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 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 AT&T Communications of Virginia Inc., Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia Corporation Commission Regarding Interconnection Disputes With Verizon Virginia Inc.	)	CC Docket No. 00-251

WORLDCOM'S APPLICATION FOR REVIEW

WorldCom, Inc. (d/b/a MCI) ("MCI"), pursuant to 47 C.F.R. § 1.115, hereby submits this application for review of those parts of the above-captioned Order released by the Wireline Competition Bureau ("Bureau") released on August 29, 2003 ("Order"), that may be considered final. Specifically, MCI seeks review of the loop rates set in paragraphs 161-356 of the Order, and review of the cost of capital calculation, set out in paragraphs 58-104 of the Order. It does not at this time seek review of those parts of the Order that are not final because no rates have yet been set. MCI expressly reserves the right to seek review of those non-final portions of the Order when those rates are set by further order of the Bureau.

In this Order the Bureau has set TELRIC-based rates for loops in Virginia. In setting the loop rates, the Bureau has relied on a cost of capital calculation that is legally unsustainable. The Bureau's decision is based on a discussion of cost of capital found in the *Triennial Review*

Order[1] that, if faithful to that Order, demonstrates that the Order in that respect should be overturned or revised, as the result announced in this case makes clear. The result is irrational and produces an input that does not serve the purpose that a cost of capital input is designed to serve in a cost study, and that violates the Commission's TELRIC rules.

The Bureau's rejection of MCI-AT&T's DS-0 equivalent calculation that is a critical input determining the appropriate size of the modeled loop plant similarly is in conflict with clear Commission precedent as well as the terms of the 1996 Act. The Bureau has based the rate on input values proposed by Verizon that are inconsistent with the Commission's TELRIC rules set out in the *Local Competition Order*[2] and other Commission orders.

For these reasons, pursuant to 47 U.S.C. § 1.115(b)(3) and (4), MCI requests that as to each of the challenged inputs, the Bureau be ordered to substitute MCI's proposed inputs for Verizon's pursuant to the baseball arbitration rules in place, and that the Bureau then be ordered to re-calculate the loop rates based on these new input values.

QUESTIONS PRESENTED FOR REVIEW

1. Did the Bureau err in choosing Verizon's cost of capital proposal over MCI's because it mistakenly applied an inappropriate and unlawful market risk premium as an input to the CAPM model (¶¶ 81-86); an inappropriate an unlawful Beta (¶¶87-95); an inappropriate and unlawful cost of equity capital estimate (¶ 99); an inappropriate and unlawful capital structure (¶¶ 100-103); and so err in reaching an inappropriate and unlawful cost of capital (¶ 104)?

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[1] *In re Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers,* Report and Order, FCC 03-36 (rel. August 21, 2002).

2. Did the Bureau err in rejecting MCI's use of "DS-0 equivalents" to account for DS-1's and DS-3's in the network (¶¶ 208-213)?

ARGUMENT

A. Cost Of Capital

In most cases in which the Bureau accepted Verizon's cost of capital inputs over MCI's, its reasoning was essentially similar: that in its view, MCI had improperly relied on cost of capital comparisons that more closely reflected Verizon's forward-looking cost of capital, while Verizon properly had selected a cost of capital based on the historical cost of capital of highly competitive enterprises.[3] The Bureau supported this judgment by referencing statements in the *Triennial Review* that a competitive cost of capital was more appropriate. Order ¶ 5 (citing *Triennial Review* at ¶¶ 680-684, 689-691).

To begin, as the Bureau itself noted, Order ¶ 64 n.203, it had available to it but declined to use data that much more closely reflected actual competitive conditions at the time the legal standard changed. Moreover, as the Bureau again acknowledged, had it used this newer data its result would have been substantially different. It was irrational for the Bureau to refuse to take into consideration newly relevant (and uncontested) factual information in its possession.

Additionally, the extraordinarily high rate calculated by the Bureau – so high that it was even *above* the Verizon's proposed rate, and is one of the highest in the country – makes clear that there is something badly wrong with the policy judgment that supports such a result. As the

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[2] *In re Implementation of the Local Competition Provision in the Telecommunications Act of 1996*, First Report and Order, 11 F.C.C.R. 15499 (1996).

[3] As AT&T correctly observes in its appeal, the Bureau committed other, additional errors in making its cost of capital calculation. MCI hereby joins and incorporates by reference those portions of the AT&T appeal that makes these additional points.

