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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Expedited Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration	)	CC Docket No. 00-218
In the Matter of Petition of Cox Virginia Telecom, Inc., etc.	)	CC Docket No. 00-249
In the Matter of Petition of AT&T Communications of Virginia Inc., etc.	)	CC Docket No. 00-251

VERIZON VIRGINIA INC.'S PROFFER OF SUPPLEMENTAL EVIDENCE

On November 22,2002, Verizon Virginia (Verizon VA) filed a motion to permit the parties a limited opportunity to supplement the record in this proceeding." The basis for that motion is straightforward. The market, legal, and regulatory landscapes have changed dramatically in the nearly two years since the cost studies were completed (based on data that now is three years old), and in the nearly year and one-half since the hearings ended in this proceeding. In light of these significant changes, the reasons to provide the parties a limited opportunity to supplement the record on key issues have continued to grow. Indeed, the supplemental evidence outlined here would materially assist the Commission in its efforts to establish wholesale rates that, to as great an extent as possible within the flawed TELRIC framework, will restore rational economic incentives for all providers to invest in and deploy competing facilities. In contrast, failure to consider this evidence and instead to knowingly rely

1/ Verizon VA's Motion to Permit Parties to Supplement the Record (November 22, 2002).

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on flawed or outdated information would be reversible error. And it obviously would serve no one's interests, including the parties or the Commission itself, to set rates here that are facially wrong from the outset, and that would add still further to the prevailing climate **of** investment-deterring uncertainty that plagues the industry. Verizon VA accordingly provides this proffer outlining the supplemental evidence that it would submit if the Commission granted its motion.

I. SUMMARY

The supplemental evidence proffered here is limited to several key issues that the Commission, the courts, and even the petitioning CLECs have recognized are relevant in setting rates under the Commission's current TELRIC rules. **As** such, the evidence will assist the Commission in setting rates that are economically rational so far as is possible within the constraints of the current TELRIC rules, and failure to consider it would risk reversal on appeal.[2]

Moreover, taking this evidence into account is particularly important in the current climate of depressed investment and market uncertainty that is attributable in some significant measure to the governing regulatory regime. Indeed, as noted economists such as Dr. Shelanski and Dr. Kahn have explained at length, the central contributors to the lack of investment incentives in the telecommunications sector are the Commission's current TELRIC rules and their application by state commissions. The black box nature of the TELRIC rules and the hypothetical network model on which they are premised have allowed regulators to consistently ratchet rates lower based on ever more extreme assumptions that are completely disconnected from the real world in which carriers must provide service. **As** Chairman Powell has pointed out, application of the TELRIC rules has produced "heavily subsidized rates set by regulators" that

[2] ***See United Mine Workers of Am. v. Dole,*** 870 F.2d 662,673 (D.C. Cir. 1989) (supplementing the record is appropriate where failure to do so would raise serious doubts "about whether the agency chose properly from the various alternatives open to it.").

discourage, rather than encourage, investment in competing facilities." Indeed, as any number of independent analysts have explained, the TELRIC rules have been applied in practice to produce rates that bear no relation to any measure of real world costs, including those relied on by investors and analysts." Ultimately, correcting this problem fully will require a thorough reform of the TELRIC rules to bring them into line with current market realities. In the meantime, however, it is critical that any rates set in conformance with those rules fully account for developments that are relevant even under the flawed TELRIC rules in order to avoid exacerbating the problem further still.

Specifically, as outlined further below, the supplemental evidence proffered here focuses on five key areas where significant marketplace, legal, or regulatory developments are directly relevant to the setting of TELRIC rates and should be taken into account.

First, the Commission has recently reiterated that the input assumptions used in setting TELRIC rates cannot be divorced from the realities of a competitive marketplace because doing so would fail to send appropriate economic signals.[5] That conclusion is strongly reinforced by

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[3] Michael K. Powell, Chairman, Federal Communications Commission, Written Statement on "Health of the Telecommunications Sector: A Perspective from the Commissioners of the Federal Communications Commission," before the Subcommittee on Telecommunications and the Internet, Committee on Energy and Commerce, U.S. House of Representatives, at 10-11 (Feb. 26, 2003) ("Powell Statement").

[4] For example, in its May 1, 2002 quarterly report, analysts for Commerce Capital Markets concluded that "regulators are forcing RBOCs to wholesale their network at rates that are significantly below the costs that the financial community looks at." A. Kovacs, *et al.*, Commerce Capital Markets, Inc., *The Status of 271 and UNE Platform in the Regional Bells' Territories* at 15 (May 1, 2002). Similarly, a Precursor Group report explains that the FCC's pricing methodology "was *profoundly uneconomic* in the long term; no company, incumbent or competitor would actually build a facility network at the TELRIC price and ever hope to earn a return on their investment." S.C. Cleland, *et al.*, The Precursor Group, *Telecom/Tech Policy: From fhe Economic Propeller to Growth Anchor* at 1 (October 2, 2001).

[5] Attachment to FCC *Triennial Review* Press Release, "FCC Adopts New Rules For Network Unbundling Obligations of Incumbent Local Phone Carriers" at 4 (rel. February 20, 2003) ("Attachment to FCC *Triennial Review* Press Release").

the continued growth in competition in the telecommunications market in Virginia. The number of lines being served by competing carriers in the state is now approaching one million, with roughly 800,000 of those lines served in whole or in part using facilities that these carriers have deployed themselves (including in all cases their own local switches). (West Supp., Attachment 1 at 1.) The deployment of competing switches is especially widespread, with competitors using their own switches to serve customers in wire centers that contain at least 85% of Verizon VA's access lines in the state. Facilities competition is not limited to switching, however. ***(Id.*** at **3-4.)** While some 150,000 of the wholly **or** partially facilities-based lines use unbundled loops purchased from Verizon, the rest use last-mile facilities that competing carriers have deployed themselves or other alternatives. *(Id.* at 4.) And intermodal competition continues to grow from cable, wireless, Internet telephony providers, and e-mail and instant messaging. ***(Id.*** at **4-5.)** The result is that for the first time ever both the number of lines and switched access minutes of use served by Verizon VA have declined for several consecutive years. *(Id.* at ***5.)*** This is a significant departure from the positive growth assumptions underlying all the cost studies initially filed in this proceeding, and is directly relevant to any number of the input assumptions used in setting TELRIC rates. For example, under the Commission's TELRIC definition, **UNE** rates are set assuming an incumbent maintains a ubiquitous network capable of serving the entirety of demand. But if demand or growth in fact turns out to be lower than expected, there will be excess spare (and thus lower fill factors) in the network.

