

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of

1993 Annual Access Tariffs

1994 Annual Access Tariffs

CC Docket No. 93-193

CC Docket No. 94-65

REPLY COMMENTS OF VERIZON¹

AT&T argues that the Commission can simply ignore the legal prohibition of retroactive rulemaking by doing the same thing in a ratemaking proceeding. It cannot. The Commission's refund power under section 204 is an exception from the prohibition of retroactive *ratemaking*, but it does not provide any exemption from the prohibition of retroactive *rulemaking*. Here, the Court has specifically found that the Commission cannot apply its 1995 add-back rule to rates charged prior to the rule's effective date. Contrary to AT&T's claim, the Commission recognized that it did not have a rule on the subject prior to 1995 and that this was not a matter of "clarifying" a rule that already existed. Nor can the Commission find that it was unreasonable for a carrier to *voluntarily* apply add-back prior to adoption of the rule, since the Commission cannot claim that add-back was inconsistent with price caps prior to 1995, even though it was not required.

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

This does not mean that the local exchange carriers were free to act in an arbitrary or inconsistent manner. The price cap rules have always allowed the carriers a certain range of choices in designing their rates and calculating their indexes, such as selecting the “X-factor” and restructuring their rates to maximize revenues. In addition, there was no guarantee that a particular carrier’s approach to add-back would maximize its revenues over the long term, because a carrier could not predict whether it would be in the sharing zone or in the lower formula adjustment zone in the future. So long as a carrier has been consistent in its approach to add-back, applying it both to sharing and to lower formula adjustments and doing it the same in each annual filing, the Commission cannot find that the carrier acted unreasonably in how it dealt with add-back prior to the time that the Commission decided to adopt add-back as part of its rules.

I. AT&T Is Wrong That The Price Cap Rules Included Add-Back Prior To The 1995 Rule Change.

AT&T’s primary argument is that add-back was always required under price caps and that the Commission should order the carriers who did not apply add-back in their 1993 and 1994 annual access tariff filings to recalculate their sharing obligations and pay refunds. *See* Comment of AT&T, 14-16 (filed May 5, 2003). However, if the price cap rules already included an add-back requirement, there would have been no need for a rulemaking proceeding – the Commission could have issued an order under section 1.3 of its rules clarifying the price cap rules. *See* 47 C.F.R. § 1.3 (2003). Instead, the Commission conducted a rulemaking proceeding to *change* its rules to adopt add-back as part of price caps. *See Price Cap Regulation for Local Exchange Carriers Rate-of-Return Sharing and Lower Formula Adjustment*, Report and Order, 10 FCC

Rcd 5656, ¶ 4 (1995) (“*Add-Back Order*”) (“we conclude that we should *amend* our rules” to require add-back) (emphasis added).

The Commission can point to nothing in its rules prior to 1995 that required add-back, even though the Commission found in the 1995 order that add-back was consistent with the *policies* underlying price caps and therefore was in the public interest as a going-forward requirement. In the rulemaking proceeding, several commenters argued that a rule requiring add-back would be a substantive rule change, rather than a clarification of existing rules, and therefore could not be applied retroactively to render existing tariffs unlawful. *See id.*, ¶ 48. The Commission agreed, finding that “the explicit add-back rule adopted here may, as a legal matter, be applied only on a prospective basis.” *Id.*, ¶ 49. That should be the end of the matter.

AT&T cites (at 14) the Court’s opinion upholding the add-back rulemaking in support of its position that the add-back rule may be applied retroactively, but the Court said just the opposite. It found that the rule could only be applied to tariffs filed *after* the rule was adopted in 1995;

the Add-back Order is not retroactive. The sharing rules, including the add-back rule, are purely prospective. They determine how much a carrier can charge for services that it will provide in the future. They do not render current tariffs unlawful, and they do not require carriers to refund money that they have already earned.²

The Court based this finding, in part, on the fact that if the add-back rule were applied to tariffs filed prior to 1995, it would change the consequences of the carriers’ decisions in selecting the X-factor. Add-back increased the rate of return of a carrier in the sharing mode and therefore its sharing obligation for the next tariff period. *See Add-Back Order*, ¶ 20. For this reason, as the

² *See Bell Atlantic Telephone Companies v. FCC*, 79 F.3d 1195, 1206 (D.C. Cir. 1996).

Court observed, the rule had a greater impact on carriers choosing the 3.3 percent X-factor, which had a lower sharing threshold than the 4.3 percent X-factor. Since the rule did not apply to tariffs filed prior to 1995, the Court held that it “does not change the past legal consequences of carriers’ decisions to choose the 3.3 percent X-factor rather than the 4.3 percent X-factor.” *Bell Atlantic*, 79 F.3d at 1207. Therefore, the Court held that the rule “does not upset petitioners’ reasonable reliance interests.” *Id.*

If the Commission tried to apply the add-back rule to the 1993 and 1994 tariffs, it would do precisely what the Court said it could not do by increasing the liability of carriers, such as *Bell Atlantic*, that chose the 3.3 percent X-factor in reasonable reliance on the absence of an add-back rule. Clearly, if the Commission had tried to do that in the add-back rulemaking, the Court would have rejected it.