Bureau understood it, the Commission has instructed state commissions simply to ignore the business risk the ILECs face when they enter the market to raise money to provide wholesale services – even viewed on a hypothetical, forward-looking manner. See *Bell Atlantic-Delaware, Inc. v. McMahon*, 80 F.Supp.2d 218, 240-41 (D. Del. 2000) (rejecting essentially the same claims by Bell Atlantic in Delaware). The Bureau's understanding of the Commission's suggestion that cost of capital be assessed in complete disregard of those conditions is unsustainable, especially in light of the tentative conclusions of the Commission's TELRIC notice,[4] which propose that inputs more *closely* reflect real-world conditions.

The Bureau asserts that consistency with the premises of TELRIC required it to *assume* that effective competition for wholesale services will exist during the next few years, *regardless of* whether Verizon *in fact* is likely to face effective competition for the business of supplying UNEs at wholesale. Whatever the instruction in the *Triennial Review*, it did not purport to overrule the *Local Competition Order,* and that Order requires a detailed factual inquiry ("demonstrating with specificity") into the competition that Verizon "faces"—not the hypothetical level of risk that Verizon *would* face *if* (contrary to fact) the local market were fully competitive or contestable. ¶ 702. The factual inquiry mandated by the FCC, and the FCC-imposed allocation of the burden of proof for resolving any disputed facts, would be pointless if the FCC now means for state commissions simply to *presume* the existence of intense competition.

There is no legal inconsistency between the requirements of Paragraph 702 and the other elements of the TELRIC standard set forth in the *Local Competition Order*. It is commonplace, if not mandatory, for state regulators to base rates on the *costs* that would prevail in an effectively competitive (or contestable) market, while limiting *returns* to the levels needed to

[4] *In re Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements,* FCC 03-224 (rel. September 15, 2003).

compensate the regulated firm for the risk it actually faces.[5] The TELRIC-like cost standard adopted by the Interstate Commerce Commission in 1985 for regulating rates paid by captive rail shippers, the stand-alone cost ("SAC") test,[6] provides clear precedent in this regard: as implemented by the ICC, the SAC test combines the forward-looking cost assumptions of perfect contestability with a cost of capital based on the existing risks of the incumbent carriers.[7]

Moreover, to base UNE costs and prices on the counterfactual assumption that Verizon faces intense competition in the business of supplying UNEs, would violate Section 252(d)(1)(A)(ii) of the 1996 Act, which requires that UNE prices be nondiscriminatory as well as cost-based. Nondiscrimination dictates that the prices paid by CLECs to Verizon are the same as

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[5] *See Bluefield Water Works Improvement Co. v. PSC*, 262 U.S. 679, 692-93 (1923); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944)). *Accord*, *Bell Atlantic-Delaware, Inc. v. McMahon*, 80 F.Supp.2d 218, 240-241 (D.Del. 2000); *id*. at 240 n. 19.

[6] *See* Coal Rate Guidelines—*Nationwide*, 1 I.C.C.2d 520, 534-47 (1985), *aff'd sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987); *Potomac Electric Power Co. v. ICC*, 744 F.2d 185, 193-94 (D.C. Cir. 1984).

[7] In determining the cost of capital component of stand-alone cost, the Surface Transportation Board, like its predecessor, the Interstate Commerce Commission, uses the agency's annual cost of capital determination for the industry, not the cost of capital of hypothetical carrier in a highly competitive or contestable market. *See* STB Docket No. 42022, *FMC Wyoming Corp. v. Union Pacific R. Co*. (decision served May 12, 2000), slip op. at 178 ("As in prior SAC cases, we find it appropriate to assume that the rate of return that the ORR [hypothetical stand-alone railroad] would earn is the railroad industry cost of capital"); *Arizona Public Service Co. v. Atchison, T. & S.F. Ry. Co.*, 2 S.T.B. 367, 438 (1997) (same); *Bituminous Coal—Hiawatha, UT, to Moapa, NV*, 10 I.C.C.2d 259, 315 n. 76 (1994) (same). The "railroad industry cost of capital" determined by the STB and ICC is based on a comparison group consisting of the publicly traded corporate parents of major Class I railroads. *See* Ex Parte No. 558 (Sub-No. 3), *Railroad Cost of Capital—1999* (decided June 6, 2000), slip op. at 1-2 & footnote 1 (noting that STB's annual cost of capital determinations for the railroad industry rely on a DCF comparison group composed of actual Class I carriers controlled by selected major railroad holding companies); Ex Parte No. 552 (Sub-No. 4), *Railroad Revenue Adequacy -- 1999 Determination* (served July 19, 2000), (finding that the 1999 railroad industry cost of capital was 10.8%).

the implicit prices (i.e., economic costs) that Verizon incurs in supplying the same elements to itself for use in providing Verizon-branded retail service. The capital costs that Verizon incurs when it engages in such self-provisioning reflect the risks that it actually anticipates, not the higher capital costs of a riskier, more competitive business.

