PUBLIC (REDACTED) VERSION

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 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

OPPOSITION OF WORLDCOM, INC. AND
AT&T COMMUNICATIONS OF VIRGINIA, LLC
TO VERIZON VIRGINIA INC.'S MOTION FOR STAY
AND APPLICATION FOR REVIEW

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OPPOSITION OF WORLDCOM, INC. AND
AT&T COMMUNICATIONS OF VIRGINIA, LLC
TO VERIZON VIRGINIA INC.'S MOTION FOR STAY
AND APPLICATION FOR REVIEW

WorldCom, Inc. (d/b/a MCI) ("MCI") and AT&T Communications of Virginia, LLC ("AT&T") respectfully submit this joint opposition to the Motion for Stay and Application for Review filed by Verizon Virginia Inc. ("Verizon") on September 29, 2003. The two Verizon pleadings challenge the Memorandum Opinion and Order adopted by the Commission's Wireline Competition Bureau on August 28 and released by the Commission on August 29, 2003. Memorandum Opinion and Order, DA 03-2738 ("*Order*"). Both pleadings should be denied.

The most urgent need in this arbitration is the issuance of a final Commission decision on pricing. Almost four years have elapsed since WorldCom and AT&T first asked Verizon to negotiate updated rates for UNEs in Virginia. Almost three years have passed since the

arbitration proceedings began at the Commission. Almost two years have passed since the close of the pricing record. Until a final decision issues, Verizon will continue to charge UNE prices that almost certainly violate TELRIC, as the Commission itself recognized in the *Virginia 271 Order*.[1]

The stay requested by Verizon could perpetuate these excessive and unlawful rates for years. The substantive changes requested by Verizon in its application for administrative review could lock in Verizon's excessive rates permanently. Allowing either outcome would abdicate the Commission's responsibilities under the 1996 Act. It is time to bring this long-running case to an end, and deliver the competition promised by the Act to ratepayers and consumers in Virginia.

SUMMARY OF ARGUMENT

A. Verizon's Motion for Stay

Verizon's motion for stay and application for review could not be more frivolous. First, allowing the *Order* to take effect will not injure Verizon, let alone inflict injury that is immediate, significant and irreparable. For the most part, Verizon challenges rates that have not yet even been set. For those rates, Verizon cannot yet claim any injury at all—let alone any irreparable injury—and cannot make any of the other equitable showings necessary to obtain a stay.

For the only rates that have been set, loop rates, Verizon's claims for a stay of those rates is equally frivolous. *All* of the rate changes imposed by the *Order* are subject to a true-up provision, imposed by the Commission precisely to preclude the kind of injury that Verizon

[1] WC Docket No. 02-214, Memorandum Opinion and Order (released October 30, 2002) ("*Virginia 271 Order*") at ¶89: "Based on the record in this proceeding and a review of the underlying state proceedings, we have serious concerns as to whether the rates established by the Virginia Commission in its state rate proceedings are TELRIC-compliant."

alleges here. In any event, the overall effect of the Bureau *Order* is to *increase*, not decrease, the loop rates that Verizon may charge in Virginia. Allowing those rates to go into effect will enlarge Verizon's cash flow pending administrative review, and granting a stay would have the opposite effect.

A fortiori, Verizon has also failed to show that the injury it purportedly would suffer without a stay will exceed the injury that Verizon's customers and competitors would suffer from grant of a stay. The reason is obvious: the financial effect to Verizon from allowing the Bureau-imposed rate changes to take effect is, by definition, equal to the financial effect to Verizon's customers and competitors from staying the rate changes. There is one critical difference, however: Verizon, "one of the great cash machines of Corporate America," can absorb any temporary changes in cash flow during the pendency of administrative review far better than can any other party in this case.

Third, the public interest clearly disfavors a stay. This is already an old case. The voluminous record closed over two years ago, and a final opinion is likely to be months in the offing, even in the best of circumstances. The open-ended stay sought by Verizon could prolong this state of affairs for years. There is no offsetting public interest in delay, for most of Verizon's agenda—particularly its ongoing war against Total Element Long Run Incremental Cost ("TELRIC") and its efforts to preserve its extortionate rates for special access—is likely to reappear *ad nauseam* in the forthcoming TELRIC rulemaking and other ongoing industrywide proceedings.

Finally, for the reasons summarized in the following paragraphs and detailed in Section II, Verizon's motion for stay should be denied because Verizon's challenges to the *Order* have no likelihood of success on the merits.

B. Verizon's Application For Review

The recently announced TELRIC rulemaking provides no basis for overturning (let alone staying) the *Order*. The Commission's existing rules, not the recent TELRIC Notice of Proposed Rulemaking,[2] establish the governing legal standards for review of the Order. Moreover, refusing to implement the *Order* until the Commission concludes the rulemaking could delay the resolution of this case, and the advent of full competition in Virginia, for years.

Verizon's challenges to specific loop inputs and rates are unfounded. Verizon has waived its objections to the 12.95 percent cost of capital adopted by the Bureau by failing to present those claims to the Bureau before the close of the record. In any event, Verizon is not aggrieved by the Bureau's exclusive reliance on a CAPM-based cost of equity: the only legitimate DCF-based estimates of the cost of equity are significantly lower. Finally, the record provides no basis for adopting the regulatory risk premium that Verizon belatedly proposes.

Verizon's arguments for shorter depreciation lives are also without substance. The *Triennial Review Order* ("TRO") leaves the choice between the Commission-approved depreciation lives and financial (GAAP) lives in unbundled network element ("UNE") cases to the adjudicator's discretion. In this case, the record provides ample evidence that the lives adopted by the Bureau provide a reasonable measure of forward-looking depreciation lives, while Verizon's proposed GAAP lives are unduly biased toward the interests of investors rather than ratepayers.

The Bureau also had ample reason to reject the forward-looking-to-current ("FLC") conversion factor proposed by Verizon. Verizon's adjustments to its embedded expense data did

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[2] *See Notice of Proposed Rulemaking, Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, FCC WC Docket No. 03-173, (released September 15, 2003) ("*TELRIC NPRM*").

not begin to make them forward-looking; hence, application of the FLC factor would have produced a result far in excess of efficient forward-looking levels.

The uncollectibles ratio is another issue that Verizon has waived by failing to present it to the Bureau before the close of record. Moreover, Verizon has made no showing that the rate of uncollectibles is likely to be higher over the long run than the *Order* found. In any event, it would be arbitrary and capricious to update the record just for recent changes in the uncollectible rate, without updating the record to reflect changes in other cost inputs, many of them downward, during the same period.

Verizon's criticisms of other loop issues resolved by the *Order*—the choice of a loop cost model, the DS-1 and DS-3 rates, the fill factor for distribution cable, and the use of GR-303 Integrated Digital Loop Carrier technology—are also unfounded for the reasons explained below.

Verizon's challenges to *non-loop* inputs and rates are premature. The *Order* did not set specific rates for non-loop UNEs or nonrecurring items, and the input values and other subsidiary findings made by the *Order* in these areas are interlocutory, nonfinal and nonreviewable until specific rates are actually set. In any event, the specific challenges offered by Verizon to the Bureau's findings concerning switching, dedicated transport and nonrecurring costs are at odds with the record and the Commission's prior decisions.

The Commission's approval of Verizon's 271 application in Virginia, and the level of the rates charged by Verizon in other states, also fail to advance Verizon's case. Neither the limited rate review undertaken by the Commission in a Section 271 proceeding, nor the interstate rate comparisons offered by Verizon, can override the detailed analysis and findings provided by the *Order* under Sections 251 and 252 of the Act. In any event, the rates set by the *Order* are by no means unusually low in comparison to corresponding rates in other states.

Finally, Verizon's confiscation claim is frivolous. The burden of production and persuasion with respect to the takings issue rests on Verizon, not the Commission, the Bureau, or the other parties. Verizon has not begun to offer a *prima facie* takings claim. Until Verizon does so, the Commission has no obligation to consider the issue on its own initiative—let alone to stay or overturn the Bureau order on a takings theory.

In short, Verizon's merits claims are as empty as its claims for entitlement to equitable relief. Verizon has filed its motion for stay and application for review not to avoid any interim injury or to assert any legitimate grievance, but to appropriate the Commission's appellate procedures as a soapbox for Verizon's ongoing political assault on the TELRIC rules. This is an abuse of the Commission's processes. The motion for stay, and the application for review, should be denied.

ARGUMENT

I. A STAY OF THE BUREAU'S ORDER WOULD BE A PREMATURE AND ILLEGITIMATE INTERVENTION INTO THE COMMISSION'S ADJUDICATIVE PROCESS.

A stay pending appeal is an "extraordinary remedy" that places a heavy burden on petitioners seeking the stay. *Virginia Petroleum Jobbers Ass'n v. FPC*, 259 F.2d 921, 925 (D.C. Cir. 1958) (describing a stay as "extraordinary relief"); Memorandum Opinion and Order, *Amendment of the Commission's Rules Regarding the 37.0-38.6 GHz and 38.6-40.0 GHz Bands*, 15 FCC Rcd. 10579 ¶ 4 & n. 13 (2000) (applying *Virginia Petroleum Jobbers*). Each of four criteria must be satisfied for a stay to issue: the petitioner must establish a likelihood of success on the merits, demonstrate irreparable harm in the absence of a stay, show that such harm will not be offset by substantial harm to other parties to the proceedings, and show that the public interest is served by a stay. *Id.* Verizon has satisfied none of these criteria.

A. Verizon Fails To Show That The Order Will Cause Any Injury, Let Alone The Irreparable Harm Required For A Stay.

Verizon's entire claim that the *Order* will result in irreparable harm rests on a radical mischaracterization of what the *Order* does and does not do. Rates, Verizon insists, will be "slashed" in Virginia, in some cases by as much as fifty percent. But most of the rates about which Verizon complains have not yet been set, and are subject to further Bureau proceedings. Specifically, the Bureau has set only loop rates. Rates for switching, transport, non-recurring charges, and the other elements at issue in this case, await further action by the parties and the Bureau, which has ordered the parties to re-run models with specified inputs, and allow the opposing party to comment on these rate proposals. As the Chief of the Pricing Policy Division noted in her October 3 procedural order in this proceeding, "most of the rates in this proceeding have yet to be established and will not be established until after the parties submit compliance filings on November 28, 2003." *Order* (rel. Oct. 3, 2003) at ¶ 4. Only after that process is completed will there be final rates.

Obviously, Verizon is not entitled to the extraordinary remedy of a stay to protect it from rates that have not yet even been set. It currently continues to lease switching and transport and to assess non-recurring charges based on rates that have been in effect since 1998. There is simply no change in the status quo that could possibly be the subject of a stay.

For loops, where the *Order* does propose rate changes, the changes are generally *increases*, not decreases. And for the handful of rate reductions, the true-up provisions of the *Order* will provide complete relief if the Commission ultimately sets higher rates than those reflected in the Order.

1. Verizon's Claim Of Irreparable Injury Is Based On Conclusory Assertions About Non-Loop Rates That Are Not Set In The *Order.*

Most of Verizon's motion is devoted to the bizarre proposition that it has been irreparably harmed by rates that the *Order* has not even set. The *Order*, Verizon insists,

radically lowered switching rates and "slashes non-recurring rates." Motion at 17 & 26. But the *Order* does not establish either switching or non-recurring rates. The only rates actually established by the *Order* are loop rates; setting all non-loop rates has been deferred to a subsequent order. All the August 29 *Order* requires with respect to non-loop rates is the resubmission of cost studies (¶¶ 695-697). The cost or inconvenience of submitting such compliance findings and participating further in the adjudicative process cannot, by any stretch of the imagination, be considered the kind of irreparable harm that justifies the extraordinary remedy of a stay. *See FTC* v. *Standard Oil Co.,* 449 U.S. 232, 244 (1980) ("Mere litigation expense, even substantial and unrecoupable cost, does not constitute irreparable injury.") (internal citation omitted).

To the extent that Verizon's assertions of irreparable injury derive from its assertions about rates that are *not* set in the *Order*, a stay at this point is entirely inappropriate. Additional work is required because the Bureau accepted one party's cost model and at least some of another party's inputs. Verizon does not suggest that it is inappropriate to have the parties re-run their models to conform to the Bureau's *Order.* To argue that a current order should be stayed on the grounds that a *future* order may affect Verizon's interest is at odds with the requirement that a petitioner show immediate irreparable injury. *See, e.g., In re Microsoft Corp. Antitrust Litigation,* 333 F.3d 517, 528-30 (4th Cir. 2003); *Direx Israel Ltd.* v. *Breakthrough Medical Corp.,* 952 F.2d 802, 815 (4th Cir. 1991) (harm must be "actual" and "immediate"); *ECRI* v. *McGraw Hill, Inc.* 809 F.2d 223, 226 (3rd Cir. 1987) (requirement of "immediate irreparable injury").

2. Loop Rates Set In The *Order* Represent An Aggregate *Increase* In Verizon's UNE Revenue.

As to the loop rates, at least they have been set in the *Order*. But the rates established in the *Order*, rather than visiting an irreparable injury to Verizon, are on average higher than those

that were in place, and so leave Verizon in a better position than it was prior to the *Order*. Verizon's revenue will *increase* as a consequence of the loop rates established in the *Order*, a fact that renders their request for a stay absurd.

Specifically, virtually the only loops that AT&T and MCI make use of in Virginia are the basic two-wire loops used to provide residential and small business services, and that are used as part of the UNE platform of loops plus switching ("UNE-P"). Those loop rates went up on average of 6 percent on a state-wide basis.[3] A stay of these rates therefore would limit, not increase, Verizon's revenue pending administrative review.

Verizon conveniently overlooks this, reacting instead with feigned indignation to changes to high capacity loop rates that have virtually no effect on the company's bottom line. DS-3 and DS-1 loops constitute an insignificant fraction of the UNEs provided by Verizon to competitive local exchange carriers ("CLECs").[4] Indeed, Verizon does not even attempt to prove any actual economic injury resulting to it from the new high-capacity loop rates, and its utter failure to meet its burden of proof on this point (or even to attempt to meet it) puts a lie to its rhetoric. The "real world" of UNEs in Virginia is one in which over 75% of CLEC customers are served by

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[3] Specifically, two-wire loop rates went up in zone 1 from $10.74 to $11.89. Over 75% of the lines in the state are in pricing zone 1. Although rates in zones 2 and 3 declined slightly, they constitute a very small part of the state's loop plant, and a much smaller percentage of the loops that are leased by AT&T and MCI, because the rates are extremely high (and remain so) making profitable use impossible.

[4] Use restrictions on unbundled high capacity loops have generally forced CLECs to purchase these elements at radically inflated special access prices and made these UNEs unavailable as a practical matter. That those restrictions may no longer apply (having been replaced by different restrictions) – which is the substance of Verizon's complaint – cannot be attributed to this *Order*. The Commission's *Triennial Review Order* removed restrictions on the use of high capacity loops, and the *TRO* is itself subject to separate appellate proceedings. AT&T and MCI intend to challenge the new use restrictions imposed by that Order, and Verizon is also free to make whatever challenges it wishes to that Order. To the extent that Verizon's complaint is with the loss of its special access revenue because the new use restriction in the *TRO* is not to its liking, those proceedings are the proper forum in which to seek redress. Such complaints hardly establish irreparable harm (or any harm at all) here.

unbundled basic loops for which the UNE rate has increased by over 10%. The only parties injured by this state of affairs are AT&T and MCI, who have sought relief from these unjustifiable rate increases.

3. The True-Up Provisions Of The *Order* Will Provide Complete Relief If The Commission Ultimately Sets Higher Rates Than Those Reflected In The *Order*.

If all of that were not enough, even if the *Order* somehow reduced Verizon's revenue during the pendency of administrative review, the *Order's* true-up provisions assure that Verizon would be fully compensated in the extremely unlikely event that any of its merits claims were ultimately sustained by the full Commission. Specifically, every rate determination in the *Order* is subject to a comprehensive true-up provision that will operate retroactively to ensure that Verizon will capture the full value of any changes the Commission makes to rates set in the *Order*. Specifically, the *Order* states that its true-up provision "must ensure that no carrier is disadvantaged by our orders in the event that [rates established by the Bureau] are subsequently modified by the Commission on review." *Order* ¶ 26. If the Commission, on review, changes any of the rates established either in the *Order* or in any subsequent orders addressing the compliance filings, the true-up provision "shall apply retroactively to the effective date of the Bureau's order adopting rates." *Id.*

In directing the Bureau to include this true-up mechanism in its rate orders in this proceeding, the Commission specifically found that the mechanism "will ensure that no carrier is disadvantaged by rates established by the Bureau's orders that differ from any rates set by the full Commission on review." Order, *Procedures for Arbitrations Conducted Pursuant to Section 252(e)(5) of the Communications Act of 1934, As Amended*, 16 FCC Rcd. 6231 ¶ 10 (2001). This finding is clearly correct. "Recoverable monetary damages do not irreparably harm the movant unless it can show that the viability of its business is placed in jeopardy." Memorandum

Opinion and Order, *Cincinnati Bell Tel. Co.*, 8 FCC Rcd. 6709 ¶ 10 (1993) (citing *Wisconsin Gas Co.* v. *FERC*, 758 F.2d 669, 674 (D.C. Cir. 1985)).

Verizon gains nothing by asserting that the true-up can compensate Verizon only for "some measure" of the losses supposedly threatened by the *Order*, because the true-up cannot make Verizon whole for the "goodwill" that the *Order* will cause Verizon to lose. Essentially, Verizon is complaining that the competition it suffers constitutes an irreparable harm, an argument that is both unproven factually, and fundamentally at odds with the goals of the 1996 Act. That is, Verizon has not shown that it will immediately lose any of its high capacity loop customers as a result of these new rates, and it is quite clear that it will not. The theoretical possibility that a party may suffer a "permanent loss of customers and goodwill" is too "remote [and] speculative" an injury to justify a stay absent compelling evidence that the threatened injury is "actual," "imminent" and substantial. *Scotts Co.* v. *United Industries Corp.*, 315 F.3d 264, 283-84 (4th Cir. 2002).

None of the string of authorities cobbled together by Verizon even remotely resembles this case. In *Multi-Channel TV Cable Co.* v. *Charlottesville Quality Cable Operating Co.*, 22 F.3d 546 (4th Cir. 1994), for example, the Court of Appeals affirmed the enjoinder of a private exclusivity agreement between a property management company and one cable company that categorically excluded another cable company from making use of its own installations in particular apartment complexes. In that case, the loss of customers was both inevitable and immediate, as well as the consequence of an unregulated private agreement. Here, the *Order* is the consequence of an exhaustive proceeding that does no more than make adjustments to the regulatory mandate of competition in telecommunications. All Verizon can claim, essentially, is that the fact that the *Order* does not raise rates as high as Verizon would have liked creates a competitive environment.

Similarly, Verizon's reliance on this Commission's order in *AT&T Corp.* v. *Ameritech Corp. and Qwest Communications Corp.,* 13 FCC Rcd. 14508 (1998), is highly disingenuous at best. There, the Commission enjoined another private agreement, between a BOC local exchange carrier and a long-distance carrier, which, in addition to constituting an arguable violation of § 271 of the Communications Act of 1934, involved the *actual* migration of customers from one carrier to another. Verizon's artful editing of quotations from that opinion tries to suggest a parallel between that case and the issues presently before the Commission. But, the circumstances of this case and of *Ameritech* could not be more different. Here the Commission address a rate order that raises slightly high-capacity loop rates at a time when competitors lease virtually no high-capacity loops. No Verizon customers are directly (or even indirectly) implicated by the *Order*. In *Ameritech*, in complete contrast, an incumbent local exchange carrier ("ILEC") impermissibly poached actual long-distance customers through an agreement pursuant to which the ILEC sought unlawfully to provide interLATA services.

* * *

Verizon's failure to show that it will suffer irreparable injury without a stay is dispositive. When an applicant for stay fails to make this showing, the Commission can deny the stay without considering the other three *Virginia Petroleum Jobbers* criteria (injury to other parties, harm to the public interest, and the likelihood of ultimate success on the merits). *Amendment to the Commission's Rules Regarding the 37.0-38.6 GHz and 38.6-40.0 GHZ Bands, supra*, 15 FCC Rcd. 10579 at ¶ 4 (citing *Wisconsin Gas*, 758 F.2d at 674). As we now show, however, Verizon has failed to satisfy the other three stay criteria as well.

B. The Harm To CLECs From A Stay Is Greater Than Any Harm To Verizon From Denying A Stay.

Tellingly, Verizon also neglects to acknowledge that, even if there were some demonstrable "goodwill" effect that could be traced to *Order* (and there is not)—it would

necessarily apply with equal force to the CLECs. If it were true that Verizon's cash flow would be affected by the implementation of the rates before final review, then it is equally true that a stay would simply transfer that effect to the CLECs and consumers. Likewise, if there were some immediate and demonstrable competitive effect resulting from the slight decrease in high-cap loop rates, staying those rates would harm AT&T and MCI every bit as much as letting them go into effect would harm Verizon. In such a situation, the balance of equities clearly militates against a stay. As a long-term monopoly carrier, Verizon is far less vulnerable to short-term fluctuations in both cash flow and market share than are AT&T and MCI. In the words of a recent cover article in *Business Week*, Verizon is "one of the great cash machines of Corporate America," generating about "$22 billion a year in cash from operations. That's 50% more than SBC, twice as much as BellSouth, and nearly three times as much as AT&T." *Business Week* (August 4, 2003), at 53-55. Verizon's incumbency advantage also renders it far more likely to resist the loss of customers to new market entrants, and it is far more likely to win back customers from a CLEC than the CLEC is to win the customer from the ILEC in the first place.

C. The Public Interest Disfavors A Stay.

Any effort to preserve high rates in the face of an order requiring lower rates could only have the effect of deterring competition in Virginia and raising rates to consumers. The public interest is in more competition and lower rates. It would be greatly disserved by a stay here.

Equally to the point, the delay Verizon seeks also would greatly disserve the public. The Wireline Competition Bureau has been considering the issues in the Virginia Arbitration for well over three years. The voluminous record itself closed over two years ago, and, as discussed above, the *Order* is, in many respects, not final. Without regard for any principles of

administrative efficiency, Verizon seeks again to draw these proceedings out.[5] But, even more startlingly, it seeks to do so on the basis of issues that are themselves subject to entirely different Commission proceedings. Many of Verizon's complaints, including its general attack on TELRIC and its continued defense of its extortionate special access rates, do not relate to this *Order* at all, but to the Commission's *Triennial Review Order* and *TELRIC NPRM*. To stay these proceedings while those other battles are fought elsewhere serves nobody's interests but Verizon's. The bizarre suggestion that Virginia rates should be frozen at 1998 levels because the Commission is now reconsidering its TELRIC rules—in a proceeding that has not even commenced and could last for years—is especially offensive. It is no exaggeration to suggest that Verizon's request runs counter to the very integrity of regulatory adjudication, and it cannot realistically be argued that further delays in this case serve any conceivable public interest.

