cost analysis that there is excessive common line cost recovery on the basis of fixed, subscriber line charges, CALLSII proposes to lower the line charges (or not institute the increases) but to recover those costs from the carrier common line pool or the multiline business PICC. This shows that the members of CALLS have no intention of allowing the result of the cost proceeding to prevent the over-recovery of cost.

III. CURRENT COST RECOVERY IN THE FEDERAL JURISDICTION IS EXCESSIVE

The CALLS proposal is based on an incorrect premise about the subscriber line charge and its relationship to other rates. It assumes, incorrectly, that the current recovery of costs in the federal jurisdiction is inadequate to cover the costs properly assigned to it.

A. FORWARD LOOKING COSTS

1. The Synthesis Proxy Cost Model

The economic evidence before the Commission shows that the current recovery of costs is excessive. The Commission acknowledges that the Joint Board has not reached a conclusion about the existence of subsidies in the current recovery of common-line revenues.

> The Joint Board, however, made no finding as to whether implicit support exists in interstate access rates, or whether the Commission should make such support explicit if it does exist. (Joint FNPRM, ¶ 42).

We arrive at this empirical result in the following fashion. Exhibit 2 is based on the cost of loop and port as calculated by the SPCM at the wire center level. It shows the cumulative percentage of lines falling below a specific dollar figure.

The statewide average for Texas is $18.22 per month. Since 25 percent of these costs have been allocated to the Federal Jurisdiction, the Federal charges should cover $4.55 per month. Similar estimates for over a dozen states representing almost two-thirds of the lines in the country are presented in Exhibit 3. This analysis shows that Texas is typical of the nation.

Before we estimate how much is collected from residential ratepayers in Texas, there is one observation we would like to make. These data are somewhat old, apparently reflecting 1996 line counts and costs. For example, the data imply that only 4 percent of households have second lines. This would be consistent with 1996 data. By 1997, which is the latest period for which the FCC has data, the percentage on a national basis had increased to about 12 percent.[16] In the 18 months since then, the momentum for second lines has increased. SBC is one of the leaders in selling second lines. For the purpose of this analysis, we use a conservative figure of 20 percent[17] for second lines. This is particularly appropriate since the impact of the FCC decisions that would flow from the instant proceeding will be next year and beyond.[18]

The addition of second lines has a dramatic effect on loop costs. The incremental cost of providing the second line is considerably lower than the first, because most of the capital equipment is deployed. This is especially true of loop and port costs. Consider the following example, which we believe is reasonable. Assume that second line penetration has moved from 4 percent to 20 percent. This assumption is supported by a recent national survey that indicated 24 percent of respondents have a second line.[19] Further assume that the second line costs half as much as the first line. This is a conservative assumption supported by testimony before the FCC

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[16] Federal Communications Commission, Trends in Telephone Service (February, 1999), table 20.4

[17] *See* Application of Southwestern Bell Telephone Company for Rate Group Reclassification Pursuant to Section 58.058 of the Texas Utility Code, (Jan. 26, 1999), General Counsel Exhibit No. 1 at pg. 23. SWBT indicates that improved marketing of additional [second] phone lines resulted in sales which accounted for approximately 14% of new access line in 1993, 18% of new access lines in 1994, 25% of new access lines in 1995, and 29% of new access lines growth in 1996, in Texas. A recent national survey conducted for Joint Consumer Commentors indicates that 24 percent of respondents have more than one line. This is consistent with the assumed 80% primary and 20% non-primary lines.

[18] Trends, Table 20.4, gives year end figures of 114.4 million for residential loops and 17.9 million for additional lines. The figure of 20% for year end 1999 is derived from setting second lines at approximately 25 million and total lines at 123 million. This acceleration of second lines is consistent with the acceleration in Texas as noted in footnote 8.

[19] The October 1999 national survey was conducted by Opinion Research Corporation for Joint Consumer Commentors. The results of this survey are discussed in the Reply Comments, In the Matter of Low-Volume Long-Distance Users, CC Docket No. 99-249 (October 20, 1999).

and the cost model itself. The statewide average cost for loop and port in Texas would decline from $18.20 to $16.60. In other words the average cost recovery in the federal jurisdiction should be closer to $4.15.

If the Commission implements its decision to utilize forward-looking economic costs and treat the loop as a common cost, it must conclude that fixed end-user charges (*i.e.*, the subscriber line charge and the PICC) should not be increased but decreased.

- Based upon the results of the default runs of the Synthesis Cost Proxy Model for Texas, we conclude that at least 80 percent of residential lines in Texas are covering 100 percent of the forward looking economic costs of loops and ports (*i.e.*, the non-traffic sensitive portion of costs) that are allocated to the Federal jurisdiction.

