explicit ratification -- does not bind immutably the implementing agency to its prior interpretations. See Chisholm v. FCC, 538 F.2d 349 (D.C. Cir. 1976). In reversing its own long-held policies and definitions, the Commission must, however, provide "'an opinion or analysis indicating that the standard is being changed and not ignored, and assuring that it is faithful and not indifferent to the rule of law.'" See id. at 364.

IV. Even if the Commission's Precedents Did Not Indicate That A Reasonable Rate is Cost-Based, Judicial Constructions of "Reasonable" Would Compel A Cost-Based Rate Under Section 222(e).

Assuming, arguendo, that the Commission were interpreting "reasonable rate" on a blank slate, the judicial construction of statutory "reasonable" standards would compel cost-based pricing of SLI under Section 222(e). The connection between "reasonable" rates and cost has been expressly drawn by the D.C. Circuit with respect to the Commission's ratemaking. According to the court, "a basic principle used to ensure that rates are 'just and reasonable' is that <u>rates are determined on the basis of cost</u>."[39] Moreover, the Court has stated that the Commission must "specifically justify any rate differential that does <u>not</u> reflect cost."[40]

In the landmark case of <u>Hope Natural Gas</u>,[41] the Supreme Court stated that a statutorily mandated "reasonable" rate must produce "enough revenue not only for operating expenses but also for the capital costs of the business."[42] In applying the <u>Hope</u>

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39 <u>ALLTEL Corp. v. FCC</u>, 838 F.2d 551, 557 (D.C. Cir. 1988) (citing cases) (emphasis added). <u>See also MCI Telecommunications Corp. v. FCC</u>, 675 F.2d 408, 410 (D.C. Cir. 1982) (cost-based rates conform with section 201(b)'s 'just and reasonable' requirement).

40 <u>Competitive Telecommunications Assn. v. FCC</u>, 87 F.3d 522, 529 (D.C. Cir. 1996) (emphasis added).

41 <u>Federal Power Commission, et al. v. Hope Natural Gas Co.</u>, 320 U.S. 591, 603 (1944) ("<u>Hope Natural Gas</u>" or "<u>Hope</u>").

42 <u>Hope Natural Gas</u>, 320 U.S. at 603. Moreover, to ensure that the enterprise can remain viable and attract sufficient capital, the equity owner's return should be similar to returns on "investments in other enterprises having corresponding risks." <u>Id.</u>

standard, Courts consistently have returned to cost as a basis for determining "reasonable" rates.[43] The ILECs themselves have argued in favor of cost-based pricing for unbundled network elements under the Hope standard.[44] Thus, in establishing the bounds within which an agency may regulate rates under the "reasonable" standard, courts repeatedly refer to cost as a basis for establishing "reasonable" rates. The Commission, of course, must obey such holdings.

V. Conclusion.

The Commission must mandate cost-based rates for SLI under Section 222(e). For decades, the Commission has interpreted the "reasonable" standard under the Act to require cost-based rates. Congress could have altered this construction in enacting Section 222(e) but chose not to do so. The law in such situations is clear: Congress intended to maintain the interpretation of "reasonable" as cost-based. Moreover, independent of the

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43 See, e.g., Duquesne Light Company et al. v. Barasch, 488 U.S. 299, 315 (1989) (despite judicial deference to agency's choice of methodology, agency could not change methods ad infinitum; here, agency avoided that pitfall by basing rates on "historical cost"); Illinois Bell, 988 F.2d at 1262 (Commission's rates conformed with Hope standard because, inter alia, the Commission "considered the cost of equity" for similarly situated firms).

44 E. Sanderson Hote and Stephen Ruscus, Taking Aim at the Takings Argument: Using Forward-Looking Pricing Methodologies to Price Unbundled Network Elements, 5 CommLaw Conspectus 231, 239 (Summer, 1997) citing GTE Takings Rep. Before the Florida Pub. Serv. Comm'n. at 32-33 (1996) (ILECs argued that pricing for UNEs must guarantee recovery of all prudently incurred costs and, under Hope Natural Gas, the utility's rates must account for capital costs as well as operating expenses).

Commission's precedents, well-established judicial interpretations of statutory "reasonable rate" standards also compel the Commission to adopt cost-based rates for SLI pursuant to Section 222(e).