D. Verizon Is Unlikely To Succeed On The Merits.

In Section II of this joint pleading, AT&T and MCI respond to Verizon's equally frivolous application for review of the *Order*. Rather than summarize or repeat our analysis of the merits here, we simply incorporate Section II by reference.

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[5] As the *Order* notes, Verizon has frequently sought to delay these proceedings. In September 2002, nearly a year after the closing of the record, Verizon made its first attempt to file additional record evidence. In November 2002, Verizon moved to reopen the record to allow for supplementation, and, in April 2003, Verizon, without seeking leave, unilaterally submitted a proffer of supplemental evidence. In seeking now to stay the *Order*, Verizon seems to have disregarded the first point the *Order* makes in rejecting Verizon's additional evidence and denying its motion to re-open the record: "[R]ate cases must end, or rates would never be set." (¶ 21).

II. VERIZON'S APPLICATION FOR REVIEW OF THE AUGUST 29 ORDER IS WITHOUT MERIT.

A. The Recently Announced TELRIC Rulemaking Provides No Basis For Invalidating Or Staying The *Order*.

Verizon argues that the Commission "should simply stay the *Order* until it reforms its TELRIC rules," because the *Order* "prejudges major policy issues now under consideration" in the TELRIC *NPRM* and "moves in precisely the opposite direction from" the *TELRIC NPRM*.[6] The Commission should reject Verizon's request. The *TELRIC NPRM* is simply a proposal. It has not been adopted by this Commission as binding law, and the timing and substance of any final action taken by the Commission as a result of the new rulemaking are speculative.

Furthermore, continuing to defer the implementation of the rates prescribed by the *Order* could impair competition for years to come. Invoking the pendency of the new rulemaking proceeding as a ground for delaying the effectiveness of the *Order* would simply stall the implementation of TELRIC-compliant UNE rates, and postpone further emergence of effective competition in the local exchange market.

1. The Commission's Existing Pricing Rules, Not The Recent Notice Of Proposed Rulemaking, Establish The Governing Legal Standards For Deciding This Case.

Absent extraordinary circumstances, a court or agency is required to apply the law in effect *at the time it* renders *its decision* – not on the basis of what the law *might* be in the future.[7]

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[6] *See* Motion at 3, 8-10; Application at 2, 9, 63.

[7] *See, e.g., Bradley* v. *Richmond School Board*, 416 U.S. 696, 711 (1974); *Meghani* v. *United States*, 236 F.3d 843, 846 (7th Cir. 2001). Conversely, there is a presumption against retroactive application of new laws. *See, e.g., Landgraf* v. *USI Film Institute*, 511 U.S. 244, 263-280 (1994). The Commission's orders have been consistent with these principles. For example, in Section 271 proceedings, the Commission only determines whether the applicant has complied with its rules that were in effect *on the day the Section 271 application was filed* (as opposed to rules that become effective while the application was pending). *See, e.g.,* Memorandum Opinion and Order, *Application by SBC Communications Inc., Michigan Bell Telephone Company, and Southwestern Bell Communications Services, Inc. for Authorization To Provide In-Region, InterLATA Services in Michigan*, WC Docket No. 03-138, ¶ 7 (released September 17, 2003);

Unless and until the Commission issues a final decision and final rules in the new *TELRIC* proceeding, the TELRIC standards set forth in the *Local Competition Order* are still in effect and are the governing standards for determining UNE rates. Verizon's prediction of what the Commission may, or may not, decide in its *TELRIC* proceeding at some unknown date in the future is no basis for further delay. If the *TELRIC* proceeding ultimately culminates in a material change in the Commission's pricing rules, Verizon will be free to apply for prospective change in its UNE rates at that time.

For now, however, the TELRIC standards applied by the *Order* remain in effect, and should be applied. Although the Commission initiated a new proceeding on September 15 to review the TELRIC rules, that proceeding remains in its infancy. Under the schedule established by the Commission, opening comments on the Notice of Proposed Rulemaking are due 60 days after publication of the NPRM in the *Federal Register*, and reply comments are due 105 days after such publication. *TELRIC NPRM* ¶ 197. As of the date of this filing, the NPRM has not yet been published in the *Federal Register.* Even if the NPRM is published within the next few days, opening comments will not be submitted until mid-December and reply comments at the end of January 2004. The Commission is not required by statute to complete its proceeding by a specific date, and its *NPRM* does not indicate whether it has even set a "target date" for completion of the proceeding. Given the complexity of the issues that the Commission has raised in the *TELRIC NPRM*, and the probability that the parties will submit voluminous comments in that proceeding, it may be years before the Commission makes its final ruling.

Memorandum Opinion and Order, *Application by SBC Communications Inc., et al., Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Texas*, 15 FCC Rcd. 18354, ¶ 28 (2000); Memorandum Opinion and Order, *Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act To Provide In-Region, InterLATA Service in the State of New York*, 15 FCC Rcd. 3953, ¶ 31 (1999).

Thus, until the Commission issues a final decision in the *TELRIC* proceeding, the current TELRIC rules will remain in place. Indeed, after the Commission considers the parties' comments in the *TELRIC* proceeding, the existing rules may well be reaffirmed—or changed in ways that lead to *reductions* in UNE rates. In the *Triennial Review Order*, the Commission modified its previous unbundling requirements by drastically curtailing the obligation of incumbent LECs to unbundle the broadband capabilities of their loops. Henceforth, incumbent LECs are not required to provide "unbundled access to hybrid loops for the provision of packetized broadband services." *Triennial Review Order*, ¶¶ 285-97. This change of position has dramatic implications for the pricing of unbundled loops, for the forward-looking economic cost of narrowband loop capacity is less than the forward-looking cost of loops that have not been stripped of their broadband functionality. Attributing to narrowband loops costs that would not be incurred but for the provision of broadband service would violate both the causation element of TELRIC[8] and the statutory prohibition against cross-subsidization of broadband services by narrowband services, an outcome that would be unlawfully unjust and discriminatory.[9] The *TELRIC NPRM* specifically requests comments on the possibility that the newly limited functionality of unbundled loops may require a corresponding adjustment to the price of unbundled loops. *TELRIC NPRM* ¶ 43.

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[8] *See Local Competition Order*, ¶¶ 675, 682, 691; 47 C.F.R. § 51.505(b) (costs attributed to a network element must be "directly attributable, or reasonably identifiable as incremental to" the element).

[9] *See* Report and Order, *Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities*, 2 FCC Rcd. 1298, ¶ 115 (1987) ("Facilities upgrades and accelerated replacement of older facilities might also be undertaken primarily for the benefit of unregulated service offerings. The principles adopted in this *Order* dictate[d] that such costs be *excluded* from the regulated accounts.") (emphasis added); *Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services,* Notice of Proposed Rulemaking, 11 FCC Rcd. 17211, ¶ 23 (1996) (attributing the costs of broadband services to telephone ratepayers is, by definition, an impermissible "cross-subsid[y] [of] the incumbent local exchange carriers' competitive operations").

Furthermore, even assuming *arguendo* that the appeals of the *Order* raise issues involving TELRIC methodology that are not specifically resolved by application of the existing TELRIC rules, the Commission can – and should – resolve those issues here, rather than await the outcome of the *TELRIC* proceeding. It is "hornbook administrative law" that an administrative agency may announce rules and interpretations of rules through adjudication, rather than through a formal notice-and-comment rulemaking proceeding.[10] Thus, to the extent that new TELRIC rules need to be established to resolve these issues, the Commission may properly establish such rules in this adjudicatory proceeding.

Although Verizon asserts that the *TELRIC NPRM* "admitted" that the existing TELRIC rules are "flawed," that assertion is both baseless and speculative. *See,* Motion at 8; Application at 5, 7. First, the Commission made clear in the *TELRIC NPRM* that – whatever else it ultimately decides – it will *not* depart from its previous decision "to base UNE prices on the forward-looking cost of providing UNEs." Instead, in the new proceeding the Commission will focus only on "clarifications or modifications of the current [forward-looking cost]-based rules that will more fully satisfy the Commission's policy goals and the statutory requirements of section 252(d)(1)."[11] Although the Commission indicated that it would consider whether the UNE pricing methodology should be more representative of the ILECs' existing, embedded

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[10] *See, e.g., NLRB* v. *Bell Aerospace Co.*, 416 U.S. 267, 294 (1974); *SEC* v. *Chenery*, 332 U.S. 194, 203 (1947); *Interstate Natural Gas Assn. of America* v. *FERC*, 285 F.3d 18, 57-58 (D.C. Cir. 2002); *Russe Broadcasting Co.* v. *FCC*, 87 F.3d 1456, 1463 (D.C. Cir. 1996); *International Union, United Auto., Aerospace and Agricultural Implement Workers of America* v. *Brock*, 783 F.2d 237, 246 (D.C. Cir. 1986); *National Small Shipments Traffic Conference, Inc.* v. *ICC*, 725 F.2d 1442, 1447 (D.C. Cir. 1984).

[11] *Id.* ¶ 37.

networks, other passages in the *TELRIC NPRM* recognize that such an approach is foreclosed by *Verizon Communications, Inc.* v. *FCC*, 535 U.S. 467 (2002).[12]

Second, aside from the Commission's commitment to forward-looking costs, the *TELRIC NPRM* is simply a proposal. It does not have the force of law. As Verizon admits – and as the *TELRIC NPRM* repeatedly made clear – the "conclusions" of the Commission on which Verizon relies, including the Commission's discussion of the use of a more "real-world approach" to UNE pricing, are *tentative.*[13] The Commission will reach a final determination on the issues that it raised only after it receives and reviews the comments that it invited in the *NPRM*. At this point, it is speculative and presumptuous to assume that the Commission will adopt the "tentative conclusions" or any other item on which the *NPRM* solicits comments, rather than decide simply to continue the existing TELRIC methodology. It is also presumptuous to assume that any changes ultimately adopted by the Commission will mirror the "tentative conclusions" of the *NPRM*.[14] And it is equally presumptuous to assume that any changes in the TELRIC

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[12] *See, e.g., TELRIC NPRM* ¶¶ 5, 21 (noting that the Supreme Court upheld the Commission's TELRIC rules and rejected the ILECs' argument that the 1996 Act requires a pricing standard that considers historical costs); *id.* ¶ 33 (acknowledging that the Supreme Court found that Section 252(d)'s pricing standard creates a heavy presumption against any method resembling the traditional embedded-cost-of-service model of ratesetting); ¶ 40 (requesting comments on whether the Supreme Court's criticism of the accuracy of historical costs undermines the Commission's ability to use a comparison of UNE rates to an ILEC's historical costs to measure the reasonableness of UNE rates).

[13] *See* Motion at 9; Application at 6; *TELRIC NPRM* ¶¶ 4, 52, 55, 62-64, 66, 69, 72, 74, 101, 117-118. Two of the five commissioners objected even to the use of the phrase "tentative conclusions" in the *NPRM* to describe the questions raised by the FCC. *Id.*, Statement of Commissioner Michael J. Copps at 1 & Statement of Commissioner Jonathan Adelstein at 1.

[14] The *NPRM* itself recognizes that the Commission may ultimately decide to retain the existing TELRIC methodology even on the issues on which it has reached "tentative conclusions." *See, e.g., TELRIC NPRM* ¶ 101 (requesting parties to comment on the issue of whether the validity of Commission-approved asset lives "depends in part on whether the Commission retains a scorched node approach to network design or instead adopts its tentative conclusion that forward-looking costs should more closely account for the real-world attributes of the routing and topography of an incumbent LEC's network").

methodology ultimately adopted by the Commission will require increases in UNE prices, not decreases.

2. Staying the *Order* Until The Commission Concludes Its New TELRIC Rulemaking Proceeding Could Produce Years Of Further Delay.

Staying the *Order* pending a final decision by the Commission in the new TELRIC rulemaking would likely entail years of unwarranted delay that would only further postpone the arrival of full competition in Virginia. If the Commission stayed the *Order*, the reductions in UNE rates that are required under the *Order* (or would be required by the subsequent Bureau order to be issued after the parties submit their compliance filings) would be postponed indefinitely. As previously noted, the Commission is under no statutory obligation to complete its *TELRIC* proceeding by a particular date. There is no way of knowing now when the Commission will issue a final decision in that proceeding.

If the Commission ultimately decides *not* to adopt the so-called "real-world approach" discussed in the *NPRM*, staying the *Order* will have accomplished nothing, other than to allow Verizon to collect its current exorbitant UNE rates while the stay was in effect. Even if the Commission ultimately adopts the "tentative conclusion" described in the *NPRM*, there will be even *further* delay before the rate issues in this arbitration proceeding are finally resolved. In such circumstances, the Commission would be required to reopen the record for the submission of additional evidence, to conduct evidentiary hearings, and then to issue a final decision. The history of this proceeding shows that such reopened proceedings could take years to complete. Although the Commission issued its notice instituting this proceeding in February 2001, the Bureau did not issue its *Order* until August 2003 – more than two and one-half years later.[15]

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[15] *See* Public Notice, *Procedures Established For Arbitration of Interconnection Agreements Between Verizon and AT&T, Cox, and WorldCom*, CC Docket Nos. 00-218, 00-249, and 00-251, DA 01-270 (released February 1, 2001).

There is no justification for delay in the disposition of the pending appeals. The *Order* applied the TELRIC standards that were, and are still, in effect in reaching its decision. That is the course that the Commission should follow here.

Quite simply, Verizon is seeking a stay in order to postpone the effective date of what it anticipates will be substantially lower UNE rates that will stimulate competition. The Commission should reject that approach. As the *Order* stated, "rate cases must end, or rates would never be set." Speculation as to what the Commission might decide at some future date in its *TELRIC* proceeding is a patently inadequate basis for postponing the effectiveness of the *Order*.

B. Verizon's Challenges To Specific Loop Inputs And Rates Adopted By The *Order* Are Unfounded.

1. Cost Of Capital

Verizon challenges the 12.95 percent cost of capital adopted by the *Order* on three grounds: (1) the Bureau should have awarded Verizon a cost of capital of 13.068 percent even though Verizon did not request the higher amount; (2) the Bureau should have based the cost of equity solely on the Discounted Cash Flow ("DCF") methodology, and given no weight to the Capital Asset Pricing Model ("CAPM"); and (3) the Bureau should have added an additional "regulatory risk" premium of 5.41 percent. Application at 49-51. These criticisms are wholly without merit.

First, Verizon waived these claims by failing to raise them properly before the Bureau. During the proceedings below, Verizon proposed a cost of capital of 12.95 percent, not 13.068 percent.[16] Verizon did not ask the Commission to disregard the CAPM, let alone disregard it on

[16] Verizon Exh. 112 (Vander Weide Reb.) at 4; 12 Tr. 34212-22 (Vander Weide); AT&T/WCOM Exh. 10 (Hirshleifer Reb.) at 10.

the theory that it was unduly "sensitive to changes in interest rates." To the contrary, Verizon itself relied in part on an adjusted version of Mr. Hirshleifer's CAPM equity cost analysis.[17]

Nor did Verizon show that Dr. Hausman's "regulatory risk" or "real options" theories justified any additive to Verizon's cost of capital. Although Verizon floated these theories from the outset of the case,[18] Verizon treated them as little more than rhetorical throw-away lines. Verizon's cost of capital witness, James Vander Weide, included no mark-up to cover these supposed risks in his proposed cost of capital, and Verizon included no such mark-up in its pricing proposal.[19] Not until April 15, 2003—*15 months after the close of the record*—did Verizon even attempt to submit such a calculation. Verizon Proffer (Apr. 15, 2003) at 14-17.[20]

By failing to present these claims in a timely and adequate fashion to the Bureau, Verizon has waived any right to raise them on administrative review by the Commission. The Commission's rules specifically provide that no application for review of action taking pursuant to delegated authority "will be granted if it relies on questions of fact or law upon which the designated authority has been afforded no opportunity to pass." 47 C.F.R. § 1.115(c). The

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[17] Verizon Exh. 112 (Vander Weide Reb.) at 8-10; *see also* Verizon Exh. 118 (Vander Weide Surreb.) at 33-34, 44 (relying on CAPM results to attack AT&T/WCOM cost of capital estimates).

[18] *See* Application at 50 n. 57 (citing Verizon testimony filed in July, August and September 2001).

[19] *Order* ¶ 119; Verizon Initial Post-Hearing Brief on Cost Issues (Dec. 21, 2001) at 47 ("the cost of capital used in Verizon VA's studies is not designed to reflect risks that would result from adopting the extreme, fantasy assumptions contained in AT&T/WCOM's cost model"—i.e., the TELRIC assumptions).

[20] The "calculation" of Professor Hausman cited by Verizon (Application at 51) was not an adjustment to the cost of capital, but a markup factor that would have approximately *doubled* the cost of loops and switching. Verizon Exh. 111 (Hausman Reb.) at 3-4.

Commission has repeatedly denied applications for review on this ground, absent a legitimate excuse for not raising the issues sooner.[21]

Second, Verizon is not aggrieved by the Bureau's reliance on a CAPM equity cost estimate. Substituting a properly calculated DCF equity cost estimate would reduce, not raise, the cost of capital adopted in the *Order*. Verizon assumes that the alternative to a CAPM-based cost of equity would have been the 14.75 percent DCF cost of equity proposed by Verizon witness Vander Weide. But the *Order* specifically rejected Dr. Vander Weide's DCF equity estimate, and necessarily so. He derived the estimate from a "constant growth" version of the DCF model—i.e., he assumed that above-average growth in earnings predicted by securities analysts for the next few years would last in perpetuity. Relying on this assumption would have been clear error. *Id.*, ¶ 68, 73-74. The constant growth assumption produces nonsensical results for firms and industries whose projected rate of earnings growth exceeds the long run growth rate of the economy. *Id.*, ¶ 73. For these reasons, economists and securities analysts have overwhelmingly rejected the use of a single-stage DCF to estimate the cost of a firm whose short-run growth projections are significantly above the long-run growth of the economy as a whole.[22] Replacing Dr. Vander Weide's one-stage approach with the three-stage DCF model used by AT&T/MCI witness John Hirshleifer—or any other commonly accepted multi-stage

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[21] *See*, *e.g.*, Order, *Application for Review of a Decision by the Common Carrier Bureau—King and Queen County Public Schools*, 18 FCC Rcd. 2303 ¶ 9 (2003); Memorandum Opinion and Order, *Application of Fresno MMDS Associates*, 18 FCC Rcd. 14733 ¶ 15 (2003); Memorandum Opinion and Order on Remand, *In the Matter of Richard Duncan d/b/a Anderson Communications*, 18 FCC Rcd. 4189 ¶ 7 (2003); Order, *Application for Review by Henrico County School District*, 17 FCC Rcd. 24237 ¶ 6 (2002); Order on Review, *Teleport Communications Atlanta, Inc. v. Georgia Power Co.*, 17 FCC Rcd. 19859 ¶ 24 (2002); Memorandum Opinion and Order, *JPJ Electronic Communications, Inc.*, 17 FCC Rcd. 5512 ¶ 5 n. 26 (2002); Memorandum Opinion and Order, *Sprint Communications Co., L.P. v. Bell Atlantic-Pennsylvania*, 15 FCC Rcd. 16124 ¶ 4 & n. 13 (2000).

[22] *See* AT&T/WCOM Post-Hearing Br. (Dec. 21, 2001) at 61 (citing record); *accord*, Richard A. Brealey and Stuart C. Myers, *Principles of Corporate Finance* (4th ed. 1991).

DCF model—would reduce Dr. Vander Weide's proposed cost of equity by approximately 200 basis points, or two percentage points. AT&T/WCOM Exh. 217 (Hirshleifer Surreb.) at 9. Even Dr. Vander Weide has conceded this. *Id*. at 11 (citing Dr. Vander Weide). This change alone would reduce the cost of equity to nearly two percentage points below the 14.37 percent CAPM equity cost adopted by the *Order*.

Third, even if Verizon had presented its case for a regulatory risk premium in a timely fashion, neither paragraphs 680-681 and 683 of the *Triennial Review Order* (cited on page 50 of Verizon's Application) nor the specific record below provide any basis for adopting any such premium. The risks alluded to in Paragraphs 680-681 of the *Triennial Review Order* are not regulatory risks, but merely "the risks of a competitive market." Even assuming—contrary to fact—that this is an appropriate TELRIC standard, the 14.75 percent cost of equity and 12.95 percent overall cost of capital proposed by Dr. Vander Weide purported to reflect the risks of a competitive firm in a competitive industry.[23] As noted above, accepting *all* of Dr. Vander Weide's risk assumptions, but replacing his nonsensical one-stage model with a more realistic multi-stage model, would produce a cost of capital substantially *below* the 12.95 percent value adopted in the *Order*.

Verizon's reliance on the Commission's separate discussion of *regulatory* risk in Paragraph 683 of the *Triennial Review Order* is also misplaced. There, the Commission specifically found that Verizon and other ILECs would be fully protected against any asymmetry in the risks and rewards of investment in assets used to provide UNEs by giving ILECs an

[23] *See* Verizon Initial Post-Hearing Cost Brief (Dec. 21, 2001) at 43 ("in assessing its risk in the forward-looking market, Verizon VA used the S&P industrial companies as a conservative proxy for the risk it would face in a competitive market"); Verizon Exh. 104 (Vander Weide Direct) at 46 ("the S&P Industrials are a well-known sample of publicly traded competitive companies whose risk, on average, approximates the risk the incumbent LECs actually face in providing telecommunications services in a competitive market").

opportunity to propose a higher cost of capital for investment "associated with new services that might be provided over certain types of facilities"—i.e., *broadband* services. *Id.* ¶ 683 & n. 2051. But the UNEs at issue here are not "associated with new services" in this sense. In other portions of the *Triennial Review Order*, the Commission modified its previous unbundling requirements by drastically curtailing the obligation of incumbent LECs to unbundle the broadband capabilities of their loops. Henceforth, incumbent LECs are not required to provide "unbundled access to hybrid loops for the provision of packetized broadband services." *Triennial Review Order*, ¶¶ 285-97. The narrowband-only loop capacity that satisfies Verizon's unbundling requirements under the *Triennial Review Order* is the antithesis of a "new" service or technology, and the provision of this capacity clearly falls on the low end of the risk continuum.

In this regard, the Bureau had ample reason to reject the "real options" theory of Professor Hausman. *Cf.* Application at 51. Dr. Hausman's testimony for Verizon was little more than a rehash of claims that the Commission considered and rejected in its *Local Competition Order*. 11 Tr. 3236-48 (Hausman); *Local Competition Order* ¶¶ 686-89; WCOM Exh. 103 (Hausman testimony to FCC in 1996). Moreover, a consistent application of real options theory is likely to produce lower, not higher, UNE prices than would otherwise be required under a strict application of TELRIC pricing principles. Even some of the economic literature that Dr. Hausman cited in his testimony recognized this fact.[24]

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[24] *See* AT&T/WCOM Exh. 20 (Murray Surreb.) at 4-33; William J. Baumol and Richard N. Clarke, "Option Value Analysis and Telephone Access Charges," in J. Alleman and E. Noam, eds., *The New Investment Theory of Real Options and its Implications for Telecommunications Economics* (1999) at 218, included as Attachment A to AT&T/WCOM Exh. 20 (Murray Surreb.). Dr. Hausman, astonishingly, cited the Baumol and Clarke article as *supportive* of his views. AT&T/WCOM Exh. 20 (Murray Surreb.) at 4-33.