Exhibit 4 presents our estimate of the amount collected from residential customers for access in the federal jurisdiction. We assume that 80 percent of the lines in the state are first lines and that 20 percent are additional lines. Based upon the estimates provided by the CALLS, we estimate that in excess of $6.00 per residential account is being collected for access – including the SLC, the PICC and the CCL. In addition, about $2 billion of high cost support is already being recovered in the federal jurisdiction. Since the above analysis looks at average loop costs, that include high cost support, this adds another $.25 to $.50 per month to the over recovery of costs.[20]

The charges exceed the costs that should be recovered for the vast majority of residential lines in Texas. The federal charges should cover $4.15 to $4.55 per month. However, the federal jurisdiction is collecting over $6.00 per residential account. In other words, based on forward-

[20] The CALLS proposal seeks to "settle" the question of subsidies in other rates at the level of $650 million. This works out to about $.21 per line. In the debate over subsidies, estimates run as high three times that level.

looking economic costs, the federal jurisdiction is over recovering $1.50 to $2.00 per month from residential consumers.

Texas is used as an example because it is a large state that is very close to the national average in forward-looking costs. We reach similar conclusions for other states as well (*see* Exhibit 3). These results show that between three-quarters and nine-tenths of the residential customers already cover the loop costs allocated to the federal jurisdiction. There are a few instances of high-cost states in which a much smaller percentage of the residential customers cover the costs allocated to the federal jurisdiction. That is an issue to be addressed by high cost fund policy.

2. Unbundled Network Elements

As noted, the Commission has required that the rates for unbundled network elements (UNEs) be set on the basis of forward looking economic costs. Examining the outcome of the application of that principle at the state level reinforces our conclusion that there is an over recovery of costs in the Federal jurisdiction.

Although UNE rates are not available on a national average basis, examination of these rates on a state-by-state basis indicate that they have been set in the same range as the cost estimates generated by the SPCM. A few examples demonstrate the point.

UNE rates in Texas are $18.36 for Southwestern Bell Telephone Company (SWBT). Forward-looking costs in Texas are $19.07 for SWBT. The statewide average for all loops in Texas (for all companies covered in the FCC support analysis) is $21.38. With second line growth this number would fall into the range of $15 to $18.

We obtain similar results for Virginia and Delaware for UNEs. In comments in this proceeding TXOPC, CFA, CU demonstrated similar outcomes for other states with the SPCM results.

In summary, over-recovery of costs falls in the range of $1.50 to $2.00 per month per residential line. The total falls in the range of $2.25 to $3 billion annually. Instead of increasing the bottom-of-the-bill charges by almost $2 billion in the residential sector, charges should be decreasing by $2 to $3 billion.

B. ONGOING PROCEEDINGS AT THE FCC

The conclusion that current cost recovery in the Federal jurisdiction is excessive is also supported by the results of ongoing proceedings at the Commission. Year-after-year, when the local exchange companies report their earnings in the Federal jurisdiction, they are far above the targeted level. As demonstrated in several proceedings at the FCC, this over-recovery arises because the Commission has not established sufficient productivity goals or held the local company books up to rigorous scrutiny.

Technological progress has made the industry a declining cost industry. Over the period since divestiture, the spread of digital line carrier systems, increasing population densities, and the growth of second lines have spurred a dramatic decline in costs. The FCC has erroneously applied all of the increased productivity to the carrier common line component of the federal cost recovery mechanism since it adopted price cap regulation. This has resulted in a dramatic reduction in usage charges. As a result, the compromise that the FCC struck between recovery of federal costs on a fixed and usage basis has been destroyed. In 1984 when the subscriber line charge was instituted, the costs were split on a 50/50 basis. Today, the fixed charges exceed 80 percent of the total. This change in policy and resulting shift in cost responsibility has occurred without justification.

The audit has found phantom assets and the FCC has noted that the RBOCs report far more assets to regulators than they carry on their financial books. This raises cost recovery far in excess of where it should be (*see* Exhibit 6). For example, the audit yielded a discrepancy of $5 billion, which would generate cost recovery reductions of about $.25 billion in the federal jurisdiction. Reconciling the depreciation discrepancy between financial and regulatory books would increase the total reductions in cost recovery dramatically -- some $1.5 billion. Reinitializing rates would result in another $2.5 billion reduction.

The FCC uses a company-wide productivity factor, rather than an interstate specific productivity factor. As a result, productivity growth is vastly understated. Each year, when rates are adjusted, they are under corrected and the over earnings reappear. Using an interstate productivity factor, based on the FCC methodology, would raise the productivity factor to 10.2%, resulting in reductions of $.9 billion in cost recovery. Reinitializing the rates for underestimated productivity in the past 3 years would reduce costs recovery by another $2.9 billion.