Second, the Commission (and even AT&T) has recognized that rates should be set at a level sufficient to compensate carriers for any charges that cannot be collected.6' At the time

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6/ ***See*** Policy Statement, *In* ***the Matter of Verizon Petition for Emergency Declaratory and Other Relief,*** 17 FCC Rcd 26884,26889 ¶ 9 (2002) ("Policy Statement Regarding Petition for Emerg. Decl.") ("the Commission's ratemaking policies for incumbent LECs also account for

Verizon VA completed its cost studies, however, it still had limited experience collecting wholesale charges (UNEs and resale) from CLECs. For that reason, Verizon VA's cost studies used the historical uncollectible rate of .56% for traditional access and similar services as a proxy. *(Declaration of Louis D. Minion,* Sept. **13, 2002,** ¶ **4** ("Minion Decl."); Minion Supp. at **4.)** Actual experience has proven that this proxy dramatically understates the uncollectible rate for wholesale products. Over the last two years, the wholesale uncollectible rate has averaged 11% across the Verizon East footprint, and more than **25%** in Virginia alone, even without including uncollectible charges as a result of the WorldCom bankruptcy. (Minion Supp. at **4-5.)** In fact, the Commission itself bas recognized that the uncollectible rate going forward will be many times the proxy rates (on the order of **4%** to *5%)* even for more stable lines of business." In view of these facts, relying here on the inaccurate proxy figure would constitute manifest error and materially understate the resulting rates.

Third, in various decisions and court filings since the cost studies here were completed, including most recently its *Triennial Review* decision, the Commission has expressly recognized that TELRIC studies must include cost of capital and depreciation assumptions that fully reflect both competitive market conditions and the "added risks associated with the regulatory risk to which a firm [providing UNEs] is subject."[7] Indeed, as Verizon VA previously explained, at an absolute minimum, the cost of capital used in a TELRIC study, should be based on a sample of

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interstate uncollectibles and provide **for** their recovery through interstate access charges"); **see** *also* Letter from James W. Cicconi, General Counsel and Executive Vice President, Law & Government Affairs, AT&T Corp. to Honorable Michael Powell, Chairman, Attachment at **pp. 1-2** (July **26,2002)** ("Cicconi Letter").

[7] Wireline Competition Bureau Staff Study of Alternative Contribution Methodologies, CC Docket Nos. **96-45,** ***et al.*** at 5-8 (rel. Feb. **25, 2003)** ("Staff Study") (assuming uncollectible rates of **4-5%).**

[8] Reply Brief for Petitioners United States and the FCC, *Verizon Communications, Inc., et al. v. FCC, et al.* at **12** n.8 (July **2001)** ("Reply Brief in *Verizon");* **see** *also* Attachment to FCC *Triennial Review* Press Release at **4.**

the S&P Industrials made up of companies of somewhat less than average competitiveness. It should even more appropriately be based on the higher cost of capital that the chief proponents of TELRIC use when it comes to making their own business decisions (as the record here reflects). Also, at a minimum, depreciation should be based on the GAAP lives that are used for financial reporting purposes (which carriers have no incentive to understate since doing so would translate into lower earnings and potentially lower stock prices), rather than longer, outdated regulatorily-prescribed lives. In both these respects, the Commission's recent pronouncements provide still further support for the cost of capital and depreciation assumptions used in Verizon VA's cost studies, which are, in fact, based on the cost of capital for a sample of the S&P Industrials and on GAAP depreciation lives.

As Verizon VA's economic and financial experts previously explained, however, the cost of capital used in Verizon VA's original cost study did not account for the added regulatory risks attributable to the UNE regime and the accompanying TELRIC pricing standard. (VZ-VA Ex. 104 at 5, 41; VZ-VA Ex. 112 at 30-31; VZ-VA Ex. 118 at 11, 21.) Specifically, the risks of providing UNEs are equivalent to the risks of cancelable operating leases, where the lessee may opt to cancel and the lessor bears the risk that the asset will sit idle or that rates may go down. (Vander Weide Supp. at 9.) To translate this into everyday experience, this is why the daily cost to rent a car is greater than the cost per day of a long-term car lease. (*Id.* at 8.) These risks are directly relevant here because CLECs are free to terminate their use **of** a particular element or of UNEs generally at any time, and instead move to alternative facilities or technologies. Even where CLECs do not stop using the incumbent's UNEs entirely, they nonetheless are able to essentially "cancel" their existing UNE leases and renew leases for the same UNEs at the lower rates that are set every few years based on new hypothetical network assumptions. While

Verizon VA had not quantified the value of this added risk at the time the initial cost studies were completed, Verizon VA's financial witness Dr. Vander Weide has now done so using widely accepted methods used to value similar options in financial markets. This calculation shows that an appropriate risk premium for Verizon VA's provisioning of UNEs, which should be added to the competitive cost of capital, is 5.41%. *(Id.* at 3.)