The reality is that the 12.95 percent cost of capital is too high, not too low. The Commission's recent holding, in its *Triennial Review Order*, that the relevant risk of supplying UNEs at wholesale is the hypothetical risk of a competitive business, is an arbitrary and unjustified departure from the findings of the *Local Competition Order* that the relevant risks are those experienced or reasonably foreseen by the incumbent LECs. In following the new standard, the Bureau erred as well. Moreover, even assuming *arguendo* that the hypothetical risk standard were appropriate, the Bureau misapplied it by adopting inflated values for several critical inputs. In particular, the Bureau erred by (1) excluding the DCF equity cost estimate submitted by AT&T/MCI, (2) adopting an CAPM equity cost estimate based on a grossly inflated market risk premium; (3) assuming a capital structure weighted with far more equity, and far less debt, than an efficient target capital structure, and (4) ignoring the undisputed and dramatic decline in interest rates and capital costs between the close of the record and the issuance of the Bureau's decision, and "updating" the record to reflect the Commission's recent pronouncements on risk in the *Triennial Review Order* without updating interest rates and capital costs. AT&T Application for Review (Sept. 29, 2003) at 3-13; MCI Application for Review (Sept. 29, 2003) at 3-8.

2. Depreciation Lives

Verizon's discussion of depreciation lives is equally meretricious. Verizon argues that the *Triennial Review Order* requires the use of GAAP (i.e., financial) lives rather than regulatory depreciation lives because only financial lives reflect the forward-looking rate of decline in asset values in the current competitive environment. Application at 51-54 (citing *Triennial Review Order* ¶ 685). In fact, the *Triennial Review Order* expressly *rejected* this position, leaving the choice of asset lives to the discretion of state commissions based on the best evidence of record. Paragraph 686, which Verizon does not even mention, is unambiguous:

> *We decline to adopt the incumbent LECs' suggestion that we mandate the use of financial lives in establishing depreciation expense under TELRIC.* The incumbent LECs have not provided any empirical basis on which we could conclude that financial lives always will be more consistent with TELRIC than regulatory lives. Both financial lives and regulatory lives were developed for purposes other than, or in addition to, reflecting the actual useful life of an asset. We cannot conclude on this record that one set of lives or the other more closely reflects the actual useful life of an asset that would be anticipated in a competitive market. Accordingly, state commissions continue to have discretion with respect to the asset lives they use in calculating depreciation expense.

Triennial Review Order ¶ 688 (footnotes omitted; emphasis added).

In the present case, the Bureau, acting in its capacity as a surrogate for the Virginia state commission, adopted the "low end of the 'safe harbor' range" of depreciation lives "prescribed by the Commission in 1994 and 1995, and modified in 1999," rather than the longer lives prescribed by the Commission for Verizon in 1994, or the shorter financial lives proposed by Verizon. *Order* ¶¶ 112-121. The Bureau's rejection of the latter lives was well within the discretion conferred by *Triennial Review Order* ¶ 688.

The Commission-approved life ranges reflect a rigorous application of forward-looking principles by the Commission, including a "detailed analysis of each carrier's most recent retirement patterns, the carriers' plans, and the current technological developments and trends."[25] Reviewing the prescribed life ranges in 1999, the Commission reaffirmed that its lives: (1) "represent the best forward-looking estimates of depreciation lives" and (2) were therefore appropriate for use by state commissions "for determining the appropriate depreciation factors for use in establishing high cost support and interconnection and UNE prices."[26] The growing

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[25] AT&T/WCOM Exh. 3 (Lee Dir.) at 5 n. 8 (citing *Simplification of the Depreciation Prescription Process*, CC Docket No. 92-296 ("*Prescription Simplification*"), Third Report and Order, FCC 95-181 (rel. May 4, 1995), at 6).

[26] *See* Report and Order, *1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers*, CC Docket No. 98-137, FCC 99-397, ¶ 14 (1999); Memorandum Opinion and Order, *United States Telephone Associations Petition for Forbearance from Depreciation Regulation of Price Cap Local Exchange Carriers*, ASD 98-91, FCC 99-397¶ 61 (1999). *See also* Report and Order*, Federal-State Joint Board on Universal*

levels of depreciation reserves throughout the local telephone industry provides empirical confirmation that the Commission-approved lives remain forward-looking.[27]

Against this record, Verizon failed to muster any "specific evidence" to support its assertion that recent technological or competitive developments require even shorter lives:

> For example, Verizon provides no studies or other documents explaining the anticipated technological advances that might cause it to retire plant more quickly than anticipated when the [depreciation life] safe harbor was established (or modified in the case of digital switching), nor has it effectively rebutted AT&T/WorldCom's argument that new technology can extend the life of assets, as DSL technology has done with copper facilities. Similarly, Verizon provided no evidence to demonstrate how increased competition has affected retirement rates since the asset lives we use were established, or how it might affect future retirement rates.

August 29 *Order* ¶ 115 (footnotes omitted); *accord*, WCOM/AT&T Post-Hearing Brief (Dec. 21, 2001) at 103-06 (citing record).

Verizon's assertion that financial or GAAP lives provide a legitimate measure of economic depreciation (Application at 52-54) is equally unsupported in the record. Verizon's derisive response to the Bureau's finding that Verizon failed to "demonstrate that [its proposed] lives are in fact compliant with GAAP" (*id*. at 53) evades the fundamental issue. The Bureau's primary objection was much more basic: that Verizon had failed to demonstrate that Verizon's financial lives, even if consistent with GAAP, are an "appropriate measure of the actual *economic life* of an asset." *Order* ¶ 116 (emphasis added).

Financial accounting lives are biased towards the low (shorter) side because they are driven by corporate objectives, including the objective of protecting shareholders, and by the GAAP principle of conservatism, which encourages the accountant to err on the side of

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Service, 12 FCC Rcd. 8776 (1997) ¶ 250 (determining that FCC would use its existing prescribed depreciation lives in calculating universal service subsidies).

[27] AT&T/WCOM Exh. 3 (Lee Dir.) at 5-8; AT&T/WCOM Exh. 22 (Lee Surreb.) at 4-10.

overstating costs for financial reporting when there is uncertainty about their precise level. AT&T/WCOM Exh. 9 (Lee Reb.) at 3-6. As the Commission has noted:

> One of the primary purposes of GAAP is to ensure that a company does not present a misleading picture of its financial condition and operating results by, for example, overstating its asset values or overstating its earnings, which would mislead current and potential investors. GAAP is guided by the conservatism principle which holds, for example, that, when alternative expense amounts are acceptable, the alternative having the least favorable effect on net income should be used. Although conservatism is effective in protecting the interest of investors, it may not always serve the interest of ratepayers. Conservatism could be used under GAAP, for example, to justify additional (but, perhaps not "reasonable") depreciation expense by a LEC to avoid its sharing obligation. Thus, GAAP would not effectively limit the opportunity for LECs to manage earnings so as to avoid the sharing zone as the basic factor range option. In this instance, GAAP does not offer adequate protection for ratepayers.

Report and Order, *Prescription Simplification,* 8 FCC Rcd. 8052, ¶ 46 (1993). *Accord*, Tenth Report and Order, *Federal-State Joint Board on Universal Service and Forward-Looking Mechanism for High Cost Support for Non-Rural LECs*, 14 FCC Rcd. 20156, ¶ 429 (1999) (emphasis added; footnote omitted):

> We also agree with GSA's comments that the projected-life values currently used by LECs for financial reporting purposes are inappropriate for use in the model. In addition, the commenters proposing these values have not explained why the values used for financial reporting purposes would also reflect economic depreciation. The depreciation values used in the LECs' financial reporting are intended to protect investors preferring a conservative understatement of net assets, partially achieving this goal by erring on the side of over-depreciation. These preferences are not compatible with the accurate estimation of the cost of providing services that are supported by the federal high-cost mechanism. We, therefore, decline to adopt the projected life values used by LECs for financial reporting purposes.

Accord, *1998 Biennial Regulatory Review—Review of Depreciation Requirements for Incumbent Local Exchange Carriers*, CC Docket No. 98-137 (1999) at ¶ 48 ("although conservatism is effective in protecting the interests of investors, it may not always serve the interest of ratepayers"); *Shalala* v. *Guernsey Memorial Hospital*, 115 S.Ct. 1232, 1239 (1995) ("financial

accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets' . . . This orientation may be consistent with the objectives of informing investors, but it ill serves the needs of Medicare reimbursement and its mandate to avoid cross-subsidization.") (internal citations omitted). Verizon submitted no evidence that would have warranted a contrary finding in this case.[28]

3. FLC Factor and CC/BC Ratio

Equally infirm is Verizon's argument that the *Order* improperly rejected Verizon's proposed forward-looking-to-current conversion factor. Verizon contends that the *Order* substantially understated Verizon's forward-looking expenses by excluding Verizon's FLC factor, and by requiring Verizon to use the current-cost-to-booked-cost ("CC/BC") ratio in

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[28] Verizon's assertion that the "Commission Staff" has "acknowledged" in a recent OSP Working Paper that "TELRIC will not permit the recovery of investment costs unless assets are depreciated over very short periods equal to the intervals in which UNE prices are set" (Application at 52) is an abuse of the Commission's policy of sharing OSP Working Papers with the public. The paper cited by Verizon was written by two individual members of the Office of Strategic Planning and Policy Analysis, and carries the express disclaimer that its "analyses and conclusions . . . do not necessarily reflect the view of other members of" the OSP, "other Commission staff, or the Commission itself." OSP Working Paper 40 (Sept. 2003). No party in this case has had an opportunity to submit testimony responding to the paper, and giving it any weight in this proceeding would be a flagrant violation of due process.

In any event, the authors' claims are far more circumspect than Verizon's. The paper contends only that, under certain specified circumstances, TELRIC pricing may lead to underrecovery of investment costs for assets whose costs are declining over time, if TELRIC prices are levelized over the life of the rates. Moreover, the paper offers two other tentative findings that point in the *opposite* direction: (1) TELRIC pricing may lead to *overrecovery* of investment costs for assets (e.g., loop assets) whose costs are *rising* over time; (2) a dynamic analysis of efficient investment paths over time suggests that cost minimizing result may be *substantially lower* than the cost estimates based on the fill factors used in traditional network planning. These propositions obviously are a far cry from the notion that "TELRIC will not permit the recovery of investment costs unless assets are depreciated over very short periods equal to the intervals in which UNE prices are set" (Application at 52). And, nothing in the paper suggests that the authors support the adoption of GAAP lives as a solution to the theoretical issues the authors explore.

developing its annual cost factors ("ACFs"). Application at 56-62. Verizon's arguments cannot withstand scrutiny. The *Order* properly recognizes that the FLC factor has nothing to do with TELRIC. The only effect of applying the FLC factor is to regurgitate as "TELRIC" expenses the embedded network expenses that Verizon inputs into the numerator of the ACFs.

Verizon's case for the FLC – that such an adjustment is necessary to avoid "double counting the TELRIC" reduction in expenses – assumes that Verizon's direct "forward-looking adjustments" to the expenses of maintaining its embedded network fully reflect the expected increases in productivity and efficiency in a forward-looking network. *Id.* at 57-58. This assumption is demonstrably false.

Although Verizon agreed that expenses can be expected to decrease in a forward-looking network (Tr. 3767), its models failed to account for this expected reduction. *See Order* ¶ 137. Except for a five percent reduction in the cost of repairing copper cable, Verizon's models accounted for *none* of the expected savings in expenses in a forward-looking network. Tr. 3809 (Minion). For example, Verizon made no adjustment to account for the efficiencies from the pressures of competition, the expense reduction from increased use of IDLC/GR-303, or any reduction in maintenance expenses from replacing outdated equipment. *See* Tr. 3896-3898 (Riolo); Tr. 3796-3801 (Minion); AT&T/WCOM Exh. 11P (Murray Reb.) at 35-37.

Verizon contends that its expense models are forward-looking because it adjusted its 1999 expenses by a productivity factor. However, Verizon's productivity factor reflects only the labor productivity flowing from a growing volume of business in Verizon's *existing* network in the normal course of business. As the Bureau aptly observed, Verizon's own witness conceded that Verizon's productivity adjustment does not reflect *total* factor productivity. *Order* ¶ 138. It does not include any factors that would reduce expenses in a forward-looking network—*e.g.*, efficiencies caused by the pressures of competition, increased use of IDLC in general and GR-

303 in particular, better or increased mechanization of certain processes over time or the lack of need to replace outdated equipment.[29]

Furthermore, although the *Local Competition Order* clearly establishes that the ILEC bears the burden of proof on disputed factual issues in UNE pricing cases, Verizon failed to satisfy its burden of proof on this issue. Verizon's entire evidentiary support for its productivity factor consisted of "a single page summarizing the factors for each year, with no supporting documentation." *Order* ¶ 138. Verizon proffered no supporting data to show its historic productivity or any time and motion studies to buttress its productivity adjustment. Tr. 3907-08 (Minion). As a consequence, the Bureau was entirely correct in finding that this "conclusory evidence" is wholly insufficient. *Order* ¶ 138.

The *Order* properly recognizes that Verizon's productivity adjustment is purely illusory and is more than offset by Verizon's adjustment for labor inflation. Indeed, Verizon's adjustments in 2001 are generally the same as those in 1999, and its expenses in 2003 are remarkably higher than in 2001. Tr. 3794-95, 3802-03 (Minion); WCOM Exh. 107. Furthermore, although Verizon, in its Application, repeatedly refers to the adoption of its FLC factor in the New York cost proceedings, Verizon conveniently ignores that, in New York, the company proposed a productivity adjustment of 10 percent above inflation for non-network expenses and two percent above inflation for network-related expenses. The New York PSC ultimately adopted a productivity adjustment of 12 percent above inflation for non-network expenses and three percent above inflation for network expenses. Tr. 3804-05 (Minion). In stark contrast, in Virginia, Verizon proposed a considerably smaller productivity factor – a factor

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[29] *See, e.g.,* Tr. 3896, 3898 (Riolo) (describing decrease in expenses associated with GR-303); AT&T/WCOM Exh. 11P (Murray Reb.) at 36 ("Verizon applies an adjustment based on a simple presumption that forward-looking expenses will be identical to current expenses"); WorldCom Exh. 108; Tr. 3793, 3795 (Minion) (conceding that Verizon's productivity adjustment is based on the productivity gains it experiences in its embedded network).

that does not reflect the productivity gains that will occur in a forward-looking network. The Bureau properly found that Verizon's arguments regarding its proposed productivity factor in Virginia were unsupported by the record evidence and were otherwise undermined by other state proceedings, including the *New York UNE Proceeding*, where "Verizon has recognized significantly higher levels of productivity than it has proposed here." *Order* ¶ 138 (footnote omitted).

Moreover, although Verizon insists that the FLC conversion factor is needed so that Verizon's ACFs can yield appropriate forward-looking expenses, the *Order* properly recognizes that the FLC factor produces no such result. Application of a FLC factor necessarily means that whatever expenses are input into the numerator of the initial expense-to-investment ratio are the expenses that Verizon ultimately claims to be TELRIC expenses. This use of an expense-to-investment ratio and FLC factor essentially cancel out, leaving Verizon's 1999 expenses with the productivity and inflation adjustments discussed above as Verizon's claimed TELRIC expenses.[30] WorldCom Exh. 105; Tr. 3777-79, 3781 (Minion). There is nothing forward-looking about this process. As the *Order* properly finds, "the approach taken by Verizon is circular because it starts with forward-looking expenses, which is supposed to be the end result of the ACF calculation." *Order* ¶ 139.[31] The recent decision of the Maryland Public Service Commission ("Maryland PSC") provides further confirmation of the soundness of this finding. The Maryland PSC similarly concluded that FLC is a "make-whole" mechanism that is "designed to recover Verizon's predetermined costs rather than actual forward-looking costs."

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[30] They do not exactly cancel out because Verizon estimates the FLC factor ahead of time based on a projection of what it expects the Commission will determine are TELRIC investments.

[31] The FLC factor suffers from an additional defect: it is "is the same for all accounts. Because the FLC factor is multiplied by embedded investment figures that do not reflect price changes over time, the resulting ratio may not accurately reflect the expense ratio that would be anticipated in a forward-looking environment." *Order* ¶ 140 n. 387.

In the Matter of the Investigation into Rates for Unbundled Network Elements Pursuant to the Telecommunications Act of 1996, Case No. 8879, Maryland PSC Order No. 78552 at 33-34 (June 30, 2003).

Equally unavailing is Verizon's challenge to the requirement that Verizon use the CC/BC ratio in developing its ACFs. Application at 59. Verizon's assault on the CC/BC rates is merely an extension of its flawed FLC argument. Verizon contends that if CC/BC ratios are applied, the FLC factor must be adjusted accordingly to ensure that expenses are recovered at their embedded levels. To bolster this assertion, Verizon asserts that "the average of the CC/BC ratios adopted by the Bureau is approximately 1.287," and that "application of the CC/BC ratio here in lieu of the FLC produces a huge *reduction* in Verizon VA's recoverable expenses." Application at 61. Although Verizon focuses on the level of the composite CC/BC ratio (1.27), Verizon glaringly fails to explain why the CC/BC ratio is wrong – other than to state that it would require a larger FLC adjustment to offset.

Furthermore, Verizon has failed to provide any evidence demonstrating why adjusting embedded investments to match the vintage of embedded expenses before computing the expense to investment ratio is erroneous. As AT&T explained—and the Bureau appears to understand—application of the CC/BC ratio eliminates the timing differences between expenses which are reported in current years and investments which are acquired over a number of years. Applying the CC/BC ratio to embedded investments before computing the expense to investment ratios eliminates the timing mismatch between expenses and embedded investment and yields an internally consistent ratio that can be applied to forward-looking investment.[32] *Order* ¶ 140.

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[32] Verizon asserts that the CC/BC ratio is adequate to determine what an embedded investment would cost in current dollars, and notes that the CC/BC ratio can be used to determine how much a 1987 computer would cost in current dollars. Application at 60. However, Verizon's example is highly misleading and fails to explain that the CC/BC ratio for computers has declined over time with the drop in computer prices. A CC/BC ratio that is less than one will result in a

Thus, the *Order*'s rejection of Verizon's flawed FLC factor and application of the CC/BC ratio is demonstrably sound and supported by the record evidence in this case.

4. Uncollectibles

Verizon's assertion that the Bureau erred in accepting "the treatment of uncollectibles contained in each of the proposed models" is also wide of the mark. *Cf.* Application at 54-55; *Order* ¶¶ 16-17, 21-23, 148-150. First, Verizon waived the issue by failing to raise it before the close of the evidentiary record. Second, even the material belatedly submitted by Verizon fails to show that the uncollectible factors adopted in the *Order* understate the forward-looking rate of uncollectibles for an efficient firm over the long run. Third, selectively updating the record for inputs that have become more costly since the close of the record, while failing to update the record for inputs whose costs have moved in the opposite direction over the same period, would be arbitrary and unlawful.

Verizon's Challenge Is Untimely. For the network elements where the *Order* adopted Verizon's cost models, the *Order* also adopted the *same* uncollectibles factor that Verizon proposed. *Order* ¶ 150. For network elements where the *Order* adopted AT&T/WCOM's cost models, the *Order* used the same rate of uncollectibles that the Commission adopted in its Synthesis Model for universal service costing. *Id.* ¶ 148. It is too late for Verizon to allege error in these values now. 47 C.F.R. § 1.115(c).

Verizon did not assert that changed circumstances warranted a higher uncollectibles allowance until September 2002, nearly a year after the close of the evidentiary record. *Id.*, ¶¶ 15, 148; *accord*, Application at 54. As the *Order* noted, it is well established that new factual developments, unless extraordinarily significant and unexpected, do not justify delaying the final

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reduction to the denominator in the calculation of the expense to investment ratio, productivity as higher ratio.

decision in a major rate case to admit new evidence. New developments that may affect the outcome of a rate case happen continually. If this were enough to warrant reopening, no rate case would ever be resolved. *Id*., ¶ 21. Indeed, the Supreme Court has recognized that TELRIC rates contain "built-in lags in price adjustments." *Id*. (quoting *Verizon Inc. v. FCC*, 535 U.S. 467, 505 (2002)). And Verizon itself has acknowledged that cost model inputs are necessarily only "snapshots" of the information known when the model is filed. *Order* ¶ 21 (quoting Verizon pleading).[33]

The policy against piecemeal reopening of the record applies with special force here. Reopening would have injected additional delay into a rate case that has been pending since January 19, 2001. *Order* ¶ 21. The record on the pricing phase closed with the filing of reply post-trial briefs 20 months ago, on January 31, 2002. Until new UNE prices take effect, Verizon continues to charge UNE prices in Virginia whose lawfulness has not be adjudicated on the merits since 1999, when the Virginia State Corporation Commission ("SCC") last set UNE prices.[34]

The further delay from reopening would have been substantial. Due process would have entitled AT&T, MCI and other interested parties to reopen the record on all cost issues, not just

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[33] Likewise, as the Virginia Supreme Court has explained in analogous circumstances, "Rate cases have to end, and we will not open this record to accommodate events and arguments arising after all parties have had a fair opportunity to address the issues." Final Order and Opinion, *Commonwealth of Virginia, ex rel. State Corporation Commission* v. *Virginia Electric and Power Company, Defendant*, 1988 WL 166804 (Va. Corp. Com.) at 12. *Accord*, *Old Dominion Electric Cooperative* v. *Virginia Electric and Power Company, et al*., 237 Va. 385, 396-97 (1989) ("At best, a general rate case gives the Commission a view of the operations of a utility at a moment in time. The next moment events may have changed considerably. We agree with the Commission that it would cause delay and confusion to reopen a complex record of this kind to substitute actual figures for projected figures.").

[34] *Ex Parte: To determine prices Bell Atlantic-Virginia, Inc. is authorized to charge competitive local exchange carriers in accordance with the Telecommunications Act of 1996 and applicable state law*, Case No. PUC970005, Final Order (April 15, 1999).

the handful of issues cherry-picked by Verizon as most favorable to its case. *Order* ¶ 23. All parties would have been entitled to discovery and cross-examination on all reopened issues—particularly because the evidence proffered by Verizon included "testimony by a Verizon witness new to the proceeding and a new cost study." *Id*. (citations omitted).

The untimeliness of Verizon's efforts to reopen the record was further compounded by the company's failure to explain why it waited until September 13, 2002, to file its supposedly new information on uncollectibles. Verizon based its submission on 2001 data, which presumably were available soon after the close of the reporting year, as is, for example, the FCC's ARMIS data.[35] Had Verizon acted in a more timely fashion, the material could have been submitted, vetted in a hearing and briefed, and would not have caused any undue delay in the arbitration decision.