The FCC uses a return on investment of 11.25 percent. Just getting the local exchange companies back to that level would lower cost recovery by $2.6 billion. Lowering the return to more reasonable levels would yield even larger reductions of cost recovery.

Some of the reductions identified in Exhibit 6 interact, so one cannot simply sum them to a grand total. However, the proposed reduction needed to "pay for" the restructuring is $4 billion in the first year, which could be easily accounted for by aggressive reductions in one category or moderate use of all three.

Although the FCC has routinely used any scheduled reductions in cost recovery to lower the switching rates, all of these sources of over recovery of costs apply to both loop costs and switching costs. A major source of the discrepancy between the regulated books and the financial books stems from the write off of loop costs. Loop costs have been falling because of the adoption of digital line carrier technology. Average loop costs have also been falling because of the growth of second lines, which are far lower in cost than first lines. The FCC's forward-looking cost methodology concludes that efficient loop costs would be far lower than claimed embedded loop costs.

C. IMMEDIATE AND PERMANENT REDUCTIONS IN COST RECOVERY ARE NECESSARY

Based on the evidence before the Commission, an immediate and permanent reduction in cost recovery in the Federal jurisdiction is necessary to return rates to a just and reasonable level. CALLSII proposes no reduction in rates. It lowers rates modestly in the first year but then allows them to rise dramatically in later years. Further, it raises the cost recovery in line items charged to consumers and perpetuates the gross overcharging on residential second lines.

The public relations claims of CALLS members that its proposal dramatically lower bills is not based on the regulated costs that are at issue in this proceeding. Individual companies have made private decisions about how they will recover their unregulated costs and tried to tie those decisions to the CALLS proceeding. The Commission cannot cite such actions in demonstrating that the rates it regulates are just and reasonable, since such commitment are irrelevant and, in any case, not binding.

IV. SERVICES THAT USE THE LOOP MUST PAY A REASONABLE SHARE OF ITS COSTS

Both CALLS proposals anticipate the use of the loop by Interexchange Carriers (IXCs) without paying for it. In our view, this violates section 254 (k) of the 1996 Act, which requires that competitive services not be cross subsidized and that basic service bear no more than (and perhaps less than) a reasonable share of joint and common costs. In our view, the loop is a shared cost between all of the services that use it. Therefore, long distance service must bear a reasonable share of such costs.

In this proceeding, the vast majority of phone companies share our view that the uncompensated use of loop facilities to provide long distance services violates section 254 (k) of the Act. In their comments in this proceeding, the small local exchange companies directly oppose the arguments of the large ILECs that support the uncompensated use of the loop. They challenge the economic argument that IXCs do not cause costs. Several parties remind the Commission that the loop is a shared cost of local and long distance service. The small local exchange companies also challenge the legal sophistry of not defining long distance as a service under 254 (k).

A. SHARING OF COSTS BETWEEN SERVICES THAT USE JOINT AND COMMON FACILITIES IS SOUND ECONOMIC AND PUBLIC POLICY.

Conceptual definitions of costs, analysis of the historic patterns of investment and current, real world activity all indicate that the distribution plant is a shared facility whose costs should be recovered from all services that use it.

1. Conceptual Definitions of Cost

Joint Commentors have consistently argued that the loop is a common cost for all telecommunications services that utilize it.[21]

The Commission has adopted a cost and pricing methodology that recognizes the fundamental economics of the modern telecommunications network. This approach involves (1) the recognition of the telecommunications network as a multi-product undertaking exhibiting strong economies of scale and scope; (2) the treatment of the loop as a common cost; and (3) the comprehension of competitive market behavior. The economic evidence that the telecommunications network is a multi-product enterprise enjoying economies of scale and scope is overwhelming.

- On the supply-side all long distance calls use the network exactly the same way local calls do. Vertical services (like Call Waiting, Call Forwarding and Caller ID) are supported by all parts of the network. Basic service accounts for about one-quarter of total revenues generated per line because the line is shared by an ever-increasing array of services.

- The demands on shared facilities are likely to accelerate as advanced services begin to share in the use of these facilities.

- On the demand-side, customers expect to receive long distance service when they order telephone service. Vertical services are strong complements of basic service. If a provider sells basic service to a customer, competitors are very unlikely to sell that customer Call Waiting.

- Companies are eager to sell local service and long distance service bundled together. One-stop shopping is an integral part of providers' business plans.

[21] "Initial Comments of the Texas Office of Public Utility Counsel," In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45, April 12, 1996, p. 6. Initial Comments of the Texas Office of Public Utility Counsel," In the Matter of Implementation of Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, May 16, 1996, pp. 21-22.

In such a bundle, why is local cost the "cost causer", as the LECs and IXCs claim?