Fourth, both the Commission and the Supreme Court have emphasized that only technologies that are currently available and deployed may be used in TELRIC studies." As the Supreme Court recently noted, the "currently available" technology limitation on UNE rates provides one of the key safeguards that prevents the TELRIC regime from "squelch[ing] competition in facilities."[10] As Verizon VA previously explained, this limitation requires the Commission to reject claims that it should pretend that Verizon will provide unbundled stand-alone loops using integrated digital loop carrier (IDLC) technology equipped with so-called GR-303 interfaces. In reality, IDLC is not capable of providing stand-alone loops even with a GR-303 interface, and, as explained below, AT&T has now admitted that fact. (Gansert Supp. at 3, 5.) Thus, loop costs cannot lawfully be based on the assumption that all fiber-fed loops are served by IDLC. What is more, the simple fact is that Verizon VA still has not deployed GR-303-compatible switches in Virginia (and does not plan to), and switch manufacturers are not even investing in research and development of that technology. *(Id.* at 10.) Thus, the correct assumption for use in setting rates here is that the forward-looking network contains no GR-303.

By the same token, of course, a TELRIC study cannot assume that technologies can be purchased at a lower cost than is currently available. In the case of circuit switches, for example,

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[9] ***See*** 47 C.F.R. § 51.505(b)(1); ***Verizon Communications, et al. v. FCC, et al.,*** 535 **U.S.** 467,505-06 (2002).

[10] ***Verizon,*** 535 U.S. at 505-06.

the CLECs claim that the Commission should assume that all, or virtually all, of the switches in a forward-looking network would be purchased at the discounts that are currently available only on all new switches. But this is precisely the type of irrational assumption that is responsible for driving the price of unbundled switching, and therefore the UNE-platform, to such absurdly low, "heavily subsidized" levels." In the real world, switch manufacturers are fully aware that Verizon and other incumbents will purchase few new switches going forward, and instead will purchase primarily growth additions. The prices manufacturers charge for switching capacity take this into account, and are designed to produce sufficient per line revenues from the expected aggregate purchases to cover the manufacturers' costs and allow them to remain viable. If manufacturers expected carriers to purchase large numbers of ***new*** switches going forward, they obviously would have to adjust the prices they charge to produce the same per line revenues from ***that*** mix of switching capacity. For that reason, the only rational basis on which to estimate the cost at which circuit switching is "currently available" is the actual per line cost that incumbents pay for the mix of new switches and growth additions they actually purchase.

Fifth, the Supreme Court also has made clear in the time since this proceeding began that UNE rates are subject to challenge at the time they are set on the basis that those rates fail to provide adequate compensation.[12/] Here, however, the rates proposed by the CLECs (and to a somewhat lesser extent by the cost studies performed by Verizon VA in conformance with the TELRIC rules) would fall far short of allowing Verizon VA to recover its historical investments and associated operating expenses. Evidence of these costs is relevant for several reasons. First, this evidence provides an objective benchmark that shows how distorted and extreme the vastly lower cost estimates manufactured by the CLECs really are. Second, it demonstrates the level of

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11/ Powell Statement at 10-11

12/ ***Verizon*, 535** U.S. at 524.

compensation to which Verizon VA is constitutionally entitled, and, therefore, quantifies the amount that will have to be made up through some independent mechanism to the extent that the rates set here do not themselves provide the full measure of constitutionally-required compensation. Indeed, the Commission itself has previously committed to do precisely that,[13] and, in any event, the law is clear that the Commission must consider this evidence and must establish such a mechanism simultaneously with the setting of the rates themselves.[14]

II. LOCAL COMPETITION IN VIRGINIA IS CONTINUING TO INCREASE, WHILE FOR THE FIRST TIME VERIZON VA'S NUMBER OF ACCESS LINES AND MINUTES OF USE ARE DECLINING.

Since Verizon VA filed the initial studies in this proceeding, intermodal and intramodal competition for both residential and business customers in the Virginia market has continued to grow, with the result that the risks for Verizon VA, as a provider of **UNEs,** have increased markedly. At the same time, notwithstanding the positive growth assumptions that both Verizon VA and AT&T/WorldCom made in their initial cost studies in this proceeding, Verizon VA has in fact been regularly ***losing*** both lines and minutes of use to competitors.

As the attached update to the Local Competition Report for Virginia demonstrates, the number of competitive lines has grown significantly in the 20 months since Verizon VA filed local competition information in this proceeding. (West Supp., Attachment 1.) The number of lines being served by competing carriers in the state is now approaching one million, with

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[13] ***See*** First Report and Order, ***Implementation of the Local Competition Provisions in the Telecommunications Act of 1996***, 11 FCC Rcd 15499, 15872 ¶ 739 (1996) ***("Local Competition Order")*** (ILECs may "seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates.").

[14] ***See, e.g., Jersey Cent. Power & Light Co. v. FERC***, 810 F.2d 1168, 1176-1179 (D.C. Cir. 1987) (where regulated entity presents serious allegations that rates may result in a taking, the agency ***must*** consider those allegations and look at the relevant evidence; and failure to do so is reversible error.); ***Presault v. ICC***, 494 **U.S.** 1, 11 (1990) (Constitution requires "reasonable, certain, and adequate provision for obtaining compensation at the time of the taking").

roughly 800,000 of those lines served in whole or in part using facilities that these carriers have deployed themselves (including in all cases their own local switch). ***(Id.*** at **1, 3.)** Since Verizon VA filed its initial local competition report in this proceeding, the overall number of competitive lines in Virginia has grown by more than 60%. *(Id.* at 1.) The number of lines that competitors serve either wholly or partially over their own facilities (in all cases using their own switch) has increased by more than 70%. ***(Id.)***