Verizon Has Failed To Show That The Long Run Rate Of Uncollectibles Has Increased. In any event, Verizon's belated proffer of evidence, even if properly part of the record, would not establish that the forward-looking rate of collectibles is substantially higher (or higher at all) than the rates ultimately adopted in the *Order*. TELRIC is a long-run cost standard. Verizon has failed to show that the reported increase in uncollectibles for 2001 and 2002 represents anything more than a short run spike caused by the recent shakeout of the CLEC sector. It is just as likely that the current spate of CLEC bankruptcies will run its course, that the surviving firms will reach a new point of equilibrium, and that the increase in uncollectibles will diminish.

Moreover, even if the recent turmoil in the CLEC sector were to continue unabated for years, Verizon has not shown that its current rate of uncollectibles from CLECs reflects the rate that an efficient provider of UNEs would experience in the long run. A prudent and efficient

[35] Verizon's 2001 ARMIS data were available on the FCC's website mid-April, 2002, and thus presumably were available to Verizon, the source of the data, well before then.

supplier of UNEs and wholesale services would reasonably enforce the existing rules governing security deposits and advance payments from those CLECs that prove unable or unwilling to pay legitimate Verizon charges. Enforcement of existing security arrangements should result in a lower rate of uncollectibles than Verizon allegedly has suffered, even assuming that the 2001 and 2002 data presented by Verizon are accurate and truly reflect the state of compensation between Verizon and the CLECs in the long run. Accepting Verizon's current rate of uncollectibles in lieu of evidence on the rate that a prudently vigilant firm would incur over the long run would violate the efficiency requirement of the TELRIC cost standard, and force credit-worthy CLECs like AT&T to cross-subsidize less credit-worthy competitors.[36]

Verizon Has Failed To Show That Its UNE Costs Have Increased Overall Since the Close of the Record. Even assuming *arguendo* that the long-run rate of uncollectibles for an efficient ILEC is higher than previously thought, this item is only one of many components of the overall cost of UNEs. Verizon has made no showing that that the *overall* cost of UNEs has increased since the close of the record. In fact, many of the cost changes during the past two years have been downward, not upward.

To pick one example out of many, the cost of capital, even under the methodology adopted by the Bureau, has been declining in the past few years. *See*, *e.g.*, AT&T Application for Review at 12-13; *Order* ¶ 64 & n. 203 (finding that "there has been a significant decline in interest rates since this proceeding started," that "our decision is based on the record before us," and that "applying [our] methodology to current data could produce different results").

Likewise, the switching investment values adopted in the *Order* were based on "data from approximately 1998-2000"—the most recent available as of the filing of the parties' cost studies. *Id*. ¶ 369. Data of this vintage clearly overstate the forward-looking cost of switching

[36] Verizon's claim that the Bureau's disallowance of Verizon's proposal to collect disconnect charges at the time of connection is unwarranted for the reasons stated in section II.C.3, *infra*.

today, for the same shakeout in the CLEC sector that Verizon seizes upon in support of its argument for an increase in the uncollectibles rate has also caused a reduction in the discounted price of switching equipment since 2000. Equipment suppliers, such as Lucent and Nortel, have suffered declines in business at least equal to if not more than the decline experienced by the CLECs. As a consequence, competition for switch business has intensified, and prices have declined. As a result, the original and replacement switch cost data that Verizon and the other parties used in their cost studies in this arbitration almost certainly overstate today's forward-looking costs. If the record were to be reopened, this development would have to be recognized as well.

When the shoe was on the other foot, Verizon itself recently (and successfully) argued against updating the record in the recent UNE proceeding before the Delaware PSC. Objecting to the request of AT&T and other parties to reopen the record to reflect intervening declines in the costs of several major inputs, Verizon argued that "the other parties disput[ing] other data contained in Verizon DE's cost studies [are] unfairly seeking to take advantage of developments since [the close of the pricing record] that have the tendency to reduce costs, while depriving Verizon DE of the counterbalancing effect of data updates that have increased costs since that time."[37] The case for reopening the record was far weaker here than in the Delaware UNE proceeding, where the evidence offered by the proponents of reopening showed that the intervening cost changes almost certainly produced a large *net reduction* in UNE costs. Here, Verizon has made no showing at all that intervening changes in the telecommunications markets since the close of the record before the Commission have had any material effect on the *overall* cost of providing UNEs.

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[37] *In the Matter of the Application of Verizon Delaware Inc (f/k/a Bell Atlantic-Delaware, Inc.) for Approval of its Terms and Conditions Under Section 252(f) of the Telecommunications Act of 1996 (Filed December 16, 1996; Reopened June 5, 2002)*, PSC Docket No. 96-324 Phase II, Brief of Verizon Delaware Inc. (November 13, 2001) ("Verizon Delaware Brief") at 10.

5. The Bureau Properly Chose The Modified Synthesis Model To Develop Loop Costs.

Verizon criticizes the Bureau's choice of the Modified Synthesis Model ("MSM") to develop loop costs, claiming that the Commission has never approved the use of the MSM to develop UNE rates. Application at 36-37. Verizon's criticism is unfounded.

The Bureau reviewed the cost models submitted by AT&T/WCOM and Verizon and determined that the MSM proposed by AT&T/WCOM was superior to Verizon's cost models in developing loop costs. *Order* ¶¶ 49-53, 171-73. The Bureau found that the MSM satisfied the Bureau's three criteria that a cost model should be: (1) consistent with the Commission's TELRIC rules, (2) transparent and adjustable; and (3) verifiable. *Order* ¶¶ 49-53. The Bureau determined that the MSM conformed to TELRIC principles in providing a forward-looking model that used the most efficient technology available. *Id.* ¶¶ 49-50, 171. The Bureau similarly found that the MSM was generally transparent and verifiable, allowing for review of inputs and adjustments by Commission staff and by Verizon. *Id.* ¶ 50.

By contrast, the Bureau had serious concerns that Verizon's loop cost model did not satisfy these criteria. *Id.* ¶¶ 171-73. The Bureau found that Verizon's LCAM model used to develop loop costs was not a cost model at all, but rather an engineering cost study that used Verizon's embedded network as its base. Accordingly, Verizon's LCAM study was not a forward-looking model based on the most efficient technology as prescribed by TELRIC principles. *Id.* ¶¶ 52, 171. Moreover, the Bureau determined that there were significant questions about the transparency and verifiability of Verizon's LCAM cost study and Verizon's other associated models, which did not allow parties to verify data or test assumptions used in the studies. *Id.* ¶ 172.

In light of these findings, the MSM was the clear choice on the record in this case for developing forward-looking TELRIC loop prices. Given Verizon's reliance on its embedded

network in its cost study, under the baseball arbitration rules, the Bureau had only one model before it that developed forward-looking costs using the most efficient technology: the MSM.

Verizon cites various Commission statements in claiming that the Commission has never approved the use of its universal service Synthesis Model to set UNE rates. Application at 36-37. Verizon is incorrect. The Bureau noted, in discussing the version of the Synthesis Model developed for universal service costing, that "the Commission developed the [synthesis model] platform in an express effort to model a forward-looking network that reflects use of the most efficient, lowest cost network configuration, assuming existing wire center locations, that an efficient carrier would deploy." *Order* ¶ 171 (citing *USF Inputs Order,* ¶¶ 29, 66; *USF Platform Order,* ¶ 54,66). This universal service Synthesis Model develops a forward-looking network used in determining universal service costs. As AT&T/WCOM acknowledged in this case, various adjustments must be made to the universal service Synthesis Model to allow it to be used to develop UNE costs, and those changes were made and included in AT&T/WCOM's submitted testimony.[38] Consistent with the Bureau's criteria of transparency and verifiability, those changes were fully available to the Bureau and Verizon throughout this proceeding for review and testing. The changes to the universal service Synthesis Model address any concerns about the appropriateness of using the MSM to develop UNE costs. As the Bureau found, the MSM satisfied the Bureau's three criteria for a cost model, and was an appropriate choice to develop UNE loop costs.

Verizon's other specific criticisms of the MSM are addressed elsewhere in this Opposition, but one overarching theme must be noted. Verizon derides various inputs to the MSM as "entirely hypothetical" and "based on little more that the opinions of AT&T/WCOM's subject matter experts," and complains that the Bureau ignored Verizon's "proposed fill factors

[38] AT&T/WCOM Exh. 1 (Pitkin Dir.) at 8-17.

based on efficient engineering guidelines and the actual utilization levels it has experienced in operating a real-world network subject to Virginia-specific service guidelines." Application at 38. This comment exemplifies the basic flaw in Verizon's approach in this case: Verizon's pervasive reliance on its embedded network, which is *irrelevant* in forward-looking cost modeling based on TELRIC principles. Verizon, having criticized the MSM without proposing alternatives based on use of the MSM, has waived any objection to the Bureau's lack of any alternative to the MSM under the baseball arbitration rule of decision.

6. Verizon's Arguments Against the DS-1 and DS-3 Rates Are Baseless.

Verizon argues that the DS-1 and DS-3 rates proposed by AT&T/WCOM are not cost-based and are inappropriately derived from the MSM. Application at 39-42; Motion for Stay at 22-26. In addition, Verizon complains about the low level of the DS-1 and DS-3 rates and raises a number of criticisms of the relationships between those rates and the two-wire loop rate. *Id.* None of these arguments has merit.

First, Verizon has waived any objection to the Bureau's high-capacity loop rate determinations. Although it had ample opportunity, Verizon *never* proposed adjustments to develop DS-1 or DS-3 rates based on AT&T/WCOM's cost model. Instead, it relied solely on its LCAM and Verizon High Capacity Access Cost ("Hi-Cap") models in developing its own DS-1 and DS-3 rate proposals. Verizon knew, however, that AT&T/WCOM were proposing the MSM and urging the rejection of Verizon's cost models as being based on Verizon's embedded network and not forward looking. Having put all its DS-1/DS-3 eggs in its LCAM/Hi-Cap model basket, Verizon cannot now complain that the Bureau accepted AT&T/WCOM's arguments, used the MSM to develop loop rates, and rejected the use of Verizon's models for determining such rates.[39] As it elected not to submit any alternatives based on AT&T/WCOM's

[39] Verizon does complain that the Bureau should have used its cost model to develop high-capacity line rates. Application at 42. Even though the MSM did not directly develop the DS-1

approach, in this baseball arbitration, its arguments against use of the AT&T/WCOM approach are entitled to no weight.[40]

In any event, the Bureau appropriately found that the factors developed by AT&T/WCOM to compute the DS-1 and DS-3 rates were "reasonable"—and, indeed, were similar to the relationship between two-wire loop rates and DS-1/DS-3 rates proposed by Verizon in this case and similar to the relationships found in special access and other proceedings. *Order* ¶ 342.[41] Although the Bureau noted some concerns about the AT&T/WCOM calculations, the consistency between the relationships between the two-wire loop rate and the DS-1 and DS-3 rates (4.3:1 and 9.6:1) and the factors proposed by Verizon in this case (6.1:1 and 10.0:1) is strong evidence as to the reasonableness of AT&T/WCOM's approach.

Verizon now argues that there is no relationship between two-wire and DS-1 and DS-3 rates, citing rates in various Verizon jurisdictions. Application at 41. In fact, the chart demonstrates that the rates in Virginia are certainly within the range of reasonableness. The ratio of two-wire loop rates to DS-1 rates ranges from 4.8 to 11.5 in other jurisdictions, and the Virginia ratio is only slightly lower at 4.3. For the DS-1/DS-3 ratio, the Virginia ratio of 9.6 is solidly in the middle of the range.

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and DS-3 rates, as the Bureau determined, basing those rates on cost factors applied to the two-wire rate developed by the MSM was a reasonable approach, and for that reason, there was no basis to consider using Verizon's embedded cost models.

[40] For example, in this Application (Application at 40-41), Verizon raises a number of issues regarding the cost relationships between two-wire loops and DS-1/DS-3 lines. These points may have served as the basis for proposing adjustments to AT&T/WCOM's approach, but Verizon never made such proposals. In any event, the cost relationships between the two-wire rate and the DS-1/DS-3 rates are consistent with proposals by Verizon in this proceeding and with other estimates of two-wire loop/high capacity lines. *Order* ¶ 342.

[41] *See* AT&T/WCOM Exh. 14 (Pitkin Surreb.) at 50-51.

Verizon's argument (Application at 39) that the DS-1 and DS-3 rates were not cost based is simply wrong. These rates were based on the two-wire loop rate developed by the MSM, and then derived using the factors and cost relationships that the Bureau determined to be reasonable. *Order* ¶ 342. The similarity of these cost relationships to Verizon's proposal and to Commission precedent refutes Verizon's claim that they are not cost based. They also reflect the relationships between DS-1 and DS-3 lines based on Verizon ARMIS data.[42]

7. Loop Fill Factors

Verizon challenges the distribution fill factor proposed by AT&T/WCOM and adopted in the *Order* on the following four grounds: (1) the *Order's* acceptance of AT&T/WCOM's distribution fills (which mirrored universal service inputs) violated the Commission's supposed finding that universal service model inputs are inappropriate for developing UNE costs; (2) AT&T/WCOM's distribution fill factor lacks evidentiary support and "model[s] a network with insufficient levels of spare capacity;" (3) the Bureau should have adopted Verizon's embedded distribution fills as the only "empirical data on the record"; and (4) the *Order* erred in finding that Verizon failed to proffer alternative distribution fills that could be substituted in the Modified Synthesis Model. Application at 43. Each argument is unsound.

First, there is no basis for jettisoning the adopted fill factors on the ground that they were devised for universal service. AT&T/WCOM used target distribution fill factors that ranged between 50 and 75 percent and an effective fill factor of 52.5 percent. AT&T/WCOM Exh. 14P (Pitkin Surreb.) at 13-14. In determining the effective fill factor, AT&T/WCOM compared the number of cables that were actually deployed by the model against the total current demand number in the model. AT&T/WCOM Exh. 14 at 14 n.16. It is true that the Bureau found that

[42] To the extent there are problems with these data, Verizon is responsible for those problems as it failed to provide complete answers on Verizon's special access lines in discovery in this proceeding. AT&T/WCOM Exh. 14 (Pitkin Surreb.) at 73.

AT&T/WCOM's fill factors were consistent with those "in the *Inputs Order*, in both concept and level." *Order* ¶ 247 (footnote omitted). That finding, however, provides no basis for rejecting or altering the distribution fill factor in the *Order*.

Implicit in Verizon's argument is the notion that the *Inputs Order* forbade the use of the universal service model in developing UNE prices. That simply is not true. The *Inputs Order* made no finding that the specific inputs that had been adopted for purposes of universal service were inappropriate in other contexts; rather, the Commission found only that it had not considered or resolved the issue. *Tenth Report and Order* ¶ 32. The Commission subsequently made clear, by adopting the Synthesis Model to "benchmark" the appropriateness of the relative prices for switching and unbundled loops in Section 271 Proceedings, that the universal service model could in fact be used for other purposes, including for the calculation of UNE prices and that departures from the benchmark factors would likely require strong state-specific justifications.[43]

Second, Verizon's argument that the Bureau recklessly accepted AT&T/WCOM's distribution fill factor at face value and turned a blind eye to Verizon's so-called "empirical data" is patently false. Application at 43. The *Order's* findings were grounded on a full examination of the evidence in the case—evidence that fully supported the distribution fill factor adopted in the *Order*. Verizon's assault on the distribution fill factor adopted in the *Order*, when stripped of rhetoric, reduces to a single proposition: Verizon's embedded distribution fill factor

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[43] Memorandum and Opinion Order, *In the Matter of Joint Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc., d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma*, 16 FCC Rcd. 6237 at ¶ 84 (2001); Memorandum and Opinion Order, *In the Matter of Application of Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions) and Verizon Global Networks Inc., for Authorization to Provide In-Region, InterLATA Services in Massachusetts*, 16 FCC Rcd. 8988 ¶¶ 22-23.

in Virginia, **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]** percent, is efficient, and the distribution fill factor adopted in the *Order* would increase overall costs and leave too little capacity to accommodate demand fluctuations and customer churn.

However, Verizon submitted no optimization analysis in support of this claim, or any other empirical evidence that the added costs of piecemeal plant expansion from the distribution fill factor adopted in the *Order* would outweigh the savings from the capital costs avoided by carrying less spare capacity. Notably, the Virginia Commission obviously concluded that a distribution fill factor similar to that in the Modified Synthesis Model was sufficient when it adopted a 50 percent fill in the first UNE proceeding. AT&T/WCOM Exh. 12P (AT&T/WCOM Recurring Cost Panel Reb.) at 44. In addition, AT&T/WCOM's witness, Mr. Riolo, explained that he personally directed operations that had a distribution fill factor in excess of the effective fill in the Modified Synthesis Model, and that, in reviewing Verizon's estimate cases for maintenance operations, discovered portions of Verizon's plant that operated above the effective fill in the model. Tr. 4515-15 (Riolo).

Furthermore, according to Verizon, residential customers in Virginia subscribe on average to 1.18 lines per subscriber location. Tr. 4192-93 (Gansert). An 18 percent second line penetration produces a distribution fill of 59%. AT&T/WCOM Exh. 12P (AT&T/WCOM Recurring Cost Panel Reb.) at 48. With growth in demand in Verizon's network averaging three percent per year, AT&T/WCOM's effective fill factor provides substantial spare capacity to allow for growth in customer demand, administration, and churn. AT&T/WCOM Post-Hearing Cost Br. 151-152. Even a distribution fill of 59 percent is overly conservative. Under standard engineering practices, which Verizon purportedly follows, the distribution fill ratio includes, *inter alia,* idle dedicated and connect-through pairs. When those pairs are included in the fill

ratio, distribution utilization exceeds 59%. AT&T Exh. 12P (AT&T/WCOM Recurring Cost Panel Reb.) at 48-49. And, a distribution fill factor based on a purely economic analysis, without taking growth into consideration, would be approximately 90 percent. AT&T/WCOM Exh. 12P (AT&T/WCOM Recurring Cost Panel Reb.) at 45-46.

It was against this backdrop that the *Order* found that Verizon provided no "substantiation for its claim that a network built using AT&T/WCOM's distribution fill factors would have insufficient capacity to function properly." *Order* ¶ 252. The *Order* found that AT&T/WCOM's "proposed fill factors, which vary in the MSM for different parts of outside plant … and for density zones, are intended to ensure that the network models not only the capacity needed to provide service to current customers, but sufficient capacity to provide for growth, churn, and administrative functions as well." *Order* ¶ 244. In UNE pricing cases, the incumbent carrier bears the burden of proof on disputed factual issues. *Local Competition Order* ¶ 680. Verizon clearly failed to satisfy its burden of proof on this issue.

Third, contrary to Verizon's contentions, there is considerable evidence in the record affirmatively showing that the lower fill factor proposed by Verizon was *not* efficient or optimal. Verizon's own engineering guidelines recommend two wire pairs per household. *See Order* ¶ 246. In this case, however, Verizon divided the costs of the loop plant in its models by the number of working lines, and then divided the resulting number by the fill factor. The effect was to calculate costs as if Verizon constructed **[BEGIN VERIZON PROPRIETARY]**

[END VERIZON PROPRIETARY] working pairs. AT&T/WCOM Exh. 12P (AT&T/WCOM Recurring Cost Panel Reb.) at 44-45. This procedure would require the

purchaser of each unbundled loop to pay for considerably more than the two pairs per household called for by Verizon's Engineering Guidelines.

Moreover, Verizon did not establish that it was efficient to construct even two pairs per household. In the many neighborhoods in which demand for second lines has remained stable and is likely to remain so going forward, there is no need to construct two distribution pairs per household. Far fewer distribution pairs could be built while still providing sufficient capacity to serve any demand for second lines that did arise. AT&T/WCOM Exh. 12P (Recurring Cost Panel Reb.) at 46-47. This is particularly so now that the advent of DSL and cable modems has reduced customers' need for second lines. *Cf. Tenth Report and Order* ¶ 200 (noting that ultimate demand may decrease substantially with advent of DSL). Furthermore, although Verizon insists that its distribution fill is consistent with sound engineering standards and industry practice, the record shows that **[BEGIN VERIZON PROPRIETARY]**

[END VERIZON PROPRIETARY] AT&T Exh. 117 at D3, H1.

In addition, the required capacity would need to be reduced still further to reflect the lower percentage of defective pairs in a reconstructed, forward-looking network. In calculating its existing fill factor, Verizon divides working pairs by total pairs, including defective pairs. But, in a reconstructed network with new plant, fewer than one percent of all pairs should be defective – far fewer than Verizon typically experiences in its existing embedded plant. AT&T/WCOM Exh. 12P (AT&T/WCOM Recurring Cost Panel Reb.) at 50; Tr. 3893 (Riolo). This fact alone means that the distribution fill factor should be significantly higher than Verizon

claims. When the various factors set forth above are considered, the engineering fill factor for distribution cable adopted in the *Order* is, if anything, overly conservative. AT&T/WCOM Exh. 12P (AT&T/WCOM Recurring Cost Panel Reb.) at 50.

Verizon's analysis suffers from another, equally serious error: Verizon treats the *engineering* question of how much spare capacity should be built into the distribution plant as synonymous with the *economic* question of how the costs of that spare capacity should be apportioned between present and future ratepayers. AT&T/WCOM Exh. 12P (AT&T/WCOM Recurring Cost Panel Reb.) at 42-43. Verizon would have the Commission include the *costs* of spare capacity needed to accommodate future growth in demand, without spreading the cost of that capacity over the additional *demand*. Verizon's costing approach prices UNEs as if the level of spare capacity remains constant over time, as if demand does not increase.[44] In effect, Verizon charges present customers for capacity that will be used by future customers and then *also* charges future customers for that capacity.

Projections about future growth in the demand for loops, however, must be reflected not only in the overall capacity and cost assumptions, but also in the assumed number of revenue-paying customers. In the words of Paragraph 682 of the *Local Competition Order*, unit costs must be computed as "the total cost of the element" divided by a "reasonable *projection* of the actual total usage of the element." Verizon's approach would read the word "projection" out of Paragraph 682 by substituting "actual" or "current" demand for projected demand. This approach is a clear violation of TELRIC, which requires "consistency between the numerator and the denominator in calculating the distribution fill factor." *Order* ¶ 255. As the *Order* properly found, "[j]ust as the Commission found it inappropriate to include in universal service

[44] AT&T/WorldCom Exh. 11P (Murray Reb.) at 32 ("Verizon has modified plant to meet future demand as well as current demand, but the company has calculated unit costs using only current demand in the denominator of the calculation.")

support the costs of building outside plant designed to meet uncertain ten- or twenty-year demand projections, it is inappropriate for AT&T/WCOM to bear the cost today of building plant for uncertain ultimate demand." *Id*. ¶ 254.