A reasonable basis to determine the allocation of shared costs is to analyze the facilities and functionalities necessary and actually used in the production of goods and services. In order to produce a long distance call IXCs need distribution plant, as well as switching plant and transport plant. Instead of basing economic analysis on a guess about what consumers really wanted when they purchased a bundle of services, the Commission should rely on a "service pays" principle. That is, services that use facilities should be considered to benefit from the deployment of those facilities and every service that uses a facility should help pay for it.

2. Historic Patterns of Investment Reveal the Fallacy of Attributing Loop Costs to only Basic Local Service

Historical analysis of why telecommunications investments were actually made shows that most telecommunications technologies were deployed for and used by business customers first. Hence, it is more reasonable to assume that those customers caused the investment. History shows that the integration of the long distance network into the local network (they actually started as two separate networks) raised the cost of the integrated network. Since the integrated network costs more as a result of the addition of long distance, it is reasonable to assume that long distance causes costs in the integrated network. In other words, complaints that business customers and long distance users pay too much actually ignore the historic pattern of cost causation.

Now that the companies are intensely competing to sell bundles of services, the fiction that local service causes the loop cost should be put to rest once and for all. In truth, since the first decade of this century, the network, including the loop, has been consciously designed to serve local and long distance. Long distance was not an afterthought; it was always a forethought, included in the design, development and deployment of the network. Vertical services have been included in economic analyses of network design and architecture for over a decade.

Although historical analysis demonstrates the fallacy of attributing loop costs to only basic local service, it is clear that efforts to unravel the network into cost causation categories are difficult. For that reason, the analysis of costs should be based on the only footing on which sensible economic analysis can be launched -- an assessment of the product, not the psychology of the customer. Regulators should analyze the facilities and functionalities necessary and actually used in the production of goods and services. They should rely on a service pays principle. That is, services that use facilities should be considered to cause the deployment of those facilities. Assumptions about prime movers are arbitrary. There should be no free rides; every service that uses a facility should be required to share in the recovery of the cost of that facility on a reasonable basis.

- As a matter of economics, costs for joint and common facilities should be recovered on the basis of the nature and quality of use that each service makes of those facilities.
- As a matter of public policy from a universal service docket perspective, recovery of joint and common costs should be structured in such a way as to promote universal service by keeping basic service affordable. Adding line items to the bottom of the bill or increasing them makes connectivity to the network more expense and less affordable.

Although some theoretical economists chafe at the thought of recovering shared costs across a range of products, common sense and real world experience demonstrates that this is the way markets work. For example, one of the Regional Bell Operating Companies made this argument in the federal universal service proceeding.[22] In a similar proceeding in Texas, one of the potential competitors also made the point that a common sense understanding of economic behavior requires the recovery of costs across all services that share facilities.[23]

Moreover, the SLC and other fixed charges make no sense in a competitive market when competitors sell bundled local, toll, and long distance service. The fictions that the FCC has established among these "classes" of service will no longer be relevant and will be unable to exist in a competitive market where the line has been blurred between jurisdictional offerings. Competitors will not be selling "local" service or "long distance"; they are and will be selling a bundled package of telephony along with cable, data and Internet services.

B. LEGAL PRINCIPLES

1. Federal and State Law

The Telecommunications Act of 1996 certainly understood the economics of the industry and sought efficient entry across a broad range of services.

- The Act promotes the deployment of advanced telecommunications services and information technologies and insists on a sharing of joint and common costs.
- The Act repeatedly recognizes that advanced services and basic service are linked.

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[22] "NYNEX Comments," before the Federal Communications Commission, <u>In the Matter Of Federal-State Joint Board on Universal Service</u>, CC Docket No. 96-45, April 12, 1996, pp. 3, 4, 5.

[23] "Reply Comments of Teleport Communications Houston, Inc. and TCG Dallas Concerning Proposed Rules on Universal Service Fund Issues," before the Public Utility Commission of Texas, <u>Investigation of Universal Service Issues</u>, Project No. 14929, October 10, 1997.

- The Act recognizes that competitive and non-competitive services will be commingled on the network and its purpose is to advance this multi-product network.

The law directly addresses the revenue responsibility of these various services. The cross-subsidy and joint cost language of 47 USC 254 (k) addresses this point.

> Subsidy of Competitive Service Prohibited – A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

This policy recognizes two distinct steps that are necessary to have fair and efficient pricing in an emerging, partially competitive environment -- a strict prohibition on below cost pricing and a reasonable recovery of joint and common costs across services that share facilities. The Conference Report states this principle more vigorously. The Conference Committee Report clarifies the standard for cost allocation by adopting the Senate report language --

> The Commission and the states are required to establish any necessary cost allocation rules, accounting safeguards, and other guidelines *to ensure that universal service bears no more than a reasonable share (and may bear less than a reasonable share)* of the joint and common facilities used to provide both competitive and noncompetitive services. [24]

In pursuit of universal basic service, this language establishes a reasonable share of joint and common costs allocated to basic service as an *upper* limit.