Since the time of the last report, competitors have deployed 10 new switches to serve customers in Virginia. ***(Id.*** at **3.)** The deployment of competing switches is especially widespread, with competitors now using their own switches to serve customers in wire centers that contain at least 85% of Verizon VA's access lines in the state. *(Id.)* Facilities competition is not limited to switching. While some **150,000** of the wholly or partially facilities-based lines use unbundled loops purchased from Verizon VA, the rest use last-mile facilities that competing carriers have deployed themselves or other alternatives. *(Id.* at **4.)** And, this increase in competition has occurred for both business and residential customers. ***(Id.*** at **1-2.)** This results in part from the rapid growth in intermodal competition from cable companies. ***(Id.*** at **2-3.)** For example, Comcast already provides cable telephony service to tens of thousands **of** customers in Virginia, and Cox is investing millions of dollars to provide a variety of broadband and telephony services. ***(Id.)*** Of course, both Comcast and **Cox** offer telephony service to a far greater number of homes than they are currently serving. *(Id.* at **2.)**

In addition, since the last report filed in this case, Verizon VA has begun to lose **an** increasing number of lines and minutes to alternative telephony sources including wireless, IP telephony, e-mail and instant messaging. *(Id.* at **4.)** For example, wireless providers are offering attractive packages that include a large number of minutes for a set price, making wireless

phones an increasing source of substitution for Verizon VA's network. *(Id.)* As the FCC has found, broadband PCS is "marketed and provided as a replacement for wireline service" and is an "actual commercial alternative" to wireline service.[15/] Like wireless service, IP telephony is also quickly becoming a substitute for more traditional wireline service. For example, Vonage has launched its Digitalvoice service using IP telephony in Virginia. Nationwide, Vonage transmits one million calls each week over its network. ***(Id.)***

The effect this intramodal and internodal competition has had on Verizon VA is stark as noted, both the number of lines and minutes **of** use served by Verizon VA have declined for several consecutive years. *(Id.* at ***5.)*** The number of lines served by Verizon VA declined by 4% in 2001 and by an additional 7% in 2002. *(Id.)* The number of switched access minutes has decreased at an even greater rate: 5% in 2001 and an additional 11% in 2002. ***(Id.)*** Thus, contrary to the assumptions of growth that underlie both AT&T/WorldCom's and Verizon VA's TELRIC cost studies in this case, total demand has actually declined.

This decline impacts several different cost study inputs. For example, AT&T/WorldCom's studies assume high percentages of fill factors, while Verizon VA's studies generally base fill factors on the amount of spare capacity in its network.[16/] The decline in access lines and minutes **of** use is strong evidence that fill factors are likely to decline as traffic is increasingly being diverted to the networks of facilities-based competitors. In other words, while

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[15/] Memorandum Opinion and Order, ***In the Matter of Application by SBC Communications Inc., Nevada Bell Telephone Company, and Southwestern Bell Communications Services, Inc.*** for ***Authorization to Provide In-Region, InterLATA Services in Nevada,*** **WC** Docket No. 03-10, FCC 03-80 (rel. Apr. 14,2003).

[16/] Verizon has clear incentives, due to both competitive pressures and price-cap regulation, to reduce spare as much as possible to lower its costs. At the same time, there must be sufficient spare to meet relevant service quality requirements so that, for example, Verizon can provision second lines or meet demand spikes in a particular location within the time period required by a state commission.

the Commission's definition of TELRIC requires that UNE rates be set assuming that an incumbent maintains a ubiquitous network capable of serving the entirety of demand,[17] if demand or growth in fact turns out to be lower than expected, there will be excess spare (and thus lower fill factors) in the network. The decline in access lines and minutes of use also affects the cost of capital and depreciation. We discuss these two inputs below.

111. THE COMMISSION SHOULD SET AN UNCOLLECTIBLE RATE IN VIRGINIA THAT REFLECTS VERIZON VA'S ACTUAL EXPERIENCE.

The uncollectible rate for wholesale products (UNE and resale) is substantially higher than the estimates contained in the cost studies. AT&T itself has recognized that if Verizon is experiencing increasing difficulty in collecting payments from CLECs, it should be "free to ask state regulators to reopen its UNE prices so that the allowance for uncollectibles may be increased going forward."[18] The FCC has also recognized that carriers should be able to pass through uncollectibles in their rates. In addition, recent staff studies have estimated future uncollectibles at levels many times the proxy rates (approximately 4% to 5%) for substantially less volatile lines of business.[19] Given that the Commission has not yet set rates, it should simply reflect this more accurate and current uncollectibles evidence in the UNE rates it sets.

At the time Verizon VA completed its cost studies, its experience collecting payment from CLECs in Virginia was still relatively limited, as was the data needed to calculate the

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17/ See, *e.g.*, 47 C.F.R. § 51.511(a).

18/ Cicconi Letter at 1-2.

19/ Policy Statement Regarding Petition for Emerg. Decl., 17 FCC Rcd at 26889 ¶ 9 ("the Commission's ratemaking policies for incumbent LECs also account for interstate uncollectibles and provide for their recovery through interstate access charges"); Staff Study at 5-8 (for revenue-based methodology, study contains uncollectible rate of 5% for ILECs' and CLECs' retail interstate special access market and IXCs' and wireless carriers' retail markets; for connection-based methodology, study contains uncollectibe rate of 4% for ILECs' and wireless carriers' retail markets; for telephone number-based methodology, study contains an uncollectible rate of 4% based on a market that consists of all JLEC, CLEC and wireless carrier telephone numbers).

uncollectible rate. (Minion Decl. ¶ **4.)** Accordingly, Verizon VA used as a proxy the uncollectible rate (.56%) for intrastate access charge and reseller payments from IXCs. (Minion Decl. ¶ **4;** Minion Supp. at **4.)** Since then, actual experience with uncollectible UNE charges makes it clear that the study significantly understated the uncollectible rate. As carriers **go** out of business permanently, seek bankruptcy protection (in which carriers such as Verizon are unsecured creditors), or are otherwise unable or unwilling to pay for the services they use, providers of UNEs must bear increasing financial risk as a significantly larger amount of their UNE charges will never be collected. Unless the higher uncollectible rate resulting from this actual market experience is taken into account in setting UNE rates, those rates will necessarily fail to account for a significant portion of Verizon VA's forward-looking TELRIC costs.