For these reasons, the Commission cannot legally apply the 1995 add-back rule to the 1993 and 1994 tariffs at issue here.

II. AT&T Mixes Up The Concepts Of Retroactive Rulemaking And Retroactive Ratemaking.

AT&T tries to get around the bar against retroactive rulemaking by arguing that the Commission can do in a tariff investigation what the Court said quite clearly that the Commission cannot do – apply the 1995 rule change to the 1993 and 1994 tariffs. It does so by answering a question that the Commission did not ask – whether enforcement of the add-back rule is prohibited by the prohibition of retroactive ratemaking. *See* AT&T, 16. What the Commission really asked was “[w]ould application of the add-back rule to the 1993 and 1994 access tariffs constitute unlawful application of a substantive rule change?” *Further Comments Requested on*

the Appropriate Treatment of Sharing and Low-End Adjustments Made by Price Cap Local Exchange Carriers, Public Notice, 18 FCC Rcd 6483, 5 (2003). In other words, the Commission was asking whether this would violate the prohibition of retroactive rulemaking, not the prohibition of retroactive ratemaking. As the Court made clear, the answer to the question that the Commission actually posed is unequivocal – the 1995 rule change cannot be applied to tariffs filed prior to the effective date of the rule change.

The rule against retroactive ratemaking prohibits an agency from ordering refunds in a ratemaking proceeding unless and only to the extent that it is authorized to do so by Congress. *See Illinois Bell Telephone Co. v. FCC*, 966 F.2d 1478, 1482-83 (D.C. Cir. 1992). Section 204 of the Act provides an exception from the prohibition of retroactive ratemaking by permitting the Commission to order refunds in a tariff investigation if it follows the procedures mandated by Congress, including issuing an order suspending and investigating the tariff before it goes into effect, and issuing an order concluding the investigation and making appropriate findings prior to the statutory deadline.³ But this provides no exception from the prohibition of retroactive *rulemaking*. The Commission cannot predicate refunds in a tariff investigation on rules adopted *after* the tariff was filed and was no longer in effect. That is exactly the type of retroactive rulemaking that the Supreme Court struck down in *Bowen v. Georgetown Hospital*, 488 US 204 (1988).

AT&T argues (at 15-17) that the Commission can modify its price cap rules in the context of a tariff proceeding without violating the rule against retroactive rulemaking, citing the

³ As Verizon pointed out in its comments, the Commission failed to meet the 12-month deadline applicable to the 1993 and 1994 tariff investigations and therefore may not order refunds in these proceedings. *See* Comments of Verizon, 14-18 (filed May 5, 2003).

Commission's statements that ratemaking proceedings are “rulemakings of particular applicability.” This is incorrect. The Commission did not claim that it had the authority to apply rule changes retroactively in a ratemaking proceeding. Rather, the Commission found that section 204 of the Act gives it the authority to order refunds at the conclusion of a tariff investigation based on its reasonable interpretation of the Act and of its *existing* rules. As the Commission explained, its order in a tariff investigation “merely applies the obligations imposed by statute or *previously adopted* Commission rules to particular carrier conduct.” *Investigation of Special Access Tariffs of Local Exchange Carriers*, 5 FCC Rcd 4861, ¶ 8 (1990) (emphasis added). AT&T also cites the 1998 access charge reform order, but all that order states is the unremarkable proposition that the Commission often adopts ratemaking methodologies and policies in the context of tariff investigations, and that this does not violate the notice and comment requirements of the Administrative Procedure Act because the tariff proceeding provides for such a comment cycle. *See Tariffs Implementing Access Charge Reform*, 13 FCC Rcd 14683, ¶ 80 (1998). The Commission did not claim that it could modify its price cap rules in a tariff proceeding, and it certainly did not claim that it could apply a rule change that it had adopted in a rulemaking proceeding to a tariff that was filed and placed under investigation *before* the rule became effective. Such a claim would completely eviscerate the prohibition of retroactive rulemaking.

III. The Commission Cannot Find That It Was Unreasonable For Some Carriers To Apply Add-Back Voluntarily.

AT&T argues, in the alternative, that if the Commission cannot apply the add-back rules retroactively (which it obviously cannot), then the Commission should find that the carriers who voluntarily applied add-back, such as the former NYNEX, should be ordered to pay refunds due

to the effect of add-back on their sharing obligations. *See* AT&T, 18-19. However, it offers no arguments to support this position, which contradicts its own arguments that add-back was consistent with the underlying purpose of price caps. Even if add-back was not required as a matter of law, the Commission cannot find that it was unreasonable for a carrier to apply add-back *voluntarily*. All of the reasons that the Commission gave for adopting add-back as a rule of general applicability support the reasonableness of the carriers that adopted it for their 1993 and 1994 tariffs.

