Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	
Access Charge Reform	CC Docket No. 96-262
Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94-1

VERIZON REPLY

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I. Introduction and Summary

The Commission should allow the public interest benefits of the CALLS plan to continue by avoiding any interruption in the phasing out of carrier common line charges and presubscribed interexchange carrier charges and in the scheduled increases in subscriber line charge caps. The commenters that criticize the forward-looking cost submissions of the price cap carriers miss the point that these studies are not the standard for determining whether to go forward in implementing the CALLS plan. As Verizon noted, price cap maximum rates are not based on forward-looking costs, or on any costs at all – they are the product of a pricing regime designed to provide incentives for carriers to become more efficient than they would under Commission-prescribed, cost-based rates while passing along some of the benefits of these increased efficiencies to ratepayers. Moreover, the adjustment to the subscriber line charge caps under CALLS is a revenue neutral realignment of rates – any increase in the subscriber line charge will

[1] The Verizon telephone companies ("Verizon") are the affiliated local telephone companies of Verizon Communications Corp. These companies are listed in Attachment A.

be offset by reductions in other, less economic charges. Furthermore, the Commission's access charge reform policies rely primarily on market forces, rather than rate prescriptions, to set access charges. The Commission adopted the CALLS plan because it is consistent with this approach, and because it provides a transition to market-determined rates. The forward-looking costs analyses cannot and should not be used to prescribe a maximum subscriber line charge or to limit the revenues that the price cap carriers are entitled to receive during this transitional period.

II. The Commission Should Permit The Scheduled Increases In The Subscriber Line Charges To Take Effect.

The price cap carriers' submissions and the comments provide overwhelming support for the scheduled increases in the caps for subscriber line charges under the CALLS plan. Even commenters who do not support the local exchange carriers' forward-looking cost analyses agree that the Commission should continue to implement the CALLS plan with regard to the phased increases in subscriber line charges. ***See*** Ad Hoc, 9; WorldCom, 2-6; ***see also*** GSA, 4-5. The few commenters who oppose increases in the subscriber line charge caps incorrectly presume that rates for specific services must be based on cost, whether forward-looking or embedded.[2] The Commission abandoned that concept when it adopted price caps and when it adopted a market-based approach to restructuring access charges. ***See*** *LEC Price Cap Order*, 5 FCC Rcd 6786 (1990); *Access Charge Reform*, 12 FCC Rcd 15982 (1997).

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[2] ***See*** NASUCA, 8-9; Florida PSC, 3-4; California PSC, 5-17. Florida Legal Services opposes increases out of concern that they would make telephone service less affordable, but it "objects strenuously to the use of hypothetical cost models" rather than actual costs to estimate the costs of basic telephone service. ***See*** Florida Legal Services, 8.

The Courts have upheld the Commission's non-cost based approach since the beginning of price cap regulation. ***See*** *National Rural Telecom Assoc. v. FCC*, 988 F.2d 174 (D.C. Cir. 1993). The Commission adopted price caps because it found that basing rates on a cost standard did not provide the carriers with a sufficient incentive to cut costs and to become more efficient and innovative. ***See*** *LEC Price Cap Order*, ¶ 22 (price caps "create[s] a regulatory environment that requires carriers to become more productive . . . rate of return regulation is akin to a 'cost-plus' contract"). Although price caps were initialized at the level of the most recent rate-of-return annual access tariff filings, rates since that time have been governed by productivity adjustments that allow carriers to earn higher returns based on their ability to meet or beat the productivity standard. ***See*** id., ¶¶ 22, 230; *Access Charge Reform,* 15 FCC Rcd 12962, ¶ 16 (2000) ("*CALLS Order*"). In addition, the price cap rules have always allowed the carriers a certain amount of flexibility in determining the amount of revenues to recover from each service. ***See*** *CALLS Order*, n. 15. The Commission found that "permitting flexibility in price-setting generates economic efficiencies that benefit ratepayers through lower rates" and that "[s]ince it is no longer required that every service cover its fully distributed cost of overheads, LECs also have the incentive to provide more services, to the benefit of ratepayers." *LEC Price Cap Order*, ¶ 35. As a result, over time the initial correlation between costs and revenues in the price cap baskets and service categories disappeared.