Verizon VA has now calculated a far more accurate and current uncollectibles rate specific to the provision of wholesale services (UNEs and resale) to CLECs. To do this, Verizon used its 2001 and 2002 accounting data -- data that was not available when the original cost studies in this proceeding were performed. These calculations show the annual average uncollectibles rate is 11.8% in the Verizon East footprint. (Minion Supp. at **4.)** The uncollectible rate for Virginia specifically during those two years was even higher: 25.82%. *(Id.* at 5.)

Verizon VA's recalculated uncollectibles rate is appropriately forward-looking and a reasonable estimate of the actual uncollectible amounts for UNE and resale provisioning that Verizon VA is likely to experience in future years. *(Id.* at 8.) It has remained high over the last several years and, as the staff has recently confirmed in a study of **a** far less volatile segment of the industry, is substantially above the rate in Verizon VA's study.[20/] UNE rates under TELRIC,

[20/] Staff Study at 5-8.

of course, must account for the risks that the ILEC expects to encounter due to competition and regulation in the telecommunications industry. If the Commission were to ignore Verizon VA's supplemental data about the correct uncollectible rate, the resulting UNE rates would seriously underestimate the costs Verizon VA will incur in providing UNEs. This is especially true in light of the continuing turmoil in the telecommunications industry.[21]

IV. THE COST OF CAPITAL AND DEPRECIATION MUST REFLECT COMPETITIVE AND REGULATORY RISKS.

Since the record closed in this proceeding, the Commission has emphasized that "the risk-adjusted cost of capital used in calculating UNE prices should reflect the risks associated with a competitive market," and must send "appropriate economic signals."[22] The cost of capital Verizon VA initially proposed in this case, in contrast to the figure proposed by AT&T/WorldCom, takes into account competitive risks by using the cost of capital of companies of less than average competitiveness (a sample of companies in the S&P Industrials) as a conservative proxy of the risk a firm faces in a competitive market. Indeed, AT&T and WorldCom actually use an even higher cost of capital in making their own business decisions, and that would be an even more appropriate assessment of the competitive cost of capital.

Similarly, in its ***Triennial Review*** decision, the Commission made it clear that the appropriate depreciation lives should account for the competitive nature of the telecommunications market.[23] The Commission, therefore, should adopt Verizon VA's proposed GAAP lives. These lives, which are updated frequently to reflect technological and other changes that affect the length of an asset's economic life, are both forward-looking and

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[21] For example, CLECs such as Focal Communications, Ntelos Inc., and Supra Telecom are in bankruptcy protection, while others, such as MPower Communications, McLeod USA, Inc., and XO Communications Inc., have recently emerged from bankruptcy.

[22] Attachment to FCC ***Triennial Review*** Press Release at **4.**

[23] *Id.*

would send "appropriate economic signals." AT&T/WorldCom's proposal, in contrast, is based on demonstrably out-of-date regulatorily prescribed lives.

The FCC has also confirmed that the cost of capital should take into account "risks associated with the regulatory regime to which a firm is subject.'" However, as Verizon VA witness Dr. Vander Weide explained in his original testimony, Verizon VA's initial cost of capital proposal failed to account for the regulatory risks of the UNE regime or of TELRIC pricing in particular; as Dr. Vander Weide noted, Verizon VA's initial proposal would have to be revised upward to take these risks into account. (VZ-VA Ex. 104 at 5, 41; VZVA Ex. 112 at 30-31; VZ-VA Ex. 118 at 11, 21.) Dr. Vander Weide has now used a well-known methodology to include an explicit risk premium to at least partially account for these regulatory risks.[25/]

The risks of providing UNEs are equivalent to the risks of providing cancelable leases, such as a short-term car rental. (Vander Weide Supp. at 9.) CLECs are able to terminate their use of a particular element or of UNEs generally at any time, and instead move to alternative facilities or technologies. This risk is particularly pronounced in the use of switching, for example, because CLECs can readily deploy (and have widely deployed) their own switches, thus allowing them to bypass the ILEC's switch and cancel any UNE switching they may have leased. But the risk is not limited to switching, because, as the update to the competition information shows, CLECs are using alternatives to unbundled loops as well. Even where CLECs do not cancel their UNE leases entirely, because UNE rates are re-set every few years to reflect a new hypothetically more efficient network, CLECs are able to periodically "cancel" their UNE leases (at the previous, higher rates) and renew at the new lower rates. (*Id.* at 7-8.)

24/ Reply Brief in ***Verizon*** at 12 n.8.

25/ ***See Verizon,*** 535 U.S. at 519 (noting that 11.25 is a "mere starting point[], to be adjusted upward if the incumbents demonstrate the need").

Thus, the provision of UNEs, like the provision of rental cars, involves a significant risk that the lessee will lease the asset for less time than expected or at lower rates than expected. In the case of UNEs, the risk is even greater than in the usual cancelable lease context because the assets in question are long-lived and the investment is sunk. As a result, if CLECs cancel their UNE leases and either renew at lower rates or switch to alternative facilities or technologies, the ILEC will necessarily recover less than its costs, particularly because TELRIC rates are set on the assumption that the ILEC has 100% of the wholesale market and can spread its costs across this entire demand. (*Id*. at 5, 7, 10-11.) If other sources of competition, such as wireless and cable telephony providers, capture the customer, revenue again will be inadequate to recover the incumbent's TELRIC costs. And, unlike a real world competitive venture, the ILEC has no way to balance out that risk by charging rates above cost or exceeding demand forecasts. (*Id*. at 5-6.) As a result, absent adjustment for these additional risks, the "expected value" of a UNE provider's return will always be lower than its cost of capital. (*Id*. at 6.)