AT&T also argues (at 19-21) that the Commission cannot allow the carriers to apply a “bifurcated” approach whereby they applied add-back only when it increased their rates, i.e., when they had lower formula adjustments. But this is a straw-man argument – no carriers adopted a bifurcated approach. Carriers that applied add-back, such as NYNEX, applied it both when they had lower formula adjustments and when they shifted to the sharing zone. Carriers that did not apply add-back also did so consistently – for example, GTE included some local exchange carriers that were in sharing and others that were in the lower formula adjustment. The Commission cannot find that any individual carrier acted arbitrarily, because each followed its own, consistent policy until the Commission adopted the add-back rule.

AT&T argues that this harms the ratepayer by allowing the carriers to pick the approach that minimized their sharing obligations, but as Verizon has explained, there is no way to predict which approach would maximize a carrier’s revenues. A carrier could not predict whether it would be in the sharing or lower formula adjustment zone over the long term, and carriers such as NYNEX shifted very quickly from the lower formula adjustment to sharing. A decision to apply add-back might allow a carrier to maintain higher revenues when it was in the lower formula

adjustment zone, but it would later have lower revenues by applying add-back if it were in the sharing zone. Conversely, a carrier in the sharing zone that did not apply add-back would have lower revenues in the future if it fell to the lower formula adjustment zone. A carrier's future earnings were subject to a variety of factors beyond its control, such as changes in the economy, the growth of competition, and loss of lines to new technologies, such as wireless, as well as to the challenge of continuing to achieve the efficiency gains that were needed to "beat" the price cap formula's productivity factor. None of these factors can be predicted over the long term. AT&T's argument that allowing the carriers to take different approaches to add-back allowed them to "assign bad outcomes to ratepayers" does not hold water.

While the Commission decided in the 1995 rulemaking proceeding to require all carriers to apply add-back, this did not mean that it was inconsistent with the price cap system to allow the carriers discretion in their approach to add-back prior to that time. The price cap system was designed to give the carriers much more flexibility than they had under rate-of-return to design rates within pricing bands, to restructure their rates in a way that would maximize their revenue due to demand growth, and to retain part of the benefits of lower costs and increased revenues. *See, e.g., Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786, ¶¶ 22, 35, 198-99 (1990). In this context, the Commission allowed the carriers to use different, but equally reasonable, ratemaking approaches where the rules did not require a particular methodology. For instance, the Commission allowed the price cap carriers to use different costing methodologies to develop their forecasts of the "base factor portion" that was previously used to establish subscriber line charges. *See, e.g., 1997 Annual Access Tariff Filings*, 13 FCC Rcd 3815, ¶ 76 (1997) ("We continue to believe that there are many different methods that could produce reasonable forecasts for individual LECs, and that it would be counterproductive for us

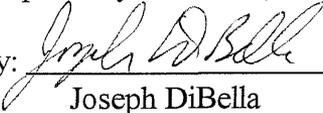
to prescribe the use of any particular methodology. In fact, the LECs whose forecasts we accept in this proceeding have used a wide variety of forecasting techniques, as was permitted by the 1997 TRP.”). The Commission also allowed the carriers to use different approaches in allocating universal service fund assessments among baskets. *See, e.g., Tariffs Implementing Access Charge Reform*, 13 FCC Rcd 14683, ¶ 165 (1998) (“We find generally that each of the three methods utilized by the price cap LEC's reasonably allocates their USF exogenous adjustment among the baskets.”). While the Commission sometimes prescribed a particular ratemaking methodology going forward, it did not mean that it was unreasonable for the carriers to follow different approaches prior to that time.

Similar flexibility with regard to add-back prior to the rulemaking was not inconsistent with the price cap system. Unlike rate-of-return, price caps was not intended to refund earnings above a specific, prescribed level, but to allow earnings within a “zone of reasonableness.” *See Add-Back Order*, ¶ 7. The sharing and lower formula adjustment mechanisms were designed as “backstops” for potential errors in calculating the productivity factor and to provide incentives for the carriers to become more efficient. *See id.*, ¶¶ 9-10. The lack of an add-back rule did not undermine these mechanisms or prevent them from achieving their purpose. The add-back rulemaking merely provided additional direction to the price cap carriers in their future choices of X-factors and rate structure changes.

Conclusion

The Commission cannot apply its add-back rule retroactively, but it also cannot find that a carrier that voluntarily adopted add-back acted unreasonably. The Commission should terminate these investigations without ordering refunds or taking any other remedial actions.

Respectfully submitted,

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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.
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