Verizon's fundamentally flawed approach is also at odds with the behavior of competitive markets. In a competitive market, a firm will rationally install excess capacity in anticipation of future growth only when doing so is expected to minimize the net present value of deploying the network over the life of the network. In any event, the unit price of the capacity should be based on the total expected demand over the life of the facility. Tr. 3212 (Murray); AT&T/WCOM Exh. 11P (Murray Reb.) at 33.

Verizon's approach also violates well-established economic principles of intergenerational equity and efficiency for the pricing of long-lived capacity acquired to meet future growth in demand. Significantly, even Dr. Alfred Kahn, a NERA colleague of Verizon witnesses William Taylor and Timothy Tardiff, and a longstanding spokesman for Verizon and other incumbent LECs, has agreed that requiring present customers to pay for all of the spare capacity built for future customers would be unfair and inefficient:

> We have already posed the question of the proper rate [of depreciation] when a plant is built far in advance of total need – perhaps because there are great economies of scale. To charge depreciation in equal annual installments would be to impose a disproportionately heavy burden on customers in earlier years, when much of the capacity lies idle. Considerations of fairness – the idle capacity is really for the benefit of future, not present customers – and economic efficiency present a case for something similar to SRMC pricing, which would have the effect of concentrating the capital charges in later years."

AT&T Exh. 100, Alfred E. Kahn, *The Economics of Regulation* (1970) at 121. *Accord*, *Tenth Report and Order* ¶¶ 56, 58.

When current ratepayers are properly credited for the expected revenue contribution from the future growth in demand, the cost per customer is actually *lower* than the estimate produced by assuming the absence of any spare capacity for growth. *See* AT&T/WCOM Exh. 12P

(AT&T/WCOM Recurring Cost Panel Reb.) at 42-43; *Tenth Report and Order* ¶ 58 (refusing to include future demand because of the speculative nature of that demand).

A rigorous economic analysis would reflect ultimate demand in both the assumed cost of the spare capacity assumed for future growth and the assumed number of revenue-paying customers from whom the capacity costs would be recovered over the life of the assets. Because ultimate demand is uncertain, however, the FCC has adopted instead the simplifying approximation of including little spare capacity for growth. *Cf. Tenth Report and Order* ¶ 199 ("the fill factors selected for use in the federal mechanism generally should reflect current demand and not reflect the industry practice of building distribution plant to meet ultimate demand."); *Order* ¶ 247 (in its *Tenth Report and Order*, the FCC "expressly adopted use of current demand, rather than ultimate demand, in applying fill factors."). By comparison with the results of such an analysis—which itself tends to overstate capacity costs – the distribution fill factor adopted in the *Order* is extremely conservative. The fill factor for distribution resulting from such an analysis—in which customers were charged only for working pairs, pairs reserved for maintenance purposes and other pairs needed to operate the network today—would be in the order of *90 percent*. AT&T/WCOM Exh. 12P (AT&T/WCOM Recurring Cost Panel Reb.) at 45-46.

Verizon tries to brush off this analysis by suggesting that the mere fact that its actual distribution fill rates have remained stable demonstrates that no portion of the costs of spare capacity will be recoverable from future ratepayers. *See* Application at 45. However, this rejoinder is both incorrect and irrelevant. It is incorrect because distribution plant is sized from the outset to meet *ultimate* demand. Tr. 3000 (Tardiff). And it is irrelevant because Verizon confuses the average utilization of the network *in the aggregate* with the utilization of *individual* loops, serving areas or other subcomponents of the network – the level of aggregation at which

Verizon makes plant-sizing decisions and offers discrete units of capacity for sale to CLECs and other ratepayers.

At that disaggregated level, Verizon clearly sizes its plant in the expectation that demand will tend to grow over time, and that capacity utilization *for a given set of facilities* will tend to trend upward until the capacity is reinforced. When a previously idle loop is brought into revenue-generating service by increased demand, the new customer receives no credit for whatever contribution that prior ratepayers may have made to the cost of that loop when it was merely unused spare capacity. As a consequence, charging current ratepayers for spare capacity that is expected to go into future revenue-generating service produces double-recovery of costs, and requires current ratepayers to cover costs they did not cause. AT&T/WCOM Exh. 11P (Murray Reb.); Tr. 2996 (Tardiff); AT&T/WCOM Exh. 20 (Murray Surreb.) at 38-41. Even Dr. Kahn, a longstanding partisan of Verizon and other ILECs on cost issues, agrees. AT&T Exh. 100 (Kahn Treatise) 121.

Verizon's scenario of static capacity utilization is also at odds with Verizon's own loop cost study. In developing unit costs, Verizon divided the total cost of the capacity it models by a quantity of service units equal to the existing level of demand multiplied by the life of the asset. Tr. 4206-07 (Gansert). If, as Verizon assumes, total demand remains constant over the life of the plant, its model generates exactly enough revenue to cover the full costs of the facility. If total demand increases (as is likely, and as Verizon assumed in *sizing* the plant), its model inevitably generates *more* revenue than needed to cover the full costs of the facility. AT&T/WCOM Exh. 11P (Murray Surreb.) at 32.

The *Order* also properly rejected Verizon's claim that its reliance on its embedded distribution fill factor was eminently reasonable because "the average fill factor in the competitive environment assumed under the Commission's TELRIC rules would be less than its

current actual fill due to increased fluctuations in demand and customer churn." *Order* ¶ 249. The *Order* correctly found that Verizon's failure to proffer any evidence on this issue rendered it impossible for the Bureau to conclude that there "is a negative correlation between competition and outside plant utilization rates." *Id.* (footnote omitted). The *Order* properly recognized that, although competition could spawn increased fluctuations in demand, it is also possible that competitive pressures would result in more efficient mechanisms to respond to such fluctuations. *Id.*

Fourth, in its last-ditch attempt to convince this Commission that the *Order*'s finding is fatally flawed, Verizon argues that the Bureau incorrectly found that it failed to propose any alternative distribution fill for the Modified Synthesis Model and references Verizon Exh. 204 that contains its distribution fill adjustment. Application at 46. However, Verizon's cited exhibit can be given no weight. Verizon did not submit it to the Bureau until *after* the close of hearings, and it thus never faced the rigors of cross-examination. Moreover, Verizon's Application conspicuously omitts any discussion of its restated distribution fill factors for the Modified Synthesis Model. Verizon's silence on this issue is hardly surprising, for its adjustments were nothing more than its embedded distribution fill factors – the same fill factors that the *Order* properly rejected. For all of these reasons, Verizon's criticisms of the distribution fill factor adopted in the *Order* are baseless and provide no sound basis for a modification of the *Order's* finding on this issue.

8. IDLC/UDLC/GR-303

Verizon contends that the Bureau erroneously assumed that, in the forward-looking network, all fiber-fed loops would be served by Integrated Digital Loop Carrier ("IDLC") by using GR-303 technology. Application at 21; Motion at 19-22. In support of this assertion, Verizon argues that the *Order*'s finding, which excludes universal DLC ("UDLC") from the

forward-looking network, ignores Verizon's *unrebutted* evidence demonstrating that IDLC-GR-303 cannot be used to unbundle standalone loops or to serve non-switched services. Application at 21. Verizon also asserts that this "irrational" finding contravenes "the Commission's rule that TELRIC rates must be based only on 'currently available' technology." *Id*. Verizon's arguments cannot withstand scrutiny.

(a) The Relative Use Of GR-303 Vs. TR-008

In its model, Verizon assumed that 70% of all fiber-fed loops (57.6% of all loops) would be served with IDLC, 30% of fiber-fed loops (24.7% of all loops) would use UDLC, and 10 percent of all loops would be served using GR-303, with the remainder using TR-008. Verizon Cost Br. at 88; Verizon Switch Cost Br. at 12-13. The *Order* rejected these values, finding that all fiber-fed loops served by IDLC would exclusively use GR-303 technology in a forward-looking network. The Bureau's findings are fully supported by the record evidence. Verizon's proposed values would result in an overstatement of costs. *See* AT&T/WCOM Post-Hearing Cost Br. at 133-143.

In analyzing the DLC systems that should appropriately be used in a TELRIC model, the Bureau first considered whether the Modified Synthesis Model should use Next Generation Digital Loop Carrier ("NGDLC") (*i.e.* a DLC system with a GR-303 switch interface standard) or the TR-008 switching interface. The *Order*'s finding that the "newer and more advanced" GR-303 NGDLC systems would be used in a forward-looking network is plainly correct, and Verizon's mix of DLC technology, which assumed that the vast majority of loops would be served with TR-008, is plainly inconsistent with forward-looking cost principles. AT&T Exh. 117 at D3, H1.

In rationalizing its reliance on TR-008 in its cost model, Verizon stressed that its "existing switches and DLC system are designed to support TR-008 interfaces but would require

upgrading or replacement to support GR-303 interfaces." *Order* ¶ 311. Verizon also asserted that its assumption of 10% GR-303 equipment was generous because less than one-tenth of one percent of the total working loops in the Verizon-East footprint are currently served using GR-303, and that it "has no plans to deploy GR-303." Verizon Cost Br. at 94; Verizon Switch Cost Br. at 12-13 n.13. Thus, Verizon left no doubt that its assumption that the majority of its outside plant would use TR-008 is based on the constraints of its embedded network. Indeed, Verizon implicitly and repeatedly acknowledged that GR-303 would be the most cost-effective technology in a forward-looking network, but defended the high proportion of TR-008 assumed in its studies on the ground that, *inter alia*, "the huge existing investment in modern digital switch ports that support TR-008 IDLC would have to be replaced and stranded to deploy the GR-303 interface widely." Verizon Exh. 107 (Verizon Cost Panel Dir.) at 91. Similarly, at hearing, Verizon's witness, Mr. Gansert, was forced to acknowledge that much of the IDLC deployed by an entrant unconstrained by Verizon's embedded plant would be GR-303. Tr. 4556 (Gansert).

The *Order* properly found that Verizon's embedded network is not the appropriate starting point for TELRIC analysis—an analysis that "is not constrained by the technical limitations of Verizon's embedded plant." *Order* ¶ 311. A competitor constructing an efficient network today would not be bound by the limitations of Verizon's embedded plant, and without such a constraint, would only deploy switches that use GR-303 technology. AT&T/WCOM Exh. 11P (Murray Reb.) at 26. Moreover, the Bureau's finding that GR-303, rather than TR-008, would be deployed in a forward-looking network is fully supported by the evidence which demonstrated that: the older TR-0008 technology uses small-sized remote terminals and has limited capability to engineer and concentrate subscriber traffic; switch blocking may occur with a TR-008 switch when the traffic offered to the peripheral exceeds the capacity of the switching

fabric; GR-303 Interface Groups are generally larger than TR-008 Interface Groups and are less susceptible to traffic load variations; and GR-303 generally has a lower cost because GR-303 is engineered to concentrate traffic and is brought into the switch at DS-1 levels. AT&T/WCOM Exh. 12P, (AT&T/WCOM Recurring Cost Panel Reb.) at 24-25, 104-106.

(b) UDLC/IDLC - GR-303

The Bureau next considered whether any fiber-fed loops in the forward-looking network would use UDLC. The pool of evidence confirmed that the most efficient forward-looking Digital Loop Carrier technology current available is the IDLC system that utilizes a Time Slot Interchanger ("TSI") feature and interfaces to the Local Digital Switch *via* the GR-303 interface, rather than the older UDLC system. The evidence showed that UDLC is less efficient than IDLC/GR-303 because: the back-to-back digital/analog conversions that are required with UDLC are inefficient and degrade transmission quality; the multiple signal conversions with UDLC require additional line cards and other equipment; and there is increased risk of equipment failure due to the Main Distribution Frame cross-connect activity. *Id.*

In mounting its defense of UDLC in its model, Verizon argued that the assumed mix of DLC technology in the forward-looking network must include UDLC because: (1) IDLC-based loops are not capable of being unbundled with GR-303 and require migration to UDLC or copper; and, even if such loops can be unbundled, substantial manual tasks are needed to perform the unbundling; (2) UDLC is required for non-switched services; and (3) unresolved issues involving network security and the lack of OSS demonstrate the unfeasibility of unbundling IDLC-based loops with GR-303. *Order* ¶ 308. The *Order* properly rejected each of these arguments.

(c) The Feasibility Of IDLC/GR-303 Unbundling

Noting that "[t]he Commission's rules place the burden of proof on Verizon to demonstrate that a method of accessing UNEs is not technically feasible" (*Order* ¶ 313), the Bureau found that Verizon failed to meet its burden of proving that it is not technically feasible to unbundle NGDLC loops. Verizon's assertion that it submitted *unrebutted* evidence that IDLC loops served by GR-303 cannot be unbundled and require migration to UDLC or copper is patently false.

The Bureau found that Verizon's arguments regarding the technical unfeasibility of unbundling IDLC with GR-303 technology contradicted the testimony of its own witness, who "admitted that Verizon has had the technical ability to provide unbundled NGDLC loops for *four to five years*, but chose not to implement a standard offering because competitive carriers had not sufficiently pursued such an offering" (*Order* ¶ 315), as well as the "repeated" admissions of BellSouth that it unbundled loops that traverse NGDLC and GR-303 systems. *Id.* n. 819. Although Verizon insists that the Bureau has mischaracterized the import of the testimony of Verizon's witness (Application at 25), Verizon glaringly omits any reference to the second prong of the Bureau's analysis, which took administrative notice of the admissions of BellSouth, a peer of Verizon, that it had unbundled IDLC loops.

The record is replete with other evidence demonstrating that Verizon's assertions regarding the technical unfeasibility of unbundling IDLC-based loops using GR-303 are meritless. For example, NYNEX's 1997 Technical Document recognized that GR-303 would likely play a critical role in unbundling, and that Verizon would use TR-008 methods of unbundling (without any UDLC) until the industry developed multi-hosting capabilities for GR-303. AT&T Exh. 120 at 4. **[BEGIN VERIZON PROPRIETARY]**

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The technical feasibility of unbundling IDLC-based loops using GR-303 is further borne out by Telcordia Notes on the Networks, October 2000, Figure 12-35, AT&T Exh. 122. Although Verizon insists that Telcordia has not resolved the technical issues and challenges of unbundling loops using GR-303 (Application at 22-23), Telcordia determined that, in updating its SCIS model, GR-303 was the forward-looking DLC technology to use with Lucent's new SM-2000 module – a determination providing further confirmation that GR-303/IDLC unbundling is not only forward-looking, but technically feasible. *See* AT&T/WCOM Switch Cost Br. at 4-5; AT&T/WCOM Exh. 24P (Pitts Supp. Surreb.) at 6-7. And the evidence shows that SBC is using GR-303 throughout its network in its Project Pronto. AT&T/WCOM Exh. 11P (Murray Reb.) at 36-37.

More fundamentally, the record shows that Verizon's argument that IDLC-based loops must be converted to analog UDLC/copper facilities when migrating service to a CLEC is based upon the flawed syllogism that: (1) the loop element must contain a physical point of interconnection on the Main Distribution Frame; (2) the only loop having a physical appearance on the Main Distribution Frame is a two-wire "analog" loop; and, therefore (3) all unbundling must take place at the Central Office Main Distribution Frame to support the physical point of interconnection. AT&T/WCOM Exh. 13 (AT&T/WCOM Non-Recurring Costs Panel Rep.) at 15-16. However, Verizon's major premise – that the loop element must contain a physical point of interconnection on the Main Distribution Frame – is unfounded. With the advent of the Time Slot Interface, grooming of circuits provisioned at a Remote Terminal can be effected via a software command, and loops can be handed off to CLECs via a tie cable from the DSX frame to

the CLEC Point of Presence, rather than a 2-wire analog signal. Additionally, virtual interface groups can be used to unbundle loops provisioned to the host switch by rearranging the circuit to an interface group of a different host switch. This feature is used almost daily by incumbent local exchange carriers to balance the "load" on their own switches by moving heavy use circuits from one interface group to another. AT&T/WCOM Exh. 12P (AT&T/WCOM Recurring Costs Panel Reb.) at 27-28. At hearing, AT&T/WCOM's witness, Mr. Riolo, described and provided a diagram showing precisely how IDLC-based loops can be unbundled using GR-303 – unbundling that required no migration to UDLC or copper or extensive manual tasks. Tr. 4610-17 (Riolo). Significantly, Verizon's own witness, Mr. Gansert, was forced to admit that Mr. Riolo correctly described how IDLC-based loops can be unbundled using GR-303. Tr. 4185 (Gansert).[45]

(d) Non-Switched Services

Forced to concede the "theoretical" feasibility of IDLC/GR-303 unbundling, Verizon retreats to the claim that UDLC is required to provision non-switched services. Application at 25. Verizon is wrong. The record evidence demonstrated that GR-303 is an efficient means of providing non-switched services, and that UDLC is not required to provide such services.[46] The *Order* properly found that Verizon's argument that UDLC is required for non-switched services is not credible, particularly given Verizon's 2000 planning guidelines which state explicitly that growth in the network will be based on GR-303 NGDLC. *Order* ¶ 317. In challenging this

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[45] *See also* AT&T/WCOM Exh. 12P (AT&T/WCOM Recurring Costs Panel Reb.) at 23, 28-29; AT&T/WCOM Exh. 13 (AT&T/WCOM Non-Recurring Costs Panel Reb.) at 15-18; AT&T Exh. 123 (describing the Time Slot Interface feature which can be used for GR-303 unbundling); WCOM Exh. 116, U.S. West 1998 Presentation at 6-7.

[46] *See* AT&T Exh. 124 (NYNEX Loop Technologies Application Guidelines, March 1997 at 38 (GR-303 is an efficient means of providing ISDN); WCOM Exh. 117 (GR-303 Deployment: An ILEC Perspective, July 1998 at 10 (GR-303 supports ISDN and non-switched services)); AT&T/WCOM Exh. 12P (AT&T/WCOM Recurring Cost Panel Reb.) at 27-28.

aspect of the *Order's* finding, Verizon contends that the Bureau's characterization of the guidelines is plainly incorrect because the document nowhere mentions "non-switched services." Application at 26 n. 35. However, the absence of these words supports, rather than undermines, the *Order's* finding. **[BEGIN VERIZON PROPRIETARY]**

[END VERIZON PROPRIETARY]

Not only did the Bureau find that Verizon failed to prove that UDLC is required to provide non-switched special services, but it also found that Verizon failed to specify the types of non-switched special access lines that purportedly required UDLC. *Order* ¶ 318. In this regard, Verizon contended that all non-switched services require UDLC, and that ten percent of its network consists of non-switched services. However, the Bureau found that "Verizon's statement that non-switched services comprise ten percent of its network is less than clear [because] [a] network is comprised of facilities, not services, and many of these facilities (*e.g.* DLC systems) are shared among multiple services." *Id.* ¶ 318 n. 824. After noting that Verizon's definition of non-switched services appeared to refer to voice and 64 kbps data special services, the Bureau observed that, if DS-3s and DS-1s (as well as other special access services) were excluded, the remaining lines would constitute far less than the ten percent figure on which Verizon relies. *Id.*

In rejoinder to this finding, Verizon asserts that it presented evidence that its ten percent estimate "accounted only for *narrowband* services and therefore did not include DS1s and DS3s." Application 25 n. 34 (emphasis in original). Even assuming *arguendo* that is true, the *Order* properly found that Verizon's evidence could not otherwise be credited because it suffered from internal inconsistencies. Indeed, the *Order* found that Verizon's assertion that *25* percent of all loops "must use UDLC to support non-switched services" is at war with its assertion that *ten* percent of its network consists of non-switched services. *Order ¶ 319 n. 824.* Verizon's Application fails to mention these discrepancies in its analysis, which served as a separate basis for the *Order's* rejection of Verizon's inclusion of UDLC in its plant mix.

(e) Network Security/OSS Issues

Equally unavailing is Verizon's contention that the unresolved network security and OSS issues regarding GR-303/IDLC unbundling warranted a finding that UDLC must be deployed in the forward-looking network. The Bureau's rejection of these claims is fully supported by the record evidence. The *Order* properly found that Verizon's assertions regarding network security issues precluding GR-303 NGDLC unbundling are a red herring because Verizon must have resolved any such security concerns in deploying GR-303 in the Verizon West territories. Verizon's own guidelines in Verizon West territories and the testimony of Verizon's own witness confirmed that "GR-303 systems are used for growth throughout Verizon West territories." *Order* ¶ 320 (footnote omitted). Tellingly, the record shows that Verizon's guidelines which specified the use of GR-303 in the Verizon's West territories were still in effect despite Verizon's professed and "unspecified security concerns." *Id.* ¶ 320.[47]

[47] *See* Tr. 4166-68 (Gansert) (acknowledging that Verizon faced yet resolved security concerns in deploying GR-303 for loops used for retail customers in Verizon West; Tr. 4615-16 (Riolo).

The *Order* also properly dismissed Verizon's claim that the lack of OSS to support GR-303 unbundling demonstrates that the GR-303 technology cannot be used to unbundle loops served by IDLC. Although Verizon suggested that the difficulties in developing OSS for unbundling are somehow insurmountable, Verizon clearly resolved OSS issues with respect to its backend systems to deploy GR-303 (outside the context of unbundled loops) once it decided to deploy GR-303. Tr. 4587 (Gansert). At bottom, Verizon's criticisms of AT&T/WCOM's network assumptions rest on the presumption that "only the technology [that Verizon] expects to install in its network during the study period is 'currently available.'" *Order* ¶ 568. This premise was and is invalid, for it would effectively preclude CLECs and customers from benefiting from the least costly, most efficient technologies until Verizon saw fit. Hence, the salient inquiry is not whether Verizon has already developed the OSS to support IDLC/GR-303 unbundling, but rather "whether the technology is 'currently available.'" *Id.* ¶ 321. A process or function may be "technically feasible" within the meaning of the *Local Competition First Report and Order* even if its implementation "may require *some modifications to existing systems.*" *Id.* (emphasis in original).

The reality is that Verizon has elected to deploy relatively little GR-303 in its existing network solely because of the parochial economic incentives created by the company's embedded switch investment. Until this investment reaches the end of its useful life, Verizon has no incentive to work with vendors on OSS issues that would be useful in supporting GR-303 unbundling—even if the resolution of such issues would be readily achievable and in the overall interest of competitors and ratepayers generally. In fact, as long as Verizon can argue for higher UNE prices on the ground that GR-303 unbundling is not yet available, it has every incentive to delay the development of OSS to support such unbundling. Because the development and implementation of OSS to support IDLC/GR-303 unbundling is squarely "within Verizon's

control," the *Order* properly rejected Verizon's assertion that a lack of OSS proves that IDLC/GR-303 loop unbundling "is not technically feasible or currently available." *Id*.

Against this backdrop, Verizon's arguments that the Bureau erred in concluding that fiber-fed loops would be served with IDLC using GR-303 technology are utterly meritless. The Bureau correctly concluded that, in a forward-looking network, all fiber-fed loops would be served by IDLC/GR-303 technology and properly rejected Verizon's contention that a forward-looking network must contain UDLC.