The FCC, the states, and the courts have found consistently and repeatedly that the loop is a common cost. The courts recognized this almost three quarters of a century ago in Smith

[24] Conference Report, p. 129, *emphasis added.*

v. Illinois.[25] Many of the states have formally recognized this in comments in federal proceedings,[26] and in their own cost dockets.[27]

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[25] 282 U.S. 133 (1930).

[26] Two of the Regional Bell Operating Companies take this point of view (Bell Atlantic and NYNEX), as do a number of state regulators: the Texas Public Utility Commission, the Nebraska Public Service Commission, the New Hampshire Public Utilities Commission, the New Mexico State Corporation Commission, the Utah Public Service Commission, the Vermont Department of Public Service and Public Service Board, and the Public Service Commission of West Virginia. In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 p. 18; "Comments of the State of Maine Public Utility Commission, the State of Montana Public Service Commission". Virtually all other Consumer Advocate commentors share this view in their initial comments. "Comments of the Idaho Public Service Commission" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, p. 17; "Comments of the Public Utility Commission of Texas" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, p. ii; "Initial Comments of the Pennsylvania Public Utility Commission to the Notice of Proposed Rulemaking and Order Establishing Joint Board" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, p. 7.; Florida, p. 22; "Initial Comments of the Virginia Corporation Commission," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, p. 5; "Comments of the Staff of the Indiana Utility Regulatory Commission" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, p. 9.

[27] "Report of Glenn P. Richardson, Senior Hearing Examiner, "pplication of GTE South Incorporated For Revisions to Its Local Exchange, Access and IntraLATA Long Distance Rates, Commonwealth of Virginia State Corporation Commission, Case No. PUVC950019, March 14, 1997, p. 84; Application of the Mountain States Telephone and Telegraph Company dong Business as U.S. West Communications, Inc., for Approval of a Five-Year Plan for Rate and Service Regulation and for a Share Earnings Program, Colorado Public Utilities Commission, Docket Nos. 90a-665T, 96A-281T, 96S-257T, Decision No. C97-88, January 5, 1997, pp. 42-43; Decision and Order Rejecting Tariff Revisions, Washington Utilities and Transportation Commission v. U.S. West Communications Inc., Docket No. UT-950200, April 11, 1996 pp. 83-84; Department of Utility Controls' Investigation Into the Southern New England Telephone Company's Cost of Providing Service, Department of Public Utility Control, Docket No. 94-10-01, June 15, 1995, pp. 24-25; Report and Order, In Re: US West Communications, Inc., Utah Public Service Commission, Docket No. 95-049-05, November 6, 1995, p. 95; Final Decision and Order, In Re US West Communications Inc., Iowa Utilities Board, Docket No. RPU-95-10, May 17, 1996, p. 295, 306; Final Decision and Order, In Re US West Communications Inc., Iowa Utilities Board, Docket No. RPU-94-1, November 21, 1994; In the Matter of the Application of GTE Southwest Incorporates and Contel of the West, Incorporated to Restructure Their Respective Rates, New Mexico State Corporation Commission, Docket NO. 94-291-TC, Phase II, December 27, 1995, pp. 11, 14-15; New England Telephone Generic Rate Structure Investigation, New Hampshire Public Utilities Commission, March 11, 1991, DR 89010, slip, op., pp. 39-40; Order No. 18598, Re: Investigation into Nontraffic-Sensitive Cost Recovery, Florida Public Service Commission, 1987; Docket No. 860984-TP, pp. 258, 265-266; Order No. U-15955, Ex Parte South Central Bell Telephone Company, Docket No. 1-00940035, Louisiana Public Service Commission, September 5, 1995, p. 12; In Re Formal Investigation to Examine and Establish Updated Universal Service Principles and Policies for Telecommunications Services in the Commonwealth, Docket No. 1-00940035, September 5, 1995, p. 12; In the Matter of a Summary Investigation into IntraLATA Toll Access Compensation for Local Exchange Carriers Providing Telephone Services Within the State of Minnesota, Minnesota Public utilities Commission, Docket No. P-999/CI-85-582, November 2, 1987, p. 33.

The failure to take legitimate joint and common costs into account would frustrate the purposes of the 1996 Act. Allowing incumbents to recover joint and common costs excessively from fixed charges on the bottom of the bill discourages efficiency and frustrates competition by allowing incumbents to price more competitive services at an artificially low level. Contrary to the basic premise of the 1996 Act, allowing incumbents to recover an unreasonable share of joint and common costs from basic service insulates incumbents unfairly from market forces.