Financial markets already value such risks in the context of cancelable operating leases, recognizing that these involve significantly more risk than a typical long-term lease because the lessor bears the risk that its asset may sit idle or that rates may fall. (*Id.* at 9.) As a result, operating lease payments typically account not only for investment and operating expenses, but also for the value of the option to cancel the lease. (*Id*. at 8.) Put another way, the daily cost to rent a car from Hertz is much higher than the cost per day of a long-term car lease. Of course, the risk that incumbent telephone companies face is significantly higher than that of a rental car agency, since the incumbent cannot move its large, fixed-cost assets in response to shifts in demand. In other words, while Hertz can move cars from one state to another if demand patterns change, Verizon cannot move its loops in response to shifting demand.

As Dr. Vander Weide explains, in order to at least partially account for these risks in the UNE and TELRIC contexts, he has now used a well-accepted methodology to supplement his original cost of capital estimate to include an explicit risk premium. (*Id*. at 14-15.) Specifically, he assessed the regulatory risks Verizon VA faces due to CLECs' option to cancel and renew the UNE at a lower price or bypass the ILEC entirely by calculating a risk premium based on the commonly accepted methodology for valuing cancelable operating leases. (*Id.* at **15-16.)** The calculation determines the market value of the CLECs' option to cancel their **UNE** contracts (and move to alternatives or retake the same UNE at a **lower** rate), based on the pricing methods firms use to value similar options in the financial markets. ***(Id.*** at 15.) This value is then used to calculate the amount required to compensate Verizon VA for the risk it incurs because of the CLECs' cancellation option. ***(Id.*** at 16.) This calculation indicates that an appropriate risk premium for Verizon VA's provisioning of UNEs, which should be added to the competitive cost of capital, is 5.41%. ***(Id.*** at 19.) And, as Dr. Vander Weide explains, this risk premium is in addition to the cost of capital based on the risk of a competitive market. (*Id.*)

V. TELRIC COSTS MAY NOT BE BASED ON HYPOTHETICAL EFFICIENCIES OF TECHNOLOGY THAT IS NOT "CURRENTLY AVAILABLE," OR ON HYPOTHETICAL, UNAVAILABLE PRICING FOR EXISTING TECHNOLOGY.

Since the hearings concluded, the Supreme Court has emphasized that TELRIC requires only the use of technology that is "currently available."[26] As the Court noted, the "currently available" technology limitation on UNE rates provides one of the key safeguards that prevents the TELRIC regime from "squelch[ing] competition in facilities."[27] Reversing its earlier position in this proceeding, AT&T has now conceded that no currently available technology makes it possible to unbundle standalone loops using integrated digital loop carrier (IDLC), even

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[26] ***Id.*** at 505-06.
[27] ***Id.***

with a GR-303 interface. (Gansert Supp. at 5-6.) Accordingly, pursuant to FCC Rule 51.505(b)(1), which requires that UNE costs be set on the basis of "currently available" technology?' the Commission may not base stand-alone UNE loop costs **on** the imaginary efficiencies of IDLC; instead, the Commission must adopt the realistic mix **of *universal*** digital loop carrier (UDLC) and IDLC proposed in Verizon VA's studies. Moreover, in addition to the fact that the GR-303 interface does not permit unbundling of standalone loops, such technology is not forward-looking even for switching: manufacturers are no longer investing in developing GR-303, and Verizon VA is not deploying GR-303 in its network. It therefore is most appropriate to assume that the forward-looking network contains *no* GR-303. Finally, even for technologies that are appropriate to assume for a forward-looking network, UNE rates cannot be based on hypothetical ***prices*** for such technology that **are** not, in fact, "currently available."

AT&T/WorldCom asserted in this proceeding that loop costs should be reduced to account for the efficiencies that the CLECs contended could be gained if all fiber-fed loops were provisioned over IDLC rather than UDLC. (AT&T/WorldCom Ex. 12 at 20-21.) Verizon VA explained, however, that the capabilities necessary to unbundle stand-alone loops over IDLC have not been developed and that no technology **or** equipment that would permit IDLC/GR-303 unbundling for stand-alone loops was available. (VZ-VA Ex. 107 at 93.) Accordingly, Verizon VA explained that it would be inconsistent with the Commission's rules to calculate the cost of a stand-alone loop on the assumption that it could be provisioned over IDLC. (VZ-VA Ex. 122 at 81-82.)

Verizon VA's evidence shows that AT&T has conceded each of Verizon VA's points. First, as the Commission itself has noted, AT&T has agreed in a different proceeding -- as it

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28/ 47 C.F.R. § 51.505(b)(1).

must -- that TELRIC costs must reflect only the costs of technologies that are "currently available and being deployed." (Gansert Supp. at 5.) Second, AT&T has now admitted in its ***Triennial Review*** filing and elsewhere that it is not practicable to use IDLC to unbundle stand-alone loops, and that there is no magical GR-303 solution to this problem. ***(Id.*** at 5-6.) In fact, AT&T is no longer even advocating the possibility of IDLC unbundling using GR-303, and is instead proposing a massive and extremely costly rebuilding of the local network to facilitate what it calls "electronic loop provisioning" using alternative technology.[29] ***(Id.*** at 6.) AT&T's concession underscores Verizon VA's original testimony showing that IDLC/GR-303 that is capable of stand-alone loop unbundling is not currently available.