C. Verizon's Challenges To Non-Loop Inputs And Rates Are Premature And, In Any Event, Without Merit.

Verizon's application for review and motion for stay rest in large part on allegations that the *Order* sets unduly low rates for switching, other non-loop elements, and recurring charges. As noted in Section I of this Opposition, however, the only rates actually established by the *Order* are loop rates; the setting of specific non-loop rates has been deferred to a subsequent order. All the August 29 *Order* requires Verizon to do about its non-loop rates is to submit "compliance" cost studies, or respond to the compliance studies submitted by MCI and AT&T (¶¶ 695-697). Accordingly, the findings of the *Order* concerning inputs and other methodological issues for non-loop rates are merely interlocutory, and therefore nonfinal and nonreviewable until the Bureau issues its further decision after receiving the compliance runs and responses.

The Commission has made clear that 47 C.F.R. § 1.115 does not authorize review of interlocutory staff rulings until the issuance of a final decision on the merits. *In the Matter of Implementation of the Telecommunications Act of 1996—Amendment of Rules Governing Procedures to be Followed When Formal Complaints are Filed Against Common Carriers*, 16 FCC Rcd. 5681 ¶ 38 (2001). This policy "rests on the need to maximize the efficient use of limited administrative resources" and prevents parties from "engaging in dilatory tactics." *Id*.

Deferral of review in this manner is entirely fair, "because all rights to appeal a staff decision to the Commission are preserved" for review after the delegated authority issues its subsequent decision disposing of the remaining issues in the case. *Id.*

Administrative orders are not final and reviewable "'unless and until they impose an obligation, deny a right, or fix some legal relationship as a consummation of the administrative process.'" *Chicago & Southern Air Lines, Inc.* v. *Waterman Steamship Corp.*, 333 U.S. 103, 112-13 (1948). A final order must have a "definitive character dealing with the merits of a proceeding before the Commission." *FPC* v. *Metropolitan Edison Co.*, 304 U.S. 384 (1938). Moreover, "the requirement that a reviewable order be 'definitive' is something more than a requirement that it be unambiguous in legal effect. It is a requirement that the order have some substantial effect on the parties which *cannot be altered by subsequent administrative action*." *Public Service Co. of New Mexico* v. *FPC*, 557 F.2d 227, 233 (10th Cir. 1977) (emphasis added). "To be reviewable the order must have an impact upon rights and be of such a nature that it will cause irreparable injury if not challenged." *Id*. at 233. A decision that determines rate design or input issues, but defers the setting of specific rates until after the submission of compliance filings or other additional evidence, is clearly interlocutory and nonfinal under this standard. *See Cities of Riverside and Colton, California* v. *FERC*, 765 F.2d 1434, 1438-39 (9th Cir. 1985) (agency order prescribing rate design, rejecting electric utility's compliance filing, and ordering the submission of a revised compliance filing was interlocutory and nonreviewable until the agency approved a revised compliance filing and implemented the specific rates stated in it).

For these reasons, there is no need for the Commission to consider the merits of Verizon's non-loop claims at this time. Even if the claims raised by Verizon were properly before the Commission now, however, they would have to be denied on their merits. We discuss each issue in turn.

1. The *Order* Correctly Resolves Switching Cost Issues.

(a) Verizon's Criticisms of the Flat-Rated Port Charge for End Office Switching Are Erroneous.

Verizon argues that the Bureau erred in establishing a flat-rated charge for end office switching. Application at 10-16. Verizon rehashes its claims from the proceeding that switching investment should largely be recovered through traffic-sensitive charges and argues that a flat-rated switching design requires low-volume users to subsidize high-volume users. None of Verizon's arguments has merit.[48]

First, Verizon ignores the overwhelming evidence in the record that switching investment largely does not vary with usage.[49] As AT&T and WorldCom showed, the enormous reserves of memory and processor capacity in modern digital switches have eliminated switch exhaustion from usage.[50] AT&T/WCOM witness Catherine Pitts testified that Verizon switch utilization was "infinitesimally small," which allows usage to increase exponentially without exhausting the switch processor.[51] Verizon witnesses conceded at the hearing that modern switches were designed not to exhaust on usage: "[T]here is no question that in ordering the switch, it's designed so it will be, in effect, port-limited, so [what] will trigger you to do additions is ports."[52] Even Telcordia, whose proprietary SCIS model is used by Verizon to develop switching

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[48] In the proceeding, AT&T supported the adoption of the flat rated port charge as an alternative to port and per minute rate design. AT&T/WCOM Initial Switching Br. at 27. In this Opposition, AT&T supports the Bureau's decision on the flat-rated port charge.

[49] *See, e.g*. AT&T/WCOM Initial Switch Brief at 15-19; AT&T/WCOM Reply Brief at 86-90.

[50] AT&T/WCOM Exh. 4 (Pitts Dir.) at 7-8.

[51] AT&T/WCOM Exh. 12P (ATT/WCOM Recurring Cost Panel Rebuttal) at 112 n. 93 ; Tr. 5171; 5447, 5455-56 (Pitts).

[52] Tr. 5449 (Gansert).

investment, acknowledged in its documentation that the "getting started" investment and EPHC costs[53] do not vary with usage.[54]

Verizon offered no answer to this evidence. It cited a single blocked switch in New Hampshire and limited examples of supplements to switch components in Virginia,[55] but made no showing that these isolated examples were representative, or even involved modern digital switches. *Order* ¶ 468 & n.1188. In any event, this smattering of isolated examples from Verizon's several hundred switches would not undercut the reality that switch investment is largely non-traffic-sensitive.

Verizon's claims (Application at 15-16) that its engineers size its switches based on expected usage and that the usage determines the amount of the switch investment are misleading. Verizon creates the impression that the switches are carefully engineered to keep ahead of exhaust, and that Verizon engineers are "skilled at predicting such usage." *Id*. at 15. The record refutes any such claim. If the Verizon engineers were able to calibrate switching capacity with anticipated usage as Verizon contends, then Verizon's switch utilizations at any given time would be close to capacity. In fact, Verizon maintains such enormous switching capacity reserves that switching usage can double or quadruple without exhausting capacity.[56] This massive spare capacity, the result of the evolution of switch processor capacities and declining costs, virtually eliminates the need to detail engineer switch processor equipment based on usage.

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[53] These "equivalent POTS half call" costs represent the common equipment costs for the switching module to terminate line interface and trunk interface equipment on the Lucent 5ESS switch. *Order* ¶ 469.

[54] AT&T/WCOM Exh. 24P (Pitts Supp. Surreb.) at 16-17.

[55] Tr. 5448 and Verizon Exh. 122, at 176-78.

[56] Tr. 5171; 5447, 5455-56 (Pitts).

That Verizon sometimes adds growth equipment during the life of the switch in no way contradicts the foregoing, for the growth additions involve additional ports or line cards, not additional processing capacity: "it's true that if you exceeded the [processor] limit, you would have to put in more switches, and over recent years we haven't been doing that. The reason why is because the vendors have been increasing the capacity of their switches."[57] Given the evidence in the record from AT&T/WCOM, Verizon, and Telcordia, the Bureau properly concluded that the "getting started" investment, the EPHC costs, and right-to-use ("RTU") fees of the current generation of digital switches are all fixed costs that do not vary with usage. *Order* ¶¶ 463-72.

With respect to the small portion of switching investment that was found to be traffic-sensitive, Verizon complains that such investment should have been recovered through traffic-sensitive charges.[58] Application 12-16. The Bureau found, however, that any traffic-sensitive costs were incurred during peak periods, but that peak-period pricing was impractical.[59] Faced with the choice of spreading these peak-period costs over all minutes of use or spreading the costs over all switch ports, the Bureau properly selected the flat-rated charge as "the better approach" of the available alternatives. *Order* ¶ 475.[60]

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[57] Tr. 5449 (Gansert).

[58] AT&T/WCOM determined that approximately 16% of Verizon switching investment was traffic sensitive. AT&T/WCOM Exh. 12P (ATT/WCOM Recurring Cost Panel Reb.) at 115.

[59] *Order* ¶¶ 474-75, AT&T/WCOM Exh. 8 (Murray Dir.) at 17-18 (noting lack of publicly available data to develop peak-driven switching costs in a manner that reflects cost causation).

[60] Flat-rated port charges have been established in Illinois (Docket No. 98-0396, at p. 68); Wisconsin (Open Mtg. 12/13/01 Docket No. 5720-TI-161), Indiana (Cause No. 40611-S1 Phase I, 3/28/02, at p. 42), Utah (Report and Order, *Determination of the Cost of the Unbundled Loop of Qwest Corporation*, Docket No. 01-049-85 (5/5/03), Minnesota (Order, *Setting Prices and Establishing Procedural Schedule - PUC*, MPUC Docket No P421/CI-01-1375 (10/2/02).

Verizon claims that a flat-rated port charge violates the Commission's rules and precedent. Application at 10-11. In fact, although Commission rules and precedent recognize that some portion of switching investment may be traffic sensitive, but they do not require that such traffic sensitive charges be recovered through minute-of-use rates. Resolution of such an issue depends on the record in each case. In this proceeding, after weighing the evidence and acknowledging that there was no "ideal" resolution, the Bureau appropriately determined that recovery of traffic-sensitive costs was best achieved through the flat port charges.

Verizon also attacks the flat-rated port charge on the ground that it will result in low volume customers subsidizing customers with above-average usage levels. Application at 13. As the Bureau found, however, in specifically considering and rejecting this argument, the only relevant usage is peak period usage. Off peak, neither high volume users nor low volume users incur capacity costs; hence, no subsidy can result from off-peak usage. Traffic-sensitive cost causation thus is even a theoretical possibility only during peak periods. The record contains no evidence, however, about which users—high volume or low volume—use switch resources during the peak period. *Order* ¶ 478.[61]

Further, Verizon claims that a CLEC's costs should reflect the way in which the underlying network costs are incurred. Application at 14. Because Verizon's switching costs largely do not vary with usage, it is appropriate that the CLEC's switching costs should be recovered through flat-rated port charges. Verizon's switch manufacturers do not base the cost of a switch to Verizon on usage, and as the Bureau has determined, Verizon's switching costs

[61] Verizon's "all you can eat buffet" example is off base. The key point is that for most periods, Verizon does not incur any capacity costs for switching, thus there is no subsidization of any group by any other group. During peak periods, certain traffic-sensitive costs may be incurred, but one does not know who is eating at the telephonic buffet at that time. Moreover, the timing of the buffet differs, as each switch is different. For example, a high use residential customer with usage in the evening would legitimately have zero cost in a switch that is dominated by business customers with a peak period of mid-morning.

generally do not vary with volume. By aligning the costs to Verizon for switching and the costs to CLECs for switching, a flat-rated port charge allows for recovery of switching investment in a competitively neutral manner. *Order* ¶ 464.

Recovery of switching investment through minute-of-use ("MOU") charges, on the other hand, does not recover costs in a competitive neutral manner. MOU charges impose on CLECs a cash-outlay, for each and every minute, of each and every call, that their customers make, even though Verizon incurs no such cost. This creates very different cost implications for CLECs and for Verizon for calls that are identical, introducing a serious distortion to the market. For example, a CLEC pays more to Verizon for a high volume user, yet the high volume does not affect the costs incurred by Verizon to provide unbundled switching for such user. Recovery of peak-period prices through MOU charges can lead to underconsumption of switching resources during off-peak period when Verizon does not incur traffic sensitive costs.[62] Such market distortions are particularly critical in a local market where Verizon offers flat-rate service and the market is moving towards *more* flat-rate offerings.[63] In such an environment, it is important that CLECs not be penalized through a contrived usage rate for local switching.

As flat-rated port charges for unbundled local switching recovers costs in a competitively neutral manner, Verizon's request for reconsideration should be rejected.

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[62] *Order* ¶ 475; AT&T/WCOM Exh. 8 (Murray Dir.) at 18-23. As the Bureau notes, the MOU charge can lead to overconsumption of switching resources during peak periods, but Verizon's widespread use of flat rated calling plans allayed such concerns. *Order* ¶ 478.

[63] Not surprisingly, Verizon seeks to downplay the importance of its flat-rated calling plan for its retail users by claiming that each CLEC should decide how to charge its customers. Application at 13-14. This argument ignores the fact that the flat-rated calling plans establish the market rate for CLECs and must be offered to customers given their universal availability. As a result, a CLEC must offer customers a flat-rated service even though the CLEC's costs for unbundled switching may be tied to minutes of use.

(b) The Bureau's Switch Discount Appropriately Reflects the Life Cycle of the Switch in Determining Switching Investment.

Verizon claims that the Bureau erred in failing to adopt its proposed growth switch discount and choosing instead a switch discount based on the switch life cycle that uses the new switch discount for the initial capacity of the switch and the growth discount for the additional growth lines added during the life of the switch.[64] Application at 17-20. Verizon's arguments are meritless.

Verizon's approach of basing the weighted-average switch discount on a snapshot of Verizon's actual purchases in 2000 (Application at 20) in no way complies with TELRIC. Verizon's cost study, in essence, assumes that an efficient carrier would repurchase its entire inventory of switches at the outset of the study period, but in the long run would obtain *only* the shallow discounts available for growth equipment. It also assumes that an efficient new entrant would not replace its switches in the long run, but would simply "add on" capacity or growth equipment. The result: costs higher than those that an efficient new entrant would incur, higher than those that Verizon incurs over the long run, and even higher than Verizon has actually incurred in the past – or is likely to incur in the foreseeable future.[65] Verizon's method is analogous to someone trying to calculate the price of a new car by going to the dealer and adding up the prices of all the car's parts if bought separately in the dealership's aftermarket parts department.

Verizon's position is also illogical. Because Verizon has replaced in Virginia *all* of its outdated analog switches with digital switches, *it obtained with respect to each and every one of those switches the very switch discounts that it now asks the Commission to disregard in setting*

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[64] Verizon complains that the new switch discount is as high as 99% off list price. That relates to one switch in 2000. Verizon Exh. 216 (confidential).

[65] AT&T/WCOM Exh. 12P (AT&T/WCOM Recurring Cost Panel Reb.) at 97-104 , AT&T/WCOM Exh. 11P (Murray Reb.) at 33-35.

network element rates. Verizon would have this Commission allow it to charge its potential competitors inflated rates that reflect only a shallow growth discount for the use of switches that Verizon *actually purchased* at the much deeper discount and can continue to use at virtually no added cost for years.

Verizon's rejoinder that manufacturers would not offer high new switch discounts if carriers bought most of their switching capacity through new switches without the prospect of sales of growth additions (Application at 17-18) is also unfounded. The Bureau's adoption of a life cycle approach explicitly takes into account both the current capacity of the switch (purchased at the new switch discount) and the growth of the switch through growth additions (at the growth switch discount) every two years at 2.5% line growth per year over the twelve-year life of the switch. These several growth additions to the switch over its 12-year life are all reflected at the growth discount level in the determination of the switching discount. As such, the Bureau's switch life cycle approach captures both the appropriate new switch capacity and the growth in the switch on a present value basis and reflects all the switch investment—*including the growth purchases*—at the appropriate switch discount.

Moreover, Verizon's claims about the intent of switch vendors is totally speculative. Technology changes that have significantly decreased costs and increased switch capacity, changes in the wide range of telecommunications products offered by these vendors, and the convergence of various telecommunications, broadband, and narrowband technologies all affect the determination of pricing strategies for telecommunications products. Given all these factors affecting switch vendors, the evidence of actual discounts obtained on switch purchases is the best evidence of the market, and accordingly, the Bureau's use of the discounts received on 2000 purchases is appropriate. *Order* ¶ 398.

Verizon's complaint about the use of the new switch discount for "getting started" investment (Application at 19-20) is similarly misguided. As demonstrated above, the record evidence cited by the Bureau clearly demonstrates that the "getting started" investment is fixed and does not vary with the number of lines, trunks, or usage on the switch.[66] Verizon cites evidence of several upgrades that it claims were made to switch processor components, but it failed to provide supporting evidence regarding these upgrades, conceded during the hearings that these upgrades were made for several purposes, and in any event never demonstrated that such upgrades were common among the *hundreds* of Verizon switches in its service territory.[67] Importantly, these upgrades were substantially part of an historical trend, and there is no evidence that future switch upgrades will continue in the same manner. Nor is it appropriate for unbundled network switching purchasers to pay for possible future upgrades that may or may not become available, and may or may not be relevant to narrowband circuit switching for unbundled switching.

(c) The Bureau's Treatment of Reciprocal Compensation Is Consistent with Its Order Establishing the Flat-Rated Port Charge.

Verizon claims that the reciprocal compensation portion of the *Order* (¶¶ 484-89) fails to address the situation in which Verizon is terminating a CLEC customer's call to a Verizon customer and that Verizon is entitled to reciprocal compensation for terminating such a call. Application at 27-28. Verizon is misreading the Order, which prescribes that CLECs purchasing unbundled switching and paying the flat port charge for unbundled switching do not incur any reciprocal compensation obligation to Verizon for terminating the CLEC's traffic.

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[66] *See Order* ¶¶ 391-95 and associated footnotes.

[67] *Order* ¶ 392; *see* Verizon Exh. 122, at 175-78; Tr. 5434-38, 5440-41 (examples of reasons for adding processing capacity).

In the *Order*, the Bureau discussed the consequences of its adoption of the flat-rated port charge on reciprocal compensation and determined that end-office switch and shared end-office trunk port costs should be excluded from Verizon's reciprocal compensation prices. *Order* ¶ 488. It then stated that the adoption of a flat-rated port charge for unbundled switching and shared end-office trunk ports meant that the switch price equaled total switch costs divided by total line ports. *Id.* The imposition of this flat port charge on CLECs and on Verizon's end-users would mean that Verizon was fully compensated for all of its switch costs through the flat-rated port charge. If so, then, contrary to Verizon's claim, CLECs purchasing unbundled switching and paying the flat-rated port charge would not pay Verizon reciprocal compensation for Verizon to terminate reciprocal compensation traffic: such reciprocal compensation would lead to cost overrecovery for Verizon.

Verizon's argument that it must be allowed to charge for reciprocal compensation for terminating calls is mistaken. Application at 27-28. Verizon is again mistaking cost allocation and cost recovery. As the Bureau notes, Verizon is fully compensated for the cost of the switch through the flat-rated port charge, *Order* ¶ 488, and thus it recovers any costs in providing reciprocal compensation through the port charge. In such circumstances, Verizon is not entitled to additional compensation.

Furthermore, Verizon's claim that any change in reciprocal compensation rates cannot occur because such an action would prejudge the resolution of a pending rulemaking (Application at 28) is unsupportable. As noted above, an administrative agency has discretion to establish rules and interpretations of rules through adjudication as well as through formal notice-and-comment rulemaking proceedings.[68] The Bureau has resolved the reciprocal compensation

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[68] *See, e.g., NLRB* v. *Bell Aerospace Co.*, 416 U.S. 267, 294 (1974); *SEC* v. *Chenery*, 332 U.S. 194, 203 (1947); *Interstate Natural Gas Assn. of America* v. *FERC*, 2854 F.3d 18, 57-58 (D.C. Cir. 2002); *Russe Broadcasting Co.* v. *FCC*, 87 F.3d 1456, 1463 (D.C. Cir. 1996); *International Union, United Automobile, Aerospace and Agricultural Implement Workers of America* v. *Brock*,

issue in the context of this proceeding, and that ruling can take effect, notwithstanding the pendency of a rulemaking that may address some of the same issues. Verizon's cramped notion of administrative procedure would deprive the Commission of a useful and long-accepted adjudicative device.[69]

(d) The Bureau Appropriately Adjusted Verizon's Computation of Total Annual Minutes.

Verizon complains about the Bureau's revisions to Verizon's calculation of total annual minutes of use developed in determining the tandem switching rates. Application at 29-32. Verizon claims that no party contested its computations and argues that the Bureau's recalculation is erroneous. Verizon is wrong on both counts.

First, as the Bureau found, WorldCom objected to Verizon's MOU calculations, which included it Busy Hour to Annual MOU Ratio ("BHAR"), *Order* ¶ 453, and AT&T/WCOM used 270 days as an input in the Modified Synthesis Model rather than the 251 days as proposed by Verizon. AT&T/WCOM Exh. 19 (Turner Surreb.) at 5-6. In addition, the Bureau determined that Verizon had provided inadequate support for its proposed annual number of MOU, and, accordingly, the Bureau recalculated those numbers. *Order* ¶ 456. Such action by the Bureau was entirely consistent with the baseball arbitration rules of this proceeding, which allow the Bureau to depart from the final proposals of the parties if the circumstances warrant. *Id.* ¶ 24. Given the Bureau's finding that Verizon understated its annual number of MOU by 24 percent,

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783 F.2d 237, 246 (D.C. Cir. 1986); *National Small Shipments Traffic Conference, Inc.* v. *ICC*, 725 F.2d 1442, 1447 (D.C. Cir. 1984).

[69] Verizon claims that it will include a reciprocal compensation rate in its compliance filing. For the reasons stated above, any such reciprocal compensation rate relating to the termination of traffic would allow Verizon to overrecover its switching investment. Verizon's example of a CLEC that does not purchase unbundled switching would not appear to be relevant to this proceeding, which relates to the purchase of unbundled network elements by *AT&T and MCI*. In any event, Verizon would have to justify any rate it included in a compliance filing.

which would significantly overstate its costs, departure from the baseball arbitration rules was appropriate.

In its calculations, the Bureau was required to adjust the BHAR to 339 equivalent busy days to take account of Verizon's understatement of annual MOUs. *Order* ¶ 457. In so doing, the Bureau explained its methodology and approach in developing the tandem switching DEMs that led to adoption of the 339 equivalent busy day figure. *Id.* In light of Verizon's failure to provide accurate and supportable annual MOU information, Verizon cannot now criticize the Bureau for making an adjustment to the BHAR designed to address this lack of supporting information.[70] Adjustments to Verizon's proposed BHAR have also been made in recent state cost proceedings that have similarly adjusted the BHAR figure to over 300 equivalent busy days.[71] For these reasons, Verizon's criticism that the BHAR of 339 is overstated (Application at 31) must be rejected.

(e) No Adjustments are Required to the EF&I and RTU Factors

Verizon claims that changes must be made to the EF&I factor and RTU fees as a result of the Bureau's action. Application at 32-34. Neither of Verizon's claims has merit.

EF&I Factor. The EF&I factor covers the cost of installing and engineering switching investment. Verizon argues that the EF&I factor should be increased because the level of switch

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[70] Verizon's criticism of the computations (Application at 31 n.41) is similarly misplaced. For example, Verizon argues that use of the 2001 ARMIS DEMs by the Bureau was flawed as those figures included operator service calls, but Verizon's argument is baseless because the level of operator service calls in the ARMIS DEMs is *de minimis*.