When the Commission adopted its *Access Charge Reform* order, it specifically rejected arguments that it should require the price cap carriers to re-initialize their rates at either the authorized rate of return or on the basis of forward-looking costs, finding that it would have "substantial pernicious effects on the efficiency objectives of our current policies." ***See*** *Access Charge Reform*, ¶¶ 288-295. As the 8th Circuit Court of Appeals noted in upholding the *Access*

Charge Reform order, "setting rates on the basis of forward-looking economic costs is not statutorily required," and "the purpose of price-cap regulation is to promote efficient use of the network while ensuring that rates, as opposed to earnings, are no greater than they would have been under historical rate of return regulation." *Southwestern Bell, et. al v. FCC*, 153 F.3d 523, 548 (8^{th} Cir. 1998). The Fifth Circuit Court of Appeals echoed these findings in its reviewing the *CALLS Order*, stating that the Act "does not compel the FCC to conduct forward-looking cost-studies." *Texas Office of Public Utility Counsel v. FCC*, 265 F. 3d 313 (5^{th} Cir. 2001) ("*TOPUC*").

After 11 years of price cap regulation, the only relevant measure of revenues to be recovered through common line charges is the carrier common line, marketing, and transport interconnection charge revenue ("Price Cap CMT") per line, which is used as a cap on the subscriber line charge under the CALLS rules. ***See*** 47 C.F.R. §§ 61.3(d), 69.152(d). The forward-looking cost studies that the price cap carriers submitted provide the Commission with additional assurance that the increases in subscriber line charges are not unreasonable. However, the Commission should use these submissions to supplement the record, not to revisit sound policy decisions that have already been made or to invent new approaches to the regulation of interstate rates.

California PSC argues (at 3, 8) that the Court in *TOPUC* approved the CALLS plan only in reliance on the Commission's promise to conduct a cost study before the subscriber line charge cap was scheduled to increase above $5.00, citing the *CALLS Order*. However, the Commission's statement in the *CALLS Order* that it would perform a "cost review proceeding"[3]

[3] ***See*** *CALLS Order*, ¶ 83.

prior to the next scheduled increases in the subscriber line charge caps was not a finding that it intended to prescribe rates based on forward-looking costs, but merely that it would "examine" the data to be submitted by the price cap carriers to determine if further increases in subscriber line charges were warranted. This review does not require the Commission to abandon the market-based approach that it has adopted to move towards its ultimate goal of replacing regulation with competitively driven rates. ***See*** *CALLS Order*, ¶ 20.

The cost analyses submitted by Verizon and the other price cap carriers support the phased increases in subscriber line charge caps set forth in the CALLS rules. Verizon's study shows that forward-looking costs are actually higher in most cases than the CMT per line or than the rate-of-return based "base factor portion" cost per line.[4] Verizon's base factor portion cost calculations offer further assurance that the proposed cap increases are not unreasonable. California PSC and NASUCA argue that Verizon did not document sufficiently the cost inputs and assumptions for its forward-looking analyses, and that the inputs such as cost of capital and depreciation are inconsistent with the Commission's findings in the universal service proceedings. ***See*** California PSC, 10-12; NASUCA, 19-21. However, as NASUCA's sensitivity analyses show, these cost inputs are not the primary reason for the much lower per-line costs in NASUCA's analysis compared to Verizon's.[5] Adding Verizon's cost of capital, economic depreciation lives, and a 12,000 foot maximum loop length, NASUCA only adds a cumulative 92

[4] This assumes that one fourth of the total forward-looking cost per line in Attachment D of Verizon's submission can be compared to the CMT per line and the base factor portion per line. However, as is discussed *infra*, simply dividing total company costs per line by one fourth does not reflect the interstate costs that are produced under the Commission's Part 36 separations and Part 69 access charge rules.