Third, the Commission itself has applied the "currently available" technology principle in assessing loop costs in its 271 orders. ***(Id.*** at 8.) In that context, the Commission has concluded that it is appropriate to base stand-alone loop costs on 100% UDLC,[30] and has rejected CLEC arguments that 100% IDLC/GR-303 must be assumed for such loops." Given AT&T's clear recognition that no IDLC technology, including GR-303, is "currently available" **for** loop unbundling, it would be clear, reversible error for the Commission to set loop costs based on the

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[29] Even AT&T estimates that electronic loop provisioning would cost more than $17 billion, and its estimate is grossly understated for ***Verizon alone.*** In New **York,** just the access piece of AT&T's proposed architecture is estimated to cost approximately **$10** billion, and the company-wide cost of the necessary outside plant and central office upgrades is estimated at several ***tens of billions*** of dollars. ***See*** Letter from **W.** Scott Randolph to Marlene H. Dortch, Secretary, FCC, CC Docket No. **98-147** (filed September 13,2002).

[30] Memorandum Opinion and Order, ***In the Matter of Joint Application by BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in Alabama, Kentucky, Mississippi, North Carolina, and South Carolina,*** 17 FCC Rcd 17595, 17625¶ 62 (2002) ("BellSouth Five-State § 271 Order").

[31] ***Id.;*** Memorandum Opinion and Order, ***In the Matter of Joint Application by BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc. for Provision of In-Region, InterLATA Services in Georgia and Louisiana,*** **17** FCC Rcd 9018,9046 ¶ 50 (2002) ("Georgia/Louisiana § 271 Order").

imaginary assumption of unattainable IDLC efficiencies. Any such rates would clearly fail to compensate Verizon VA for even its TELRIC costs.

Verizon VA's supplemental testimony also demonstrates that ***no*** GR-303 should be assumed for TELRIC purposes. Switch manufacturers are no longer investing in developing GR-303, and it is therefore not an appropriate technology **for** the forward-looking network. Indeed, Verizon VA explained a year and a half ago that it had no GR-303 in the network in Virginia and had no plans to invest in that technology, and this has been borne out: there is no GR-303 in the Virginia network today, and Verizon VA continues to have no plans to install any. (Gansert Supp. at 9-10.) If it is not economically rational for Verizon VA to deploy GR-303, then as a practical matter, GR-303 cannot be assumed to be "currently available" and thus should not be assumed in the studies.

But there is another, independent reason that the Commission should consider Verizon VA's supplemental evidence and assess loop and switching costs accordingly: ignoring this evidence, and setting costs based on the assumption that all fiber-fed loops use IDLC and on assumed false economies from GR-303, is inconsistent with the continued development of facilities-based competition in Virginia. **As** the Supreme Court noted, the "currently available" limitation is necessary to avoid "squelching competition in facilities."%' Setting costs based on the assumption that all of Verizon VA's fiber-fed loops employ IDLC and based on false economies from GR-303, **as** AT&T/WorldCom advocate, would necessarily and artificially encourage CLECs seeking to serve customers in areas where the loops are fiber-fed to become dependent on using ILEC switching at subsidized rates and discourage CLECs from investing in their own switches. Similarly, underpricing switches based on the false assumption that GR-303

32/ ***Verizon,*** 535 U.S. at 505-06.

is a "currently available" forward-looking technology would send improper price signals to CLECs. Given that CLECs already have widely deployed their own switches in Virginia, adopting a cost model that penalized such facilities investment would be utterly nonsensical and fly in the face of the policies the 1996 Act is designed to promote. The Act "manifest[s] a preference for facilities-based competition" over "parasitic free-riding."[33] Basing loop costs on IDLC and switching costs on **GR-303** not only would undercompensate Verizon VA, but would send very negative signals to the marketplace by discouraging and undermining CLEC switching investment.

Finally, as for the technologies that ***may*** be appropriately assumed in a TELRIC study, it is equally important that the Commission not assume ***prices*** that clearly are not "currently available." This is of particular concern with respect to circuit switches, **for** which the CLECs have proposed entirely unrealistic pricing based on the switch discount that manufacturers offer only on new switches. As Verizon VA explained in its testimony during this proceeding, and as noted above, if manufacturers knew that no or even few growth additions would he purchased, the discount they now offer on new switches would be eliminated or at least radically reduced in order to ensure that the manufacturers could recover their per-line costs based on the switching mix they actually expected to sell. It would make no sense, and indeed would be reversible error, to base switch costs on pricing that is not and could never be "currently available": just like assuming unattainable efficiencies on the basis of technologies that do not exist, assuming non-existent and unattainable technology pricing would produce false cost savings that would "squelch competition in facilities."[34]

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[33] ***See Competitive Telecommunications Ass'n v. FCC,*** 309 F.3d **8,** 16 (D.C. Cir. 2002).

[34] ***Verizon,*** 535 U.S. at 505-06.

VI. THE PROPOSED TELRIC RATES WOULD NOT PERMIT VERIZON VA TO RECOVER ITS HISTORIC INVESTMENT COSTS AND ASSOCIATED OPERATING EXPENSES.

The Supreme Court recognized in ***Verizon*** that ILECs may challenge specific UNE rates on the basis that those rates fail to provide constitutionally adequate compensation.[35] Verizon VA is submitting evidence demonstrating that the UNE rates proposed by AT&T/WorldCom in this proceeding – and to a lesser extent even the TELRIC-compliant rates proposed by Verizon VA – would not come close to permitting Verizon VA to recover its historical investments and associated expenses in providing UNEs. As noted above, this evidence is directly relevant to the Commission's evaluation of the TELRIC proposals on the record and its adoption of appropriate TELRIC rates. As an initial matter, this evidence provides an objective benchmark that demonstrates that the CLECs' rate proposals are well below cost. Moreover, the evidence establishes the amount of just compensation due to Verizon, and, therefore, the amount that will have to be made up through some independent mechanism to the extent that the rates set here do not themselves fully provide this compensation.[36]

While the 1996 Act requires an incumbent to turn over parts of its network for its competitors' exclusive use, the Act also requires that competitors pay a "just and reasonable" rate for this use, a rate that is based on cost.[37] Indeed, it is axiomatic that in compensating a utility for use of its property serving the public, an agency may not set rates "so 'unjust' as to be confiscatory."[38] Rates would be confiscatory if they failed to compensate the incumbent for its unrecovered historical investment and actual operating expenses to provide UNEs to CLECs,

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[35] ***See id.*** at 524.