[71] Order on Unbundled Network Element Rates, Case No. 98-C-1357, *Proceeding on Motion of the Commission to Examine New York Telephone Company's Rates for Unbundled Network Elements*, (NY PSC) at 36-38 (January 23, 2002); Order on Reconsideration, Docket No. TO00060356, *In the Matter of Board's Review of Unbundled Network Elements Rates, Terms and Conditions of Bell Atlantic-New Jersey, Inc.* (NJ Bd. Pub. Util.), at 23, 26; Order No. 78552, Case No. 8879, *In the Matter of the Investigation into Rates for Unbundled Network Elements Pursuant to the Telecommunications Act of 1996*, (Md. PSC) (June 30, 2003), at 64-65.

investment will decline as a result of the higher switch discounts ordered by the Bureau. Application at 32. Verizon claims that its EF&I factor was based on the 1998 purchases that reflected largely growth and upgrade investment and now will be applied to an investment base consisting of a much larger proportionate of new switches with higher discounts. *Id*.

Verizon's claim, however, is based on a false premise regarding the switch discount. In fact, the EF&I factor is applied to the switch investment calculated to take into account the life cycle of Verizon's switches, including both new switches (with the associated new switch discount) and the growth additions added every two years. Applying the EF&I factor to switch investment that includes both new and growth switch equipment takes into account the range of switching equipment. On this basis, as the Bureau found, the EF&I percentage is "conservative," *Order* ¶ 444, and Verizon's claim that the EF&I factor will not recover the cost of engineering and installation for switches on a forward-looking basis is groundless.

RTU Fees. Verizon claims that the Bureau improperly rejected its claim that RTU fees for new switches are approximately $2 million per switch and should be recoverable by Verizon under the Bureau's approach for installation of new switches. The Bureau specifically considered and rejected this argument, and Verizon never supported the $2 million figure from its own evidence, relying instead on an AT&T/Lucent contract that the Bureau properly rejected as being irrelevant to Verizon's costs. *Id.* ¶ 450. As Verizon never presented evidence to support its claimed expense of $2 million – even though it knew that AT&T/WCOM were advocating use of all new switches and associated new switch discounts – Verizon's attempt to relitigate this issue must be rejected.[72]

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[72] Moreover, as the Verizon discovery responses in this proceeding demonstrate, Verizon has a variety of arrangements with software developers that affect the level of RTU fees, and these various arrangements undercut Verizon's claim that the RTU cost per switch is $12 million. *See Order* ¶ 472, n. 1199 (noting variety of Verizon arrangements with software developers); AT&T/WCOM Exh. 27 (Pitts Supp. Surreb.) at 15.

(f) The Bureau Adopted the Correct Digital Line Port Utilization Factor

Verizon claims that the Bureau erred in adopting a digital line port utilization factor that was lower than the analog line port utilization factor in determining switching investment. Application at 34. Verizon is mistaken. Verizon claims that AT&T/WCOM proposed that the digital line port utilization factor should be lower than the analog line port factor, citing the testimony of Joseph Riolo (AT&T/WCOM Exhibit 6.) This is incorrect, as Mr. Riolo's testimony related to the appropriate fill factors for feeder and distribution of plant. Catherine Pitts, AT&T/WCOM's witness on switching issues, used the same utilization factor for both digital line ports and analog line ports in her recalculation of Verizon's switching investment using the SCIS model.[73] Consistent with Ms. Pitts' approach, the Bureau appropriately used the same utilization factor for both digital line ports and analog line ports in computing switching investment.

(g) Verizon's Complaint About Differing Growth Rates for Tandem Trunk Ports and Trunk Usage Is Groundless

Verizon argues that the use of different growth rates for tandem trunk ports and tandem trunk usage will lead to underrecovery of costs. Application at 35. Verizon itself proposed a growth rate for trunks that was 41% less than the forecasted growth in switched access minutes. *Order* ¶ 412. The Bureau had found that the growth in the forecasted minutes was too high and reduced the growth rate in minutes by 41%. It also revised the trunk growth rate to reduce that rate "by the amount by which Verizon's switched access usage growth rate exceeds its trunk growth rate." *Id.* In so doing, the Bureau preserved the same relationship between the growth rate in the tandem trunks and the growth rate of the tandem switch minutes that Verizon had proposed. As Verizon itself proposed this relationship with the 41% differential in its filings,

[73] AT&T/WCOM Exh. 24 (Pitts Supp. Surreb.) at 13-14.

Verizon cannot now complain that the Bureau has adopted its proposal with the 41% differential in growth rates.

2. The Order Appropriately Includes the Option of Purchasing Dedicated Transport without Multiplexing or DCS.

Verizon argues that the Bureau erred in requiring that Verizon offer dedicated transport that does not include either multiplexing or digital cross connects ("DCS"). Application at 46-49. Verizon claims that dedicated transport necessarily includes those functions, and accordingly the option to purchase dedicated transport without multiplexing or DCS should be eliminated. *Id*. at 46.

Verizon is seeking to confuse the issue, and no change is necessary to the Order. Contrary to what Verizon claims (*id.* at 48), the rate for interoffice transport without multiplexing does not include simply the fiber. Interoffice transport and its associated rates include the SONET terminal equipment on each end of the interoffice transport circuit along with any electronics and fiber between the two terminating points necessary to provision the circuit. This SONET terminal equipment also has the ability to multiplex the signals onto the fiber. The cost of such multiplexing is included in the cost of dedicated transport, and AT&T/WCOM have not disputed that such costs can be recovered through dedicated transport rates.[74] Multiplexing, however, also occurs at the end of the circuit, before reaching the SONET terminal equipment on the originating or terminating side of the circuit, and this is the multiplexing or DCS that CLECs are free to purchase at their option. In essence, if the multiplexing or DCS equipment is not necessary to originate or terminate the interoffice transport at the speed (e.g., DS-1, DS-3, etc.) requested by the CLEC, it is not included in the price of the transport, and the CLEC must request that functionality by purchasing multiplexing

[74] See Tr. 5619 (Turner).

or DCS. AT&T/WCOM excluded these costs from Verizon's cost interoffice transport study and developed these costs as dedicated transport with multiplexing or DCS.[75]

The *Order* takes an appropriate approach in requiring that dedicated transport be included without either DCS or multiplexing. *Order* ¶ 511. If the CLEC elects to purchase dedicated transport without DCS or multiplexing, that customer will pay the applicable charge that compensates Verizon for that service. That charge will include any multiplexing that occurs to provide the transmission of the signal between SONET nodes, but it will not include any non-SONET based multiplexing at the end of the circuit.

Verizon's claim that it is not being compensated appropriately for dedicated transport without multiplexing is simply incorrect. Application at 48. AT&T/WCOM's restatement of Verizon's costs included the costs of SONET terminal equipment at each end of the interoffice transport circuit along with any electronics and fiber between the terminating points necessary to provision the circuit. As a result, Verizon is being appropriately compensated for the facilities and capabilities it is offering in providing dedicated transport.

3. The *Order's* Decision To Adopt The AT&T/WCOM Non-Recurring Cost Model Was Clearly Correct And Supported By The Evidence.

Verizon contends that the *Order* erred by adopting the Nonrecurring Cost Model proposed by AT&T and WorldCom ("AT&T/WCOM NRCM"), because the model is "patently inadequate" and denies Verizon the ability to recover all of the out-of-pocket costs it incurs to provide UNEs. Specifically, Verizon argues that: (1) the AT&T/WCOM NRCM improperly requires Verizon to recover most non-recurring costs through recurring rates; (2) the

[75] AT&T/WCOM Exh. 12 (AT&T/WCOM Recurring Cost Panel Reb.) at 132-36; Tr. 5619 (Turner).

AT&T/WCOM NRCM "ignores" other NRCs and "drastically understates even the costs it does estimate"; and (3) the *Order* wrongly rejected Verizon's NRCM.[76]

Verizon is incorrect. As the *Order* found, the AT&T/WCOM NRCM more closely reflects forward-looking costs and TELRIC principles than does Verizon's NRCM. *Order* ¶¶ 567, 583. Unlike Verizon's NRCM, the AT&T/WCOM NRCM properly defines non-recurring costs and calculates *only* those costs which fall within that definition. That approach does not deny Verizon full recovery of its forward-looking costs, because any truly forward-looking costs not defined as NRCs under the AT&T/WCOM NRCM are simply recovered as recurring costs. Finally, the *Order* properly rejected Verizon's NRC model because it was inconsistent with TELRIC, produced unreliable results, and would have resulted in *overrecovery* of non-recurring costs.

(a) The *Order* Was Correct In Adopting the AT&T/WCOM Model's Definition of Non-Recurring Costs.

Although Verizon asserts that the AT&T WorldCom NRCM fails to include certain types of costs (and therefore produces a "subsidy" to CLECs),[77] the heart of Verizon's challenge is its disagreement with the approach used in the AT&T/WCOM NRCM – and approved by the *Order* – to determine what costs should be treated as NRCs, rather than as recurring costs. Thus, Verizon makes the simplistic argument that it is denied full recovery of its costs, because the AT&T/WCOM NRCM adopted by the *Order* included "only" 49 NRCs, as opposed to the 115 NRCs reflected in Verizon's model. *See* Application at 63. The lower number of NRCs in AT&T/WCOM's model, however, reflected the differences between the two models' definitions of NRCs.

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[76] *See* Motion at 14-16, 26-30; Application at 62-72.

[77] *See, e.g.,* Motion at 3, 14, 16, 27; Application at 63.

For purposes of its NRCM, Verizon defined NRCs as costs associated with *any* one-time activity requested by a CLEC, regardless of whether that activity benefits more than one user over time. *Order* ¶ 581. Verizon's approach, however, violates a basic principle of cost causation: the theory that costs, such as construction and maintenance, which are incurred over time should be recovered in recurring rates and excluded from non-recurring rates.[78]

By contrast, in their cost model AT&T and WorldCom did *not* treat all one-time costs as NRCs. AT&T/WCOM's model is based entirely on forward-looking network assumptions and appropriately categorizes non-recurring and recurring costs in accordance with the principles of cost causation. For purposes of their NRCM, AT&T and WorldCom defined a particular one-time cost as an NRC *only* if it is incurred for a one-time benefit (*i.e.*, is exclusive to a particular order) and cannot be used for subsequent orders. If a facility can be reused to provide a subsequent customer without change, the AT&T/WCOM NRCM treated the cost of that activity as a recurring charge, because it benefits subsequent users. Indeed, treating the costs of an activity that benefits subsequent UNE customers as non-recurring costs would likely result in double recovery by the ILEC, because the costs are already captured in the recurring cost for that UNE.[79]

The *Order* thus correctly found that "the approach advocated by AT&T/WCOM more closely follows the TELRIC principles established by the Commission." *Order* ¶ 583. That approach, by treating as recurring costs activities that could be used by subsequent customers

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[78] *See* AT&T/WCOM Exh. 8 (Murray Dir.) at 29-32; 47 C.F.R. § 51.507(d); *Local Competition Order* ¶¶ 745, 750-751.

[79] *See, e.g.*, AT&T/WCOM Exh. 2 (Walsh Dir.) at 9-12; AT&T/WCOM Exh. 8 (Murray Dir.) at 29-31. For example, as the *Order* noted, the cost of a physical cross-connection of a loop's feeder and distribution plant at a feeder distribution interface was treated as a recurring cost under the definition of NRCs in the AT&T/WCOM NRCM, because the loop recurring cost captures the entire investment and expense of installing the loop. *See id.*; *Order* ¶ 582.

(*i.e.*, CLECs), was fully consistent with the Commission's definition of as a recurring cost as a cost "incurred periodically over time," and its "general rule that costs should be recovered in a manner that reflects the way they are incurred."[80]

Moreover, as the *Order* found, Verizon itself effectively acknowledged that many of the NRCs in its NRCM are currently recovered through *recurring* charges, because it had proposed to avoid double recovery by subtracting NRC revenues from the costs that it used to calculate its Annual Cost Factors ("ACFs"). The *Order* determined that Verizon's approach created "the significant likelihood that there is a mismatch between the costs recovered through NRCs and the costs not recovered through ACFs," because Verizon had failed to prove that the NRC revenues that it removed from the ACF calculation bore any relationship to the costs of the activities for which it sought to impose NRCs.[81] The *Order* concluded:

> AT&T/WorldCom's approach, which recovers more costs through recurring charges, diminishes the problems associated with attempting to match the costs recovered through NRCs and the costs excluded from the ACF calculations. For this reason, we conclude that the better approach is to recover these costs through ACFs and not through NRCs unless the activity provides no benefits to any future user of the same facility or if the cost of the activity is not reflected in the ACF calculations.[82]

In short, the *Order* concluded that because AT&T/WCOM had included in recurring costs the one-time activities that were "reusable," the fact that their NRCM did not include all 115 of the NRCs in Verizon's NRCM is irrelevant. Although Verizon cites the *Order*'s statement that the AT&T/WCOM NRCM "does not include certain types of costs," Verizon does not even attempt to itemize all of the NRCs in its own model that purportedly were not included

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[80] *See Local Competition Order* ¶ 745.

[81] *Order* ¶ 584.

[82] *Id*.

either in the AT&T/WCOM NRCM or in the recurring charges approved in the *Order*.[83] In any event, Verizon's quotation of the O*rder* is highly selective. The *Order* stated that "although Verizon is correct that AT&T/WCOM's NRC study does not include certain types of costs, *in most cases this exclusion is based on an assumption that the costs will be recovered in recurring charges,* rather than an overly optimistic assumption about the capabilities of currently available technology."[84]

Thus, Verizon's assertion that the AT&T/WCOM NRCM "improperly shifts most non-recurring costs to recurring rates" is baseless. *See* Application at 63, 65. To the contrary, it is Verizon's NRCM that improperly shifts costs—from recurring to non-recurring. Using a definition of NRCs that is consistent with TELRIC methodology, the AT&T/WCOM NRCM simply treated as recurring costs the NRCs proposed by Verizon (to the extent that they were otherwise proper under TELRIC principles). Because those recurring costs are already accounted for in AT&T/WCOM's recurring cost model, the exclusion of such costs from the NRCM is no "subsidy" flowing from long-term to short-term users of the network. *See id.* at 66.[85] By contrast, allowing recovery of these costs as NRCs would have resulted in double-recovery by Verizon.

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[83] *See* Motion at 27; Application at 63 (citing *Order* ¶ 569).

[84] *Order* ¶ 569 (emphasis added).

[85] The one example of a "subsidy" that Verizon describes does not support its position. *See* Application at 66. Verizon assumes that the reduction of the NRC for installing new service using an unbundled loop from $61.04 to $5.00 means that the entire $56.04 reduction will be "shifted" into recurring costs. *Id.* It is equally reasonable, however, to assume that the previous prices were far *above* TELRIC levels, regardless of whether the costs were classified as recurring or non-recurring. But even assuming *arguendo* that the entire $56.04 difference was "shifted" into recurring costs, that treatment was proper, because the loop is a reusable facility. When Verizon builds a new loop, it does not recover that entire investment "up front" from the original customer.

The *Order*'s approval of the treatment of the costs of "reusable" activities as recurring charges is fully consistent with Commission precedent, which the *Order* was required to apply at the time the Bureau issued its decision.[86] In the *Local Competition Order*, the Commission held that state commissions may require ILECs to recover NRCs "through recurring charges over a reasonable period of time."[87] The Commission reaffirmed that holding in its recent *Triennial Review Order*. There, in response to assertions that charges for loop conditioning and other network modifications are inconsistent with TELRIC methodology, the Commission stated:

> The petitions raise complicated economic and technical issues that the Commission would prefer to address on a more complete and up-to-date record. Accordingly, we will include these issues in the Commission's upcoming proceeding on TELRIC-related issues. In the interim, *we will leave it to state commissions to decide in the first instance whether a particular cost should be recovered from a competitive LEC through a recurring charge, a non-recurring charge, or not at all, in accordance with the principles identified above. A state commission could decide, for example*, that loop conditioning costs should be recovered through a NRC *only in extraordinary situations,* such as removing load coils on loops that exceed 18,000 feet in length, and that any other conditioning

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[86] "[A] court is to apply the law in effect at the time it renders its decision, unless doing so would result in manifest injustice or there is statutory direction or legislative history to the contrary." *See, e.g., Bradley* v. *Richmond School Board*, 416 U.S. 696, 711 (1974). *See also, e.g., Meghani* v. *INS*, 236 F.3d 843, 846 (7th Cir. 2001).

[87] *Local Competition Order* ¶ 749. The *Local Competition Order* recognized the "reusability" standard when it required that State commissions "ensure that non-recurring charges imposed by incumbent LECs are equitably allocated among entrants where such charges are imposed on one entrant for the use of an asset and another entrant uses the asset after the first entrant abandons the asset." *Id.* ¶ 751. Even one of the Commission decisions cited by Verizon recognized the "reusability" standard in the context of collocation, by ordering LECs to make refunds in situations where the LEC imposed recurring charges on an initial interconnector to recover common physical collocation construction costs in a central office, and at least one subsequent interconnector takes service in that central office and uses those same assets. *See In the Matter of Local Exchange Carriers' Rates, Terms and Conditions for Expanded Interconnection through Physical Collocation for Special Access and Switched Transport*, Second Report and Order, 12 FCC Rcd. 18730 ¶ 50 (1997); Motion at 15 & n.18; Application at 65 & n.75. Verizon, however, has neither proposed such a refund mechanism nor otherwise addressed the inequity that arises from charging the same user the full amount of an NRC for a reusable asset.

costs should be recovered *in recurring charges just like other loop maintenance costs*.[88]

Given the Commission's holdings, it is remarkable that Verizon describes the recovery of NRCs in recurring charges as "inconsistent with established Commission policy" and a "change [in the Commission's] own long standing policies and precedent."[89] Such recovery is precisely what the Commission has expressly permitted since the *Local Competition Order.* In fact, the *TELRIC NPRM* cited by Verizon states that the *Local Competition Order* expressed "a general preference for recovery through recurring charges."[90]

Verizon suggests that, by adopting a model that provided for the recovery of some of the costs claimed by NRCs as recurring charges, the *Order* "swallow[ed]" the general rule that rates must recover costs in a manner that reflects the way they are incurred. Application at 64-65. The *Order,* however, did nothing of the sort. The *Order* simply (and correctly) adopted the definition of non-recurring costs in AT&T/WCOM's model and provided for the recovery of costs that did not meet that definition through recurring charges. That is the approach permitted by the Commission since the *Local Competition Order*, and the approach that the Commission should adopt here.

Finally, contrary to Verizon's contention, the recovery of NRCs in recurring charges does not create a "substantial risk of underrecovery for Verizon VA" or effectively require Verizon

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[88] *Triennial Review Order* ¶ 641 (emphasis added) (footnotes omitted).

[89] Motion at 14; Application at 63-64.

[90] *TELRIC NPRM* ¶ 120 & n.159 (citing *Local Competition Order* ¶ 749). Although the *NPRM* expressed the Commission's desire to ensure that ILECs would recover all of their forward-looking costs when NRCs are defined as costs that exclusively benefit the CLEC ordering the UNE, it also expressed concern that ILECs would over-recover their costs if they were allowed to define NRCs as any one-time costs for every activity related to a CLEC's order (as Verizon's NRCM did here). *See id.* ¶¶ 123-124. Verizon's suggestion that the *NPRM* expressed concern only with the ILECs' full recovery of their costs is thus highly misleading. *See* Application at 64.

"to act as the CLECs' banker."[91] Although Verizon contends that such recovery "creates a new subsidy flow" from Verizon to the CLECs in view of constant customer "churn" and CLEC bankruptcies, its professed concerns are baseless.[92] As the *Order* found, "the risk of non-collection only exists if the competitive LEC exits the market." *Order* ¶ 598. In such cases, the "uncollectibles" markup that Verizon *already* makes to its UNE prices "is a better way of addressing these costs." *Id.*[93] Verizon's argument is also beside the point. The tasks at issue – such as cross-connects at the FDI – are "reusable," thereby allowing Verizon to serve subsequent customers (either retail customers or customers served through UNEs) at the same location, and to recover its costs through the revenues received from those customers. Allowing Verizon to recover the costs of cross-connects or database corrections through non-recurring charges would often have the incongruous result of requiring a CLEC to pay the full cost of these tasks, while allowing Verizon to receive the majority of the benefits over time.

(b) Verizon's Claim That the AT&T/WCOM Non-Recurring Cost Model Leads To Underrecovery of Costs Is Without Merit.

Verizon asserts that the *Order* "also goes to extremes by adopting a model that drives down or even eliminates rates for activities that even the *Order* agreed should be recovered on a non-recurring basis." Application at 67. The AT&T/WCOM NRCM, however, neither understates nor ignores non-recurring costs as Verizon alleges. *See id.* at 67-70.

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[91] *See* Motion at 3, 15-16; Application at 65-66.

[92] *See* Motion at 14-16; Application at 66.

[93] *See also Order* ¶¶ 125, 149 (describing Verizon's use of a Gross Revenue Loading Annual Cost Factor to account for the cost of uncollectibles and regulatory adjustments). As support for its argument, Verizon cites the Commission's decision in *In the Matter of Investigation of Interstate Access Tariff Non-Recurring Charges,* Memorandum Opinion and Order, 2 FCC Rcd. 3498 ¶¶ 32-33 (1987). *See* Motion at 15 & n.16; Application at 62 & n.71, 64 & n.74. That decision, however, was made nine years before the Commission promulgated its TELRIC rules in the *Local Competition Order*.

First, contrary to Verizon's argument (*id.*), the AT&T/WCOM NRCM is not fatally flawed merely because the *Order* found that it should have included certain activities that the *Order* agreed should be recovered on a non-recurring basis. *See* Motion at 27; Application at 68-69.[94] The *Order* properly concluded that the proper method of correcting these "omissions" was to include them in the AT&T/WCOM model, rather than reject the model itself. Thus, the *Order* directed AT&T/WCOM to add these activities to their Model.[95]

Verizon suggests that the *Order*'s approach was inconsistent with the Commission's "baseball arbitration" rules and with the *Order*'s decision to rely on Verizon's cost studies in other instances where the CLECs' model did not produce a cost. *See* Motion at 27-28; Application at 68-69. Verizon is wrong.

The "baseball arbitration" rules allow the Commission to depart from final offer arbitration if "unique circumstances warrant another result because it would better implement the [1996] Act."[96] Such circumstances plainly existed here. The *Order* had selected the AT&T/WCOM as the superior NRCM, while finding the Verizon NRCM to be fundamentally flawed and unreliable.[97] Each of the NRCs that the *Order* directed AT&T/WCOM to add to their model had originally been calculated by Verizon using the same methodology that the *Order* had rejected with respect to other NRCs.[98] Thus, allowing Verizon to recalculate the NRCs using its

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[94] If (as Verizon suggests) the test of the adequacy of an NRCM is whether it includes those activities that the *Order* found to be recoverable as non-recurring costs, Verizon's own NRCM fails that test, because it included *more* activities than those found by the *Order* be recoverable as NRCs.