Furthermore, the *Local Competition Order* makes clear that one of the main purposes of TELRIC pricing is to enable new entrants to share in the incumbents' scale and scope economies. One of those economies is the reduced cost of capital enjoyed by Verizon as a result of its near-monopoly scale and scope in Virginia local markets. As the FCC has explained:

> The incumbent LECs have economies of density, connectivity, and scale; traditionally, these have been viewed as creating a natural monopoly. As we pointed out in our NPRM, the local competition provisions of the Act require that these economies be shared with entrants. We believe that they should be shared in a way that permits the incumbent LECs to maintain operating efficiency to further fair competition, and to enable the entrants to share the economic benefits of that efficiency in the form of cost-based prices.

Local Competition Order ¶ 11 (footnote omitted).

Additionally, the evidence before the Bureau here was that estimating the cost of capital in the perfectly competitive or contestable market modeled by the TELRIC standard would be difficult, if not impossible, for no such markets actually exist; hence, there are no observations for the analyst to use as data points. Tr. 3627 (Hirshleifer). The evidence also demonstrated that the cost of capital in such a hypothetical market would, in principle, be *lower* than Verizon's actual cost of capital, because the assumption that all technology is current and no investment becomes sunk or stranded eliminates two of the largest risks faced by real firms. *Id*. at 3625-26; *accord*, AT&T/MCIMCI Cost Br. at 80 n. 71 (citing legal and economic precedent).

In sum, both for procedural and substantive reasons, the Commission should vacate the Bureau's cost of capital calculation and remand the matter to the Bureau to substitute the MCI/AT&T proposal.

B. Loop Costs Line Counts

All parties to the arbitration accounted for DS-1 and DS-3 lines in the same manner. Starting with ARMIS and information provided by Verizon in discovery, they treated those lines in terms of DS-0 equivalencies. The Commission did exactly the same thing in its Universal Service modeling. AT&T/MCI Ex. 15P (Baranowski Surreb.) at 6-8; AT&T/MCI Ex. 14 (Pitkin Surreb.) at 47.

Both parties also acknowledged that their respective models were subject to the criticism that they did not fully capture the way DS-1 and DS-3 lines are actually integrated into a network. The difference, as the Bureau noted in its *Order,* is that the MCI/AT&T model at least attempted to account for this discrepancy, while the Verizon model priced DS-0 loops as if there were no DS-1 or DS-3 in the network, thus undoubtedly raising the price of DS-0s by ignoring all economies of scale that exist in the real world. *Order* ¶¶ 208-210.

Inexplicably, the Bureau looked at this evidence and accepted what it understood to be Verizon's input, which it acknowledged led to an overstatement of the true cost of loops, ¶ 210 & n. 559, and rejected MCI/AT&T's input, which at least had tried to address the discrepancy. ¶ 209. That was a completely unjustifiable decision.

The Bureau asserts that MCI/AT&T did not prove with requisite certainty that the correction they offered "to offset overstating line counts" did not result in over- or under-counting. ¶ 209. It disparages MCI/AT&T's approach as "two wrongs-make-a right." *Id.* But it does not deny that Verizon's approach, which simply pretends that there is no DS-1 or DS-3 in the network at all, deprives competitors of all of the economies of scale provided by the loop plant. Based on that record, to accept Verizon's solution over MCI/AT&T's could not be more arbitrary and capricious. To say, as the Bureau does, that Verizon's approach "represents an upper bound" of what TELRIC permits is pure *ipsie dixit.* In truth, Verizon's approach has led to greatly inflated loop rates, as the Bureau as much as admits in the same breath it accepts the approach "as a valid application of TELRIC principles." Order ¶ 212 & n.559.

It was indefensible to accept a proposal which ignores a distortion over one that attempts to address it, especially when the result is to inflate rates on bottleneck loop facilities, and especially when the Commission itself has used the same approach as MCI and AT&T when modeling loop costs. The result unless corrected will impair all competition in the residential markets in Virginia (both UNE-L and UNE-P).

CONCLUSION

MCI respectfully request that the Commission grant its petition for review.

Respectfully submitted,

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September 29, 2003

Certificate of Service

I, Lonzena Rogers, do hereby certify, that on this twenty-ninth day of September, 2003, have served electronically and United States Postal Service first class mail, a true and correct copy of WorldCom, Inc.'s Application for Review in the matter of CC Docket No. 00-218 on the following:

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