[5] In Exhibit 1 hereto, Verizon provides additional information about the inputs and assumptions for its forward-looking cost analyses.

cents per line to its "default" scenario. ***See*** NASUCA, 54-57 & Table 4. As is shown in NASUCA's Table 1, the differences between the per-line costs in Verizon's analyses and NASUCA's greatly exceed this amount. The primary reason for these differences is the fact that NASUCA used the Commission's synthesis model, which is a hypothetical "scorched node" model using nationwide input values.[6] When the Commission adopted the model, it made it clear that the model was developed solely for the purpose of distributing universal service support and not for developing rates. ***See*** *Federal-State Joint Board on Universal Service*, Tenth Report and Order, 14 FCC Rcd 20156, ¶ 32 (1999). The Commission later reiterated that "[t]he Commission has never used the USF cost model to determine rates for a particular element, nor was it designed to perform such a task. The model was designed to determine relative cost differences among different states, not actual costs." *Verizon Mass. Section 271 Order*, 16 FCC Rcd 8988, ¶ 32 (2001); ***see also*** *SBC Kansas/Oklahoma Section 271 Order*, 16 FCC Rcd 6237, ¶ 84 (2001) ("We have previously noted that . . . the USF cost model should not be relied upon to set rates for UNEs . . . .").[7] The model cannot be used in this proceeding to set limits on subscriber line rates.

[6] In addition, as is shown by comparison to Ad Hoc's results using the synthesis model, NASUCA produces extremely low per-line costs in its "default" scenario by excluding most common costs that the Commission's model assigns to the subscriber line. ***Compare*** Ad Hoc, 14 ***to*** NASUCA, Table 25. NASUCA also understates costs by using updated July 31, 2001 line counts but keeping the original customer locations and cost inputs from the 1998-1999 time period. Consequently, NASUCA's low-ball approach produces rates that are generally below even the TELRIC rates established by the State commissions for unbundled loops. ***See*** NASUCA, Table 1.

[7] ***See, e.g.,*** The interexchange carriers have taken the same position. ***See*** Iowa Telecommunications Services Petition for Forbearance, CC Docket No. 01-331, Comments of Sprint at 3 (filed Jan. 4, 2001) ("The model was never intended to be used for estimating the costs of unbundled network elements, and was certainly never intended to be used to set service prices for individual companies"), AT&T Opposition at 6 (filed Jan. 4, 2001) ("the Commission

In addition, the universal service model cannot be used as a basis for determining the upper limits on subscriber line charges, which are specific to each tariff entity, because it does not reflect each local exchange carrier's forward-looking costs. The universal service model uses nationwide average cost inputs and a model platform that does not reflect any carrier's actual network. Use of state-specific and company-specific data is essential in evaluating each carrier's subscriber line charges. In the *CALLS Order*, the Commission stated that it would examine the data to be submitted by the price cap carriers, not a hypothetical nationwide cost model submitted by other parties. ***See*** *CALLS Order*, ¶ 83. The cost analyses based on the Synthesis model are simply irrelevant to the Commission's inquiry in this proceeding.

Using this irrelevant analysis, NASUCA claims (at 9, 46) that subscriber line charges for residence and single-line business customers are too high, and that these customers are paying as much as $1.4 billion in implicit subsidies to interexchange carriers, multi-line business customers, and the local exchange carriers' stockholders. To the contrary, these customers currently *receive* a subsidy of about $1.19 billion from the interexchange carriers and multi-line business customers because they pay a $5.00 subscriber line charge rather than the full CMT rate per line.[8] The CALLS plan is designed to substantially eliminate that subsidy by allowing subscriber line charge caps for residence and single line business customers to increase in phases to $6.50 or to the CMT per line, whichever is lower. ***See*** 47 C.F.R. § 69.152(d)(1). Keeping the current $5.00 cap, as NASUCA proposes (at 10-11), would maintain implicit subsidies and

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has expressly held that the Synthesis Model may not be used to set access rates, even for the non-rural carriers to whom the model applies").