[36] ***See Local Competition Order*** at 15872¶ 739 (ILECs may **"seek** relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates.").

[37] 47 **U.S.C.** §§ 251(c)(3), 252(d)(1).

[38] ***Duquesne Light Co. v. Barasch,*** 488 U.S. 299,307 (quoting ***Covington &Lexington Turnpike Road Co. v. Sandford,*** 164 **U.S.** 578, 597 (1896)).

particularly because those costs are the only objective standard to determine whether compensation is just. Although historical investment "need not be taken into account as such in ratemaking formulas, it may need to be taken into account in assessing the constitutionality of the particular consequences produced by those formula."[39] Moreover, rates that do not permit the incumbent "to attract capital, and to compensate its investors for the risks assumed," are confiscatory.[40] And, especially under a regulatory regime where *all* of an incumbent's business has been open to competition, a commission cannot justify the unconstitutional taking caused by such confiscatory rates by pointing to the incumbent's other revenues that are subject to competition or revenues under another sovereign's jurisdiction.[41]

To demonstrate that AT&T/WorldCom's rates in this case are not reasonable, Verizon VA has submitted the testimony of Mr. Garzillo, who describes the study performed by Verizon VA to compare the proposed rates to Verizon VA's costs and to analyze the effect on Verizon VA's finances if Verizon VA were compelled to provide UNEs at the proposed rates. As Mr. Garzillo explains, Verizon VA determined its costs of using its existing facilities to provide UNEs based on an analysis of the historical investment that Verizon VA has made for those facilities and the associated expenses reflected in Verizon VA's accounting records. (Garzillo Supp. at 3-4.) Using this data, Verizon VA calculated unit investment costs and annual carrying cost factors, in much the same manner as it did in its TELRIC studies in this case, and computed total monthly per unit costs for each relevant element. (*Id.* at 4.) Based on these calculations, Verizon VA determined that its monthly recurring cost of providing a UNE loop is $29.14 and

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39/ ***See, e.g., Duquesne,*** 488 U.S. at 317 (Scalia, J., White, J., O'Connor, J. concurring); ***see also Verizon,*** 535 U.S. at 527 n.37 (quoting ***Duquesne,*** 488 U.S. at 317).

40/ ***FPC v. Hope Natural Gas Co.,*** 320 **U.S.** 591,605 (1944).

41/ ***See Brooks-Scanlon Co. v. Railroad Comm'n,*** 251 U.S. 396, 399 (1920); ***Smith u. Illinois Bell Tel. Co.,*** 282 U.S. 133 (1930); ***Michigan Bell Tel. Co. v. Engler,*** 257 F.3d 587,593 (6th Cir. 2001).

its cost of providing a UNE-P is $42.26. ***(Id.*** at 2-3, 13.) By contrast, AT&T/WorldCom's proposed monthly recurring loop rate in this proceeding is $6.48, and its proposed monthly recurring UNE-P rate is $9.97. ***(Id.*** at 2-3.) Thus, at AT&T/WorldCom's proposed rates, Verizon VA would recover less than ***one-quarter*** of its costs of providing loops and UNE-Ps.

As Mr. Garzillo demonstrates, AT&T/WorldCom's proposed rates would produce a massive shortfall under any conceivable scenario. The annual shortfall in recovery that Verizon VA would have incurred if AT&T/WorldCom's proposed rates had been in effect in 2002 (based on the volume of UNE loops and UNE-Ps CLECs provided) is more than $59 million. ***(Id.*** at 14.) If the historic growth trends in the volume of loop and UNE-P orders in Virginia are projected forward, by 2005 the shortfall based on AT&T/WorldCom rates would be more than $158 million. ***(Id.*** at 15.) And if the number of loops and UNE-Ps Verizon provides in Virginia were to grow at rates similar to those that occurred in New Jersey or New York following the grant of 271 relief in those states, by 2005 the annual shortfall could range from $222 million to $317 million. ***(Id.)*** As Verizon VA also shows, at AT&T/WorldCom's proposed rates, Verizon VA's net income would reach ***zero*** if 22% of Verizon VA's lines were leased as UNE-Ps -- a percentage that already has been exceeded in New York. ***(Id.)***

In **sum,** the UNE rates based on the TELRIC proposals in this proceeding would force Verizon VA to provide UNEs to CLECs at an ongoing loss, and the result would be a substantial confiscation of Verizon VA's property. Given this specific evidence that AT&T/WorldCom's proposed rates would be confiscatory, failure to consider this evidence would be reversible error.[42/] And to the extent that the rates do result in a shortfall, the Commission should, as it has

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[42/] ***Jersey Central Power,*** 810 F.2d at 1176-79.

previously committed to do, simultaneously create an alternative mechanism to recover that shortfall.[43/]

CONCLUSION

For the foregoing reasons, the Commission should grant Verizon VA's motion to permit the parties to supplement the record and consider Verizon VA's proferred evidence. Failure to do so would be reversible error: the Commission's decision would be based on an incomplete and outdated record, and the resulting rates inevitably would neither be TELRIC-compliant nor compensate Verizon VA for its costs.

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43/ *See Local Competition Order*, 11 FCC Rcd at 15872 ¶ 739; see *also Presault*, 494 U.S. at 11.