In the residential sector alone, the CALLS proposal would transform over ten billion dollars of the cost of distribution facilities into a bottom-of-the-bill mandated federal payment to local exchange companies. Once these costs appear on the bottom of the bill, they tend to become institutionalized and are much less likely to be competed away. These line items become a floor that the industry starts with, rather than a cost to be attacked by competition.

2. The FCC's Conceptual Paradigm for Cost Recovery

In a series of recent rulings to implement the 1996 Telecom Act, the FCC has constructed a comprehensive paradigm that starts from the fundamentally correct premise that the loop is a shared cost. There should be no doubt that this is the correct treatment of loop costs and alternatives should be clearly and loudly rejected.

The FCC began in the local competition docket by recognizing that the loop is a shared cost of local, long distance and the other services that use the loop. As discussed above, separate telecommunications services are typically provided over shared network facilities, the cost of which may be joint or common with respect to some services.

> The costs of local loops and their associated line cards in local switches, for example, are common with respect to interstate access service and local exchange service, because once these facilities are installed to provide one service they are

able to provide the other at no additional cost.[28]

The FCC followed that decision with its proposed rulemaking on access charge reform, in which it reaffirmed the observation that the loop is a common cost.

> For example, interstate access is typically provided using the same loops and line cards that are used to provide local service. The costs of these elements are, therefore, common to the provision of both local and long distance service.[29]

The FCC applied this conclusion in its decision to convert the Common Carrier Line (CCL) charge into a flat rate charge to cover loop costs.

> We reject claims that a flat-rated, per line recovery mechanism assessed on IXCs would be inconsistent with section 254 (b) that requires equitable and nondiscriminatory contribution to universal service by all telecommunications providers. The PICC is not a universal service mechanism, but rather a flat-rated charge that recovers local loop costs in a cost causative manner.[30]

In the reform of the separations process, the FCC has stated the economic reasoning and analysis which underpins this treatment of the loop.

> Nearly all ILEC facilities and operations are used for multiple services. Some portion of costs nonetheless can be attributed to individual services in a manner reflecting cost causation. This is possible when one service, using capacity that would otherwise be used by another service, requires the construction of greater capacity, making capacity cost *incremental* to the service. The service therefore bears a causal responsibility for part of the cost. The cost of some components in local switches, for example, is incremental (i.e. sensitive) to the levels of local and toll traffic engaging the switch. Most ILEC costs, however, cannot be attributed

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[28] Federal Communications Commission, First Report and Order: Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, ¶678.

[29] Federal Communications Commission, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges: Notice of Proposed Rulemaking, CC Docket Nos. 96-262, 94-1, 91-213, 95-72, ¶ 237.

[30] Federal Communications Commission, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges: First Report and Order, CC Docket Nos. 96-262, 94-1, 91-213, 95-72, ¶ 104.

> to individual services in this manner because in the case of joint and common costs, cost causation alone does not yield a unique allocation of such costs across those services. The primary reason is that shared facilities and operations are usually capable of providing at least one additional service at no additional cost. In such instances, the cost is *common* to the services. For example, the cost of a residential loop used to provide traditional telephony services usually is common to local, intrastate toll, and interstate toll services. In a typical residence, none of these services individually bears causal responsibility for loop costs because no service places sufficient demands on capacity to warrant installation of a second loop. Another reason why a relationship may not exist between cost and individual services is that some shared facilities or operations provide services in fixed proportion to each other, making the cost *joint* with respect to the services. ILEC billing costs, for example, tend to be joint with respect to local, state toll, and interstate toll services. For the majority of bills rendered, billed charges always include all three services. The fixed combination of services makes it impossible for one service to bear responsibility for billing costs...
>
> Both incremental cost and stand-alone cost (which are usually expressed per unit of output) are greatly affected by the way we choose to define the increment and the service class. The incremental cost of carrying an additional call from residences to end offices, for example, is zero if the residences are already connected to end offices, but the incremental cost of establishing such connections is the cost of the loops. [31]

Moreover, the importance of ensuring the correct loop allocation cannot be overemphasized. As the FCC notes, the proper identification of loop costs is critical to telecommunications pricing because loop costs constitute almost half of all costs of local exchange carriers.[32] For example, ARMIS data indicate that loop plant investment in 1996 was 49% of total plant investment.

Most importantly, the FCC's methodology for estimating costs of basic service for

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[31] Federal Communications Commission, In the Matter of Jurisdictional Separations Reform and Referral to the Federal-State Joint Board, Notice of Proposed Rulemaking, CC Docket No. 80-286, November 10, 1997 (hereafter, Separations NPRM), pp. 14-15.