[8] Calculated from the June 18, 2001 Annual Filings of Price Cap Carriers, Price Cap Tariff Review Plans.

frustrate the Commission's efforts to implement section 254(e) of the Act, which requires the Commission to adopt explicit support mechanisms for universal service.

Ad Hoc submits data about the price cap carriers' "embedded" costs from their ARMIS reports (at Table 2), but these data have several flaws. Ad Hoc has understated the costs and overstated the demand, resulting in a per-line cost that is well below the "base factor portion" costs that Verizon submitted with its comments.[9] Prior to CALLS, the Commission's rules required the carriers to set limits on subscriber line charges using a calculation of their base factor portion costs, which is the result of applying the Commission's Part 36 separations and Part 69 access charges rules to their Part 32 accounts. Instead of following this procedure, Ad Hoc used the monthly universal service fund cost per line on line 9005 of the year 2000 ARMIS 43-04 Reports. Line 9005 provides total company unseparated loop costs for the 1998 period that do not include marketing expenses, customer operations expenses, and line-side port switching investment. Ad Hoc divided these costs by year 2000 universal service fund "working loops," which include official company lines that are not subject to subscriber line charges. Dividing understated loop costs by overstated lines produces an understated cost per line, which Ad Hoc then divides by four to develop an "interstate" per-line cost. In contrast, Verizon's base factor portion calculations apply the Commission's separations and Part 69 rules using year 2000

[9] ***See*** Verizon Cost Submission, Attachment C. NASUCA correctly notes (at 36-37) that Attachment C allocated all marketing costs to common line, rather than just the marketing expenses that were formerly assigned to the common line basket, the traffic-sensitive basket, and the switched services within the trunking basket. Attached as Exhibit 2 is a revised Attachment C that removes a small amount of special access and interexchange service marketing expenses that were misallocated to the base factor portion calculation. However, NASUCA is wrong in suggesting that the CMT calculation was similarly affected. The actual CMT revenues in Verizon's annual access tariff filings and in its cost submission in this proceeding are not affected, as Verizon moved the correct amount of marketing expenses to the common line category when the CALLS plan was implemented in the 2000 annual filing.

costs from other sections of the ARMIS reports, include the marketing and other expenses that Ad Hoc excludes, and using average 1999 and 2000 lines that do not include official lines. Ad Hoc's methodology in no way represents the price cap carrier's actual interstate costs.

In any event, neither actual interstate per-line costs nor forward-looking costs are the relevant standard for determining the upper limits on subscriber line charges. As WorldCom correctly points out (at 3), while the Commission promised to examine the local exchange carriers' forward-looking cost information, it did not adopt a forward-looking cost standard for purposes of determining whether the scheduled increases in subscriber line charges were justified, or for any other purpose in the CALLS plan. Indeed, it explicitly rejected such a standard in the *Access Charge Reform* proceeding and it did nothing in CALLS to reverse that decision. The only issue in the CALLS plan proceeding was how to recover CMT revenues in the most efficient manner. As the Commission demonstrated in the *CALLS Order*, the most economic way of recovering these costs is through the flat-rated subscriber line charge. ***See*** *CALLS Order*, ¶¶ 65, 78. For this reason, the Commission established a phased increase in subscriber line charges to shift revenues from these rate elements to per-line charges recovered from end users. There is no reason to forego the benefits of the CALLS plan by interfering with the scheduled increases in subscriber line charge caps.

III. The Commission Should Reject NASUCA's Attempt To Reargue Issues That Have Already Been Decided And To Raise Issues That Are Outside The Scope Of This Proceeding.

NASUCA also raises a number of issues that have already been decided and or that are outside the scope of this proceeding.[10] Among other things, NASUCA argues (at 60-108) that the Commission should require the carriers to recover some of their loop costs in their rates for advanced services rather than in subscriber line charges, that the Commission should treat the feeder portion of the loop as traffic sensitive, that the Commission should allocate all marketing costs to business lines, and that the Commission should fundamentally alter its cost allocation rules. The Commission has already addressed these issues in the *CALLS Order* and in its existing cost allocation orders. The Commission should not allow NASUCA to expand the scope of this proceeding, which is limited to the single issue of assessing the price cap carriers' cost analyses and other information prior to the next scheduled increase in the subscriber line charge caps.

NASUCA argues (at 61-62) that recovering the full cost of the local loop through the subscriber line charge rather than recovering some of these costs in the rates for advanced services violates section 254(k) of the Act, which prohibits carriers from subsidizing competitive carriers and which requires the Commission to establish cost allocation rules to ensure that services within the definition of universal service bear no more than a reasonable share of joint and common costs. The Commission answered this argument in the *CALLS Order*, finding that

[10] To the extent that NASUCA raises issues that the Commission already decided in the *CALLS Order* and in other proceedings, its comments should be rejected as an untimely petition for reconsideration of those orders. ***See*** 47 U.S.C. § 405(a) (petitions for reconsideration of a Commission order must be filed within 30 days of public notice).

section 254(k) addresses cost allocation rules, not the method by which costs are recovered under the CALLS plan. ***See** CALLS Order*, ¶¶ 91-98. The Fifth Circuit Court of Appeals upheld the Commission's analysis on appeal, finding, as the Eighth Circuit had in a similar case, that "because the SLC is a method of recovering loop costs, not an allocation of those costs between supported and unsupported services, § 254(k) is not implicated." *TOPUC*, at 324. These findings are dispositive of NASUCA's claims.

NASUCA argues (at 83-98) that the carriers' decision not to allocate loop costs to advanced services is inappropriate because the investments that the carriers are making in their networks are designed to promote advanced services such as digital subscriber line ("DSL"). However, as NASUCA concedes (at 69), the Commission specifically addressed this argument when NASUCA raised it earlier in this proceeding. NASUCA argued that assigning 100 percent of loop costs to basic local service rather than to other end user or interexchange services violates section 254(k). ***See*** NASUCA Supplemental Comments at 6-7 (filed Apr. 3, 2000). The Commission rejected this argument with specific reference to recovery of costs for DSL service. ***See** CALLS Order*, ¶ 98. In addition, when the Commission reviewed the local exchange carriers' DSL tariffs, it specifically approved the recovery of only the "direct" costs of adding DSL services, which do not include the "sunk" cost of the loop. ***See, e.g.,*** *Deployment of Wireline Services Offering Advanced Telecommunications Capability*, Third Report and Order, 14 FCC Rcd 20912, ¶ 140 (1999). The Commission should not give NASUCA a third bite at the apple.

In addition, there is no merit to NASUCA's argument that recovery of loop costs should be shifted from subscriber line charges to rates for advanced services such as DSL. A customer cannot obtain DSL service unless the customer already has voice grade telephone service. Therefore, the loop costs are the same whether a customer purchases dial tone service alone or dial tone plus DSL. The subscriber line charge recovers the cost of providing a line to a customer, regardless of what services the customer requests over that line.[11] Charging a dial tone customer for only part of the costs of the line as NASUCA proposes would leave the rest of those costs unrecovered if the customer did not subscribe to advanced services.[12] Alternatively, assigning a fixed amount of all loop costs to DSL services, such as the 50 percent fixed factor advocated by NASUCA, would cause DSL customers to subsidize loop costs for customers who only subscribe to voice service. Neither result would be cost-causative.