[32] Separations NPRM, p. 16

purposes of identifying high cost areas is consistent with its logic of properly allocating loop costs. Two of the ten criteria it establishes for specification of a cost model require similar treatment of joint and common costs:

> (2) Any network functionality or element, such as loop, switching, transport, or signaling, necessary to produce supported services must have an associated cost...
>
> (7) A reasonable allocation of joint and common costs must be assigned to the cost of supported services. This allocation will ensure that the forward-looking economic cost does not include an unreasonable share of joint and common costs for non-supported services.[33]

[33] FCC, Universal Service Order, ¶ 250.

V. OTHER ELEMENTS OF THE CALLS PROPOSAL RENDER IT ILLEGAL

A. ABSOLVING CARRIERS OF THEIR OBLIGATION TO MAKE A CONTRIBUTION TO UNIVERSAL SERVICE

The CALLS proposal would eliminate the clear requirement in the statute that carriers make a contribution to universal service. It shifts the entire cost of universal service onto end users. The federal statute makes no provision for the federal government to recover telecommunications service provider contributions for universal service from ratepayers in the form of a line item surcharge on ratepayers' bills. The federal statute is quite clear that it is telecommunications service providers who must contribute

> **Sec. 254.** (d) Telecommunications Carrier Contribution - Every telecommunications carrier that provides interstate telecommunications services shall contribute, on an equitable and nondiscriminatory basis... .
>
> **Sec. 254.** (f) STATE AUTHORITY - A state may adopt regulations not inconsistent with the Commissions rules to preserve and advance universal service. Every telecommunications carrier that provides intrastate telecommunications services shall contribute.

If subscribers are forced to pay a line item surcharge then telecommunications service providers are not contributing, as required by the Telecommunications Act of 1996. Federal case law has properly recognized that IXCs must bear responsibility for contributing as a cost of doing business. Claims that only a line item on a consumer's bill can meet the requirement that universal service is explicit is a thinly veiled effort to avoid the responsibility the law placed on telecommunications service providers. If a telecommunications service provider is assessed a contribution explicitly to be paid to a universal service fund administrator and pays no other universal service support in any of the prices it is charged, then the funding is explicit. The law does not say funding must be explicit to the customer, it says it must be explicit to the service provider.

As long as all providers are assessed a fair share of the costs of universal service in an explicit rate element, the requirements of the statute will be met. Assessing providers allows them to decide how to recover the universal service costs. Some might pass it through in the form of usage charges. Some might pass it through in the form of customer charges. Still others might not pass it through in an effort to gain market share.

The FCC recognizes this dynamic process in an earlier ruling in this proceeding.

> As telecommunications carriers and providers begin merging telecommunications products into single offerings, for example package prices for local and long distance service, we anticipate that they will offer bundled services and new pricing options. Mandating recovery through end-user surcharges would eliminate carrier's pricing flexibility to the detriment of consumers...
>
> In addition, we agree with the state Joint Board members that an end-user surcharge is not necessary to ensure that contributions be explicit. We find that basing contributions on end-user telecommunications revenues satisfies the statutory requirement that support be explicit because carriers will know exactly how much they are contributing to the support mechanism...
>
> As competition intensifies in the markets for local and exchange services in the wake of the 1996 Act, it will likely lessen the ability of carriers and other providers of telecommunications to pass through to customers some or all of the former's contribution to the universal service mechanisms. If contributors, however, choose to pass through part of their contributions and to specify that fact on customer's bills, contributors must be careful to convey information in a manner that does not mislead by omitting important information that indicates that the contributors has chosen to pass through the contribution or part of the contribution to its customers and that accurately describes the nature of the charge.[34]

[34]FCC, Universal Service Order, paras. 853, 854, 855.

CALLSII creates a new surcharge on the bill to support an unsubstantiated $650 million universal service fund. The recovery of this cost is left to the discretion of the ILEC as a line item either on a per line or a percentage of bill basis.[35] The result is that half of the one year reduction in the SLC can be immediately taken back by the ILEC. By the second year, the SLC charge is higher than it would be today on a primary line.

If the Commission enters into the matter of recovering universal service funds through items on consumers' bills, either implicitly by approving AT&T's shift to a percentage of bill basis or explicitly by putting a new item on the bill for ILEC USF cost recovery, it must come to terms with the question of how telecommunications service providers are making their contribution to universal service.

Unfairly shifting the burden of USF recovery to customers, violates the principles of the Act. Joint Commentors wholeheartedly reject imposing new surcharges on customers' bills while at the same time increasing customers' net bills.

B. DEAVERAGING AND DISCRIMINATORY PRICING WILL MAKE MATTERS WORSE, NOT BETTER

The CALLS proposals contemplate the deaveraging of rates for the new combined SLC/PICC. The Commission has not discussed to what extent differential SLCs are in conflict with the requirement that rates be reasonably comparable between rural and urban areas. Deaveraged rates must be found to be reasonably comparable.

[35] Modified Proposal, p. 1.

The CALLS proposal to deaverage rates is inconsistent with actual market practices and social policy as embodied in the Act of 1996, and is unnecessary if the Commission reforms the SLC in the proper fashion.

The notion that every product is sold at some deaveraged price in the market is simply wrong. Many goods are sold at uniform prices in spite of significant variations in cost. The result is not a subsidy, but a differential mark-up. Any effort by the Commission to deaverage prices will result in massive administrative exercises that companies in competitive markets do not undertake.

Moreover, to the extent that there is a substantial problem of cost difference between areas, there are other policy mechanisms to address this problem. Deaveraging SLC costs would complicate the calculation of necessary subsidies. It would complicate and perhaps violate the Congressional intention to ensure that rates be reasonably comparable between rural and urban areas. It would certainly make it more difficult for long distance companies to maintain geographically averaged rates, as required by section 254 (g) of the Act of 1996.

Joint Consumer Commentors have strenuously rejected the related suggestion that incumbent LECs be allowed to differentially price before all market segments served from common facilities are fully competitive. Incumbents will certainly use their market power to maximize their profit and competitive position. Residential ratepayers who are certain to be the last group offered competitive alternatives will suffer the greatest loss. Moreover, because access is an intermediate good, not an end product, the exercise of market power through differential pricing will significantly hurt competition.

Texas OPC took this view in the Local Competition proceeding in presenting its critique of Ramsey pricing.

> In no event should the Commission adopt Ramsey pricing as a cost allocation scheme. Ramsey pricing has positive welfare properties only under a very stringent set of assumptions. More importantly, the products should be final products not intermediate goods. Because interconnection services and network elements are intermediate goods, Ramsey pricing may well have negative welfare effects. Indeed, given the critical importance of interconnection services and network elements in the competitive strife between new and incumbent LECs, it is likely that a Ramsey pricing (cost allocation) scheme would weight the balance in favor of incumbent LECs, thus hampering rather than furthering the development of local exchange competition.[36]

Differential pricing in a market that is subject to inconsistent levels of competition should be rejected.

Ultimately, if the Commission does away with the SLC altogether, and guarantees a pass through to consumers of this immediate benefit, it will not have to deal with the problem of deaveraging the SLC.

C. RECONCILING REGULATORY AND FINANCIAL BOOKS

In yet another *Ex parte*,[37] the LECs propose to amortize the difference between the asset accounts on their regulatory books and the asset accounts on their financial books. The LECs commit to not seeking rate increases as a result of the charges against income that they will take over a five year period. We believe that there is no legitimate claim to these recovery of these costs, which have long been written off of their financial books. In our view, the excessive rate of return earned by the LECs has more than compensated them for the

[36] OPC Comments, In the Matter of Implementation of Local Competition Provisions in the Telecommunications Act of 1996, Docket No. 96-98 (May 16, 1996) p. 27.

[37] *Ex Parte to Lawrence Strickling*, from CALLS coalition, March 3, 2000.

occasional write-off of assets that all companies take. We have consistently argued this in the earlier rounds of the docketed proceeding.[38] We believe that consumer should be given rate reductions as a result of the reconciliation of these books and that is precisely what we intend to argue in the rate proceeding that must inevitably take place after the CALLS plan expires.

In the mean time, it is critical for the Commission to ensure that the bizarre treatment of these costs have no impact on access charges, UNE rates or USF distribution. In addition to the fact that access charges should not be increased as a result of the reconciliation of books, to which the LECs have agreed, the Commission's order in this proceeding must also ensure that UNE rates and USF distributions, both of which are based on forward looking economic costs, are not increased. The Commission has set its forward looking costs study on the basis of an internally consistent set of assumptions that are independent of the treatment of the historic, embedded costs at issue in the depreciation decision. The model cannot be changed on the basis of an effort to reconcile a discrepancy between regulated and financial books, which are not based on forward looking economic costs.

Furthermore, any proceeding to deal with depreciation charges must be open to public scrutiny.

D. OTHER PROMISES

The CALLS materials distributed with this proposal and the Chairman's comments indicate

[38] See, for example, "Reply Comments of The Texas Office of Public Utility Counsel," "Reply Comments of the American Association of Retired Persons, Consumer Federation of America, and Consumers Union, *In the Matter of Federal-State Joint Board on Universal Service*, FCC 96-93, CC Docket NO. 96-45, May 7, 19996.