[11] The Commission has consistently found since it first adopted the access charge regime in 1983 that the subscriber line charge is the most economic recovery method for interstate common line costs, and the courts have consistently upheld this finding. ***See, e.g.,*** *National Association of Regulatory Utility Commissioners v. FCC*, 737 F.2d 1095 (D.C. Cir. 1984). The Commission has limited the level of subscriber line charges by a succession of periodically increasing caps, not because of any finding that costs should be allocated to any other element, but purely because of universal service concerns. ***See, e.g.,*** *Federal-State Joint Board on Universal Service,* 12 FCC Rcd 8776, ¶ 762 (1997).

[12] Contrary to NASUCA's arguments (at 72), Verizon has not backed off on its position that rates for advanced services should be based on the incremental cost of adding this capability to the network. NASUCA cites Verizon's brief in the California line sharing proceeding, where Verizon argued that the incremental cost of providing the high frequency portion of the loop for DSL capability includes the cost of not being able to convert a customer served by a copper loop to fiber. This does not support NASUCA's argument that the cost of upgrading the network should be attributable to advanced services -- actually, it says just the opposite. Verizon demonstrated that the costs of maintaining the high frequency UNE include the lost efficiencies from not being able to upgrade the network to benefit voice service. NASUCA is also wrong (at 73-34) in interpreting Verizon's statements about the drawbacks of the TELRIC pricing standard as constituting support for NASUCA's attempts to assign loop costs to advanced services. Verizon simply argued that the TELRIC cost standard should reflect the forward-looking cost that an efficient carrier would incur to provide the high-frequency portion of the loop, not the incremental cost that Verizon incurs to add advanced services to its sunk costs. In addition, the UNE prices do not include the additional costs that the incumbent carriers incur specifically to provide UNEs to their competitors, such as access to Verizon's operating support systems and loop quality databases. These costs are not incremental to Verizon's own advanced services.

NASUCA argues (at 84-108) that the carriers should be required to recover a large portion of their loop costs solely from customers who purchase advanced services because these services are the driving force behind the carriers' efforts to upgrade the network. This is incorrect. The introduction of new technologies benefits all services, making them more reliable and efficient. Residential voice grade telephone service has been benefited as much as any other service by the use of advanced technologies such as fiber optic transport and digital multiplexing. These technologies provide increased reliability and efficiency as compared to older copper facilities. In fact, in some instances the introduction of such technologies to enhance voice grade service, such as the use of fiber-optic transport in the feeder, has limited the availability of DSL, which requires a traditional copper loop from the central office to the subscriber's premises.

The Commission should reject NASUCA's efforts to turn this into a cost allocation proceeding. The only issue here is whether the scheduled subscriber line charge increases should take effect in light of the principles of the CALLS plan and the information in the record, including the carriers' forward-looking cost analyses. Clearly, the answer is yes.

IV. Conclusion

For the foregoing reasons, the Commission should continue implementing the CALLS plan and allow the scheduled increases in subscriber line charge caps to take effect.

Respectfully submitted,

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ATTACHMENT A

THE VERIZON TELEPHONE COMPANIES

The Verizon telephone companies are the local exchange carriers affiliated with Verizon Communications Inc. These are:

Contel of the South, Inc. d/b/a Verizon Mid-States
GTE Midwest Incorporated d/b/a Verizon Midwest
GTE Southwest Incorporated d/b/a Verizon Southwest
The Micronesian Telecommunications Corporation
Verizon California Inc.
Verizon Delaware Inc.
Verizon Florida Inc.
Verizon Hawaii Inc.
Verizon Maryland Inc.
Verizon New England Inc.
Verizon New Jersey Inc.
Verizon New York Inc.
Verizon North Inc.
Verizon Northwest Inc.
Verizon Pennsylvania Inc.
Verizon South Inc.
Verizon Virginia Inc.
Verizon Washington, DC Inc.
Verizon West Coast Inc.
Verizon West Virginia Inc.