[95] *See Order* ¶¶ 618, 639, 642, 648. Verizon's assertion that the *Order* "invited" AT&T and WorldCom to add these activities to their NRCM is false. The *Order* specifically "directed" (*i.e.*, required) AT&T and WorldCom to do so. *See id.*; Motion at 27; Application at 68.

[96] *Order* ¶ 24 (citing 47 C.F.R. § 51.807(f)(3) and *Arbitration Rules Order* ¶¶ 4-6).

[97] *See Order* ¶¶ 569-579.

[98] *Id.* ¶¶ 618, 639, 642, 648.

model would likely have resulted in overrecovery. Using the AT&T/WCOM NRCM to calculate these NRCs was therefore the only logical approach, particularly since the evidence showed that the model could be modified with little difficulty to reflect any changes ordered by the Commission.[99]

The *Order*'s approach was also consistent with its method of modifying errors in the one example that Verizon describes.[100] After finding errors in Verizon's proposed rates for subloops and other UNEs, the *Order* required that Verizon adjust them in its cost study because the *Order* had *adopted* Verizon's cost study for those UNEs.[101]

Verizon further asserts that the use of the AT&T/WCOM NRCM to calculate these NRCs "provides no opportunity for Verizon VA to engage in discovery" concerning any new evidence, submitted by AT&T/WCOM, to cross-examine the relevant witnesses, or to subject the new evidence to appropriate challenge. Motion at 27; Application at 68. Once again, Verizon is incorrect. The *Order* specifically requires that when AT&T and WorldCom resubmit their NRCM as modified to reflect the changes required by the *Order*, they must also submit "testimony, workpapers, and/or other filings that *explain in detail* the specific changes they make to their study to implement [such] changes." Verizon will then be entitled to file rebuttal testimony and "any necessary supporting documentation" within 21 days of AT&T/WCOM's submission. *Order* ¶ 696 (emphasis added).[102] Because Verizon will receive workpapers and

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[99] *See* AT&T/WCOM Exh. 21 (NRC Panel Surreb.) at 52-53; *Order* ¶ 648.

[100] *See* Application at 68, citing *Order* ¶ 554.

[101] *Order* ¶ 554. Indeed, Verizon's was the only cost study that had been submitted with respect to those rates – in contrast to NRCs, for which Verizon and AT&T/WCOM submitted competing cost studies. *Id.*

[102] The *Order* adopted the same procedures with respect to the recurring cost study that it directed Verizon to submit with the modifications required by the *Order*. *Order* ¶ 695. Under that procedure, Verizon will be required to submit testimony, workpapers, or other filings that explain in detail the specific changes that it made to its study, and AT&T and WorldCom have

testimony that give a detailed explanation of the changes that AT&T and WorldCom have made to their NRCM, Verizon will have the information that it needs to verify the accuracy of those calculations – and to challenge them, if necessary, in the rebuttal testimony that it submits.[103]

Second, Verizon's assertion that the AT&T/WCOM NRCM is based on "extreme hypothetical assumptions" is flatly contrary to the evidence. *See* Motion at 28; Application at 69. The NRCM does not model a "fantasy" or "hypothetical" network, but instead reflects the same work groups and processes that Verizon employs to perform similar functions for its own retail operations. Moreover, although premised on mechanized efficient systems and processes, the NRCM appropriately includes necessary manual activities in developing NRCs.[104]

The only specific example of an "extreme hypothetical assumption" in the AT&T/WCOM NRCM that Verizon offers is the purported assumption of the NRCM that an ILEC can "process orders automatically with only 2% fallout." Motion at 28; Application at 69. Verizon, however, misstates the model's actual assumption. As the *Order* recognized, the model assumes that two percent of orders will require manual intervention by Verizon "due to some error caused *by the competitive LEC*" – as opposed to fallout caused by some deficiency in Verizon's systems.[105] That assumption is (if anything) conservative, is based on industry

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the right to file rebuttal testimony (including any supporting documentation) within 21 days after Verizon's filing. *Id.*

[103] Verizon asserts that the *Order*'s treatment of the "omitted" non-recurring costs is inconsistent with the Bureau's denial of its motion to file supplemental evidence. Application at 68-69. Verizon's argument, however, is an apples-to-oranges comparison. The Bureau denied Verizon's motion because, *inter alia,* accepting Verizon's "evidence" would have necessitated reopening of the record, including giving other parties an opportunity to present their own evidence, conduct discovery, and cross-examine Verizon's witnesses. *Order* ¶ 23. By contrast, the NRCs that AT&T/WCOM must add to their model are limited, and the *Order'*s procedures provide Verizon with the information it will need to verify the accuracy of the calculations.

[104] *See, e.g.*, AT&T/WCOM Exh. 2 (Walsh Dir.) at 35-36; Tr. 4892 (Murray).

[105] *See Order* ¶ 589 (emphasis in original).

experience, and has been adopted by several State commissions both inside and outside Verizon's service region.[106]

Although Verizon criticizes the AT&T/WCOM NRCM for defining technology to be "currently available" as long as it is technically feasible, the *Order* correctly found that this approach "is more consistent with TELRIC requirements." *Order* ¶ 569. Verizon's criticism is based on its view that only the technology that *it* intends to provide in the future is "currently available." *Id.* ¶ 568. That view is illogical, because it would effectively require CLECs and consumers to wait at the whim of ILECs before they can benefit from the most cost-efficient technologies. It is also inconsistent with the Commission's decisions. Less than two months ago, the Commission reiterated in the recent *Triennial Review Order* that "a TELRIC analysis assumes the most efficient technology available, "even if the incumbent LEC does not deploy, or plan to deploy, that technology."[107] That was precisely the approach taken by the AT&T/WCOM NRCM. Moreover, the assumptions of the AT&T/WCOM regarding OSS capability were supported by Verizon's internal documents and exhibits. Tr. 4899-4902 (Walsh and Murray); AT&T Exh. 140; Verizon Exh. 124, Attachment E, at 5.

Verizon also alleges that the AT&T/WCOM NRCM was "based 'solely on the subjective opinion of its subject matter experts.'" Motion at 28; Application at 70 (quoting *Order* ¶¶ 571-572). Verizon's criticism is hypocritical, because Verizon itself used subject matter experts to make "highly subjective" time estimates – while providing few details on the criteria or procedures that they employed. *See Order* ¶¶ 563, 570. Moreover, "in contrast, AT&T/WCOM

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[106] *Id.* ¶ 592 & n.1524; AT&T/WCOM Exh. 2 (Walsh Dir.) at NRCM User Guide, 9-12; Tr. 4659-4661, 4907-4908 (Walsh). Contrary to Verizon's assertion, the *Order* did discuss Verizon's evidence regarding the manual fallout rate, but concluded that the assumption of a 2% fallout rate due to CLEC errors was more consistent with forward-looking requirements. *See* Application at 69; *Order* ¶¶ 590, 592.

[107] *Triennial Review Order* ¶ 670.

supplied a detailed and thorough 'assumptions binder' that lays out the precise task being performed for each NRC, the activities and steps required to complete it, how it fits into the network design assumptions, and when it is necessary. AT&T/WCOM's model is clearly superior as to the transparency and reviewability of its network design assumptions and procedures." *Order* ¶ 577. In any event, AT&T/WCOM's experts had many years of experience working for ILECs with the same elements and processes. Tr. 4650-4652 (Walsh).

(c) The Order Correctly Rejected Verizon's Non-Recurring Cost Model.

The *Order*'s decision to reject Verizon's NRCM was correct, despite Verizon's protests to the contrary. *See* Application at 70-72. Even leaving aside its flawed definition of non-recurring costs, the Verizon model was flawed in numerous respects that required its rejection.

Verizon asserts that, in contrast to the AT&T/WCOM NRCM, its own NRCM "simply calculates the costs it will actually incur for a given task based on empirical data and would incur as the Commissions' prior orders require." Motion at 28; Application at 70. But that assertion alone reflects a fundamental flaw in the Verizon model. Verizon's model was inconsistent with TELRIC principles, because it determined NRCs based on its own embedded network – examining "the costs it will actually incur," rather than the costs that a carrier would incur in a forward-looking environment using the most efficient technology available.[108]

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[108] Verizon effectively acknowledges its use of its embedded network for purposes of its cost model when it criticizes the AT&T/WCOM NRCM for producing "time and frequency estimates that are well below the real-world times and frequencies of performing relevant tasks." Application at 70. A forward-looking, TELRIC-compliant model, however, would be *expected* to produce estimates below those of the "real-world," because TELRIC methodology is based on the most efficient technology currently available. Thus, the "one example" that Verizon cites in support of its criticisms of the results of the AT&T/WCOM NRCM does not support its case, because Verizon's "real-world" data are based on its current inefficient hot-cut processes. *See* Application at 70 n.77 (criticizing AT&T/WCOM NRCM's assumption "that it only takes one minute to place a wire from the frame to the CLEC's equipment in the process of performing a hot cut," because Verizon's survey of its workers shows that this task "in fact takes an average of 8 minutes"); AT&T/WCOM Exh. 13P (Murray/Walsh Reply) at 61-66 (describing inefficiency

Verizon's model was seriously flawed in numerous other respects. For example, the Verizon NRCM used a different network to calculate non-recurring costs than the network that it used to calculate recurring costs. As a result, the NRCs calculated by Verizon did not reflect the proper activities to interconnect to that network and "almost certainly would result in over-recovery or under-recovery of costs."[109]

Verizon attempts to defend its own NRCM by emphasizing the O*rder*'s statement that Verizon "provides more support" for its average times, and the "extensive survey" that Verizon purportedly conducted to determine time estimates. Motion at 28-29; Application at 70-72. However, Verizon's quotation from the *Order* is highly selective. Verizon conveniently fails to mention that the *Order* proceeded to conclude that, despite the "support" that Verizon had provided for its survey-based average times, "close examination of [Verizon's] survey process reveals numerous methodological errors and casts considerable doubt upon the meaningfulness of the results." *Order* ¶ 572. Specifically, the *Order* found that:

- Because "the instructions to employees as to the purpose of [Verizon's] survey left no doubt that their responses would be used in adversarial UNE rate proceedings to determine charges to be imposed on Verizon's competitors," it was "reasonable to expect that Verizon's employees would feel encouraged to overstate times for completing activities." *Order* ¶ 572.

- Verizon's approach was based on the "unreasonable assumption[] that each respondent [to the survey] performed the activity the same number of times," rather than factor in the frequency with which the respondents actually performed the relevant tasks. This created "a systematic bias toward higher estimates." *Id.* ¶ 573.

- Verizon's results were "further undermined by the extreme variations observed in the original survey data," which described maximum times as many as 50 or even 100 times the minimum observation. *Id.* ¶ 574.

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of Verizon's current hot-cut processes). The *Order* correctly recognized that the automated hot cut process used in AT&T/WCOM's NRCM was superior to the "labor-intensive, complex" hot-cut process used by Verizon. *Order* ¶¶ 603-604.

[109] *See Order* ¶ 569; AT&T/WCOM Exh. 11P (Murray Reb.) at 41-49.

- "[T]he mechanics of Verizon's survey methodology tend to produce a 'padded' estimate even before the averages are calculated," because Verizon reported a minimum time of one minute for each activity and broke down even simple jobs into multiple steps. *Id.* ¶ 575.

- Verizon failed to provide any documentation of the processes or criteria that Verizon's managers and subject matter experts used to adjust the average work times for purposes of calculating forward-looking costs. *Id.* ¶ 577. *See also id.* ¶¶ 562-563.[110]

As a result of the deficiencies that it found, the *Order* concluded that it had "no more confidence in Verizon's time and frequency estimates than we do in those advocated by AT&T/WorldCom." *Id.* ¶ 576. The *Order* then adopted AT&T/WCOM's model because it: (1) "is more consistent with the guidelines of the *Local Competition First Report and Order* and the criteria specified in the *Universal Service* proceeding"; and (2) "is clearly superior as to the transparency and reviewability of its network design assumptions and procedures." *Id.* ¶¶ 577, 579.[111]

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[110] The evidence showed that Verizon's survey was unreliable for reasons in addition to those specifically given in the *Order*. For example, although Verizon cites the "validation" of its time estimates by Anderson Consulting (Motion at 29; Application at 70-71), Verizon has admitted that – contrary to the representations made in its original testimony – Anderson Consulting did not conduct its study of times at its TISOC (Telecom Industry Service Operations Center), which performs ordering functions. Tr. 4689 (Curbelo). In fact, a subsequent study that Anderson Consulting *did* conduct produced *lower* time estimates than those in Verizon's original study. *See* Motion for Leave to File Corrected Non-Recurring Cost Study and Errata to Testimony, filed November 29, 2001; *Order* ¶¶ 13, 561 n.1448.

[111] Verizon asserts that the *Order*'s finding that Verizon's NRCM does not assume sufficiently forward-looking technology "makes no sense," because it cited Verizon's exclusion of IDLC equipment from its NRCM but later concluded that the NRCs for unbundling loops should be based on the assumption that all loops are copper or UDLC. *See* Application at 72. The *Order*, however, was not inconsistent. In the first place, the *Order*'s finding that Verizon did not use currently available technology was based not only on the absence of IDLC equipment, but also on Verizon's approach of using in its model only equipment that *Verizon* intended to install in its network. *Order* ¶ 568. Moreover, for purposes of calculating the loop unbundling charge, the *Order* concluded that it could assume that loops are all copper or UDLC because Verizon had offered not to charge a competitive CLEC more for unbundling an IDLC loop than for a copper or IDLC loop in situations where a spare facility is available. *Id.* ¶ 601.

Verizon does not dispute the deficiencies in its "survey" found by the *Order*, but instead seeks to excuse them by citing the above-quoted statement of the *Order* that Verizon had provided "more support" for its estimates. *See* Application at 72. As that statement demonstrates, however, the *Order* found that the amount of documentary "support" for Verizon's time and frequency estimates was irrelevant, because the methodology used to compute those estimates was unreliable. In view of Verizon's failure to dispute the accuracy of that finding, its reliance on its "survey" has no merit.

Finally, Verizon's suggestion that its NRCM has been "validated" and "relied on" by "numerous States" is both misleading and erroneous. *See* Motion at 29-30; Application at 71-72. As the *Order* found, every State commission to which Verizon submitted its NRCM "has recognized significant upward biases" in the model – and, in those States where AT&T and WorldCom presented their NRCM as an alternative to Verizon's, the State commission "rejected Verizon's model completely in favor of AT&T/WCOM's model." *Order* ¶ 580 &. nn.1487-1489.[112] For example, in New York (the State that Verizon uses as a "poster child" to support its

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[112] Verizon is equally wrong in asserting that "the Commission has approved rates generated by Verizon's non-recurring model as TELRIC-compliant in the context of 271 applications." Motion at 30; Application at 72. As described below, the Commission does not conduct a *de novo* review of a State's pricing determinations in reviewing Section 271 applications, but only makes a general determination of whether "basic TELRIC principles were violated or the state commission [made] errors in factual findings so substantial that the end result falls outside the range that the reasonable application of TELRIC principles would produce.'" *See, e.g., Application of Verizon Maryland Inc., Verizon Washington, D.C. Inc., Verizon West Virginia Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and Verizon Select Services Inc., for Authorization To Provide In-Region, InterLATA Services in Maryland, Washington, D.C., and West Virginia*, FCC WC Docket No. 02-384, Memorandum Opinion and Order released March 19, 2003, ¶ 40 ("*Maryland/D.C./West Virginia 271 Order*"). Moreover, in a number of the States in the 271 decisions cited by Verizon, the State commissions relied upon Verizon's model only after making substantial modifications to compensate for "observed biases" in the model. *See* Motion at 30 n.34; Application at 72 n.79; *Order* ¶ 580 & n.1488; *Maryland/D.C./West Virginia Order* ¶ 55; *Application by Verizon New England Inc., Verizon Delaware Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and*

claim), where Verizon's was the only NRCM submitted in the UNE rate proceeding, the ALJ and the Public Service Commission (1) reduced the manual fallout rate to 2% from the rates in Verizon's NRCM (which were as high as 25%), and (2) required that Verizon recompute its work times on the premise that loops are conditioned on average in batches of 10 at a time, rather than one loop at a time (as Verizon's NRCM had assumed).[113]

For these reasons, the Commission should affirm the *Order*'s rulings regarding non-recurring costs.

D. The Commission's Decision Approving Verizon's Section 271 Application Did Not Find That Verizon's Recurring And Non-Recurring Rates Are TELRIC-Compliant.

Verizon asserts that the rate reductions required by the *Order* are unwarranted because the Commission "concluded that Verizon's recurring and non-recurring rates in Virginia complied with TELRIC" when it approved Verizon's Section 271 application for Virginia last year.[114] The Commission made no such finding, as the *Virginia 271 Order* itself makes clear.

In analyzing Verizon's rates, the *Virginia 271 Order* expressly stated that the Commission "make[s] *only a general assessment of UNE rates in the context of a section 271 proceeding*, as the Commission could not, as a practical matter, evaluate every single individual UNE rate relied upon in a section 271 proceeding within the 90-day timeframe" within which the

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Verizon Select Services Inc., for Authorization To Provide In-Region, InterLATA Services in New Hampshire and Delaware, Memorandum Opinion and Order, 17 FCC Rcd. 18660, ¶¶ 27-28, 86 (2002).

[113] *See* Motion at 29-30; Application at 71-72; NYPSC Case 98-C-1357, *Proceeding on Motion of the Commission to Examine New York Telephone Company's Rates for Unbundled Network Elements*, Order on Unbundled Network Rates issued January 28, 2002, at 141-145; *Order* ¶ 580 n.1488.

[114] *See* Motion at 2, 5-7, 30; Application at 7, 72; *Virginia 271 Order,* 17 FCC Rcd. 21880 (2002).

Commission must make a decision.[115] The Commission reiterated its previous holdings that in Section 271 proceedings it "do[es] not conduct a *de novo* review of a state's pricing determinations," but will reject an application *only* "if 'basic TELRIC principles are violated or the state commission makes clear errors in factual findings on matters so substantial that the end result falls outside the range that the reasonable application of TELRIC principles would produce.'"[116]

Verizon itself recognized the limited scope of the Commission's review of UNE pricing in Section 271 proceedings. In its application, Verizon stated:

> The Commission has repeatedly held that it "will not conduct a *de novo* review of a state's pricing determinations" and will reject an application only if ''basic TELRIC principles are violated or the state commission makes clear errors in factual findings on matters so substantial that the end result falls outside the range that the reasonable application of TELRIC principles would produce."[117]

Verizon further emphasized that "the clear error standard is *'narrow,' and 'highly deferential,'* and the burden of establishing a clear error is on the party challenging the decision."[118]

The Commission's discussion of its application of its standard of review to the UNE rates at issue in the *Virginia 271 Order* confirms that it did not determine that those rates were TELRIC-compliant. With respect to recurring UNE rates, the Commission expressed "serious

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[115] *Virginia 271 Order* ¶ 106 (emphasis added).

[116] *Id.* ¶ 63 (quoting *Pennsylvania 271 Order* ¶ 55 and *New York 271 Order* ¶ 244). The Commission also approvingly cited the statement of the court in *Sprint v. FCC*, 274 F.3d 549, 556 (D.C. Cir. 2001), that "When the Commission adjudicates a § 271 application, it does not – and cannot – conduct *de novo* review of state rate-setting determinations. Instead, it makes a general assessment of compliance with TELRIC principles." *Virginia 271 Order* ¶ 63 n.223.

[117] Application by Verizon Virginia for Authorization to Provide In-Region, InterLATA Services in Virginia, filed August 1, 2002, in WC Docket No. 02-314, at 44 ("Verizon 271 Application") (citing *Vermont Order* ¶ 15). Verizon made the same statement in its reply comments in the Section 271 proceeding. *See* Reply Comments of Verizon Virginia filed September 12, 2002 in WC Docket No. 02-314, at 51-52.

[118] Verizon 271 Application at 44 n.38 (emphasis added; citations omitted).

concerns as to whether the rates established by the Virginia [State Corporation] commission in its state rate proceeding are TELRIC-compliant."[119] Although the Commission ultimately found that Verizon's recurring rates (including switching rates, which Verizon had substantially reduced while the Section 271 proceeding was in progress) fell "within the range of rates that a reasonable application of TELRIC principles would produce," the Commission reached that conclusion *only* by performing a "benchmarking" analysis that simply compared those rates to the recurring rates prescribed in New York, where Verizon had previously received Section 271 approval.[120]

Even the scope of the Commission's "benchmarking" analysis of recurring rates was narrow. With the exception of loop rates, the Commission conducted a benchmarking analysis of all of the rates *together* (*i.e.,* collectively), rather than examine such rates individually.[121] The Commission rejected AT&T's argument that the Commission should conduct a benchmarking analysis of switching rates, finding that Section 271 does not require it to conduct such a rate-by-rate analysis, "[g]iven the large number of rates at issue in a Section 271 proceeding and the 90-day timeframe." The Commission again stressed that its review of UNE rates in a Section 271 proceeding "is not, and cannot be, a *de novo* review of state-rate setting proceedings," but is only "a generalized decision."[122]

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[119] *Virginia 271 Order* ¶ 89.

[120] *See id.* ¶¶ 71, 89, 92, 100. *See also* Motion at 2 (stating that Verizon's rates "were reduced significantly to meet this Commission's [benchmarking] standard compared to New York"). Under the standards established by the Commission for Section 271 proceedings, when the Commission finds that the State commission has not properly applied TELRIC principles or did so improperly, the Commission will then perform a "benchmarking analysis" in which it looks to rates in Section 271-approved States to see whether the applicant's rates nonetheless fall "within a range that a reasonable TELRIC-based rate proceeding would produce." *Id.* ¶ 89 n.304 (citing *Kansas/Oklahoma Order* ¶ 304 and *New Jersey 271 Order* ¶ 49).

[121] *See Virginia 271 Order* ¶¶ 99-113.

[122] *Id.* ¶¶ 106-107.

Similarly, the *Virginia 271 Order* did not conduct a *de novo* review of Verizon's non-recurring charges, much less determine that those rates were TELRIC-compliant. The Commission merely reviewed the three methods by which Verizon had established "proxy rates" for the UNEs that had not been set by the Virginia commission (including non-recurring rates), and found those methods to be reasonable.[123]

In the *Virginia 271 Order*, the Commission made clear that it was fully aware that the instant arbitration proceeding was in progress – and recognized that Verizon's then-current rates might be changed as a result of that arbitration, despite its approval of Verizon's Section 271 application.[124] The Commission, for example, declined to consider cost evidence of proposed rates submitted in the arbitration proceeding by AT&T and WorldCom, except for specific evidence regarding Verizon's then-existing UNE rates, because it regarded the arbitration proceeding as a separate and "new cost proceeding to establish UNE rates."[125] More significantly, the Commission stated that it "recognize[d] that *updated UNE rates will be established in the Virginia Arbitration that is currently pending*, and we are confident that those rates will comply with TELRIC principles."[126]

Given the Commission's statements in the *Virginia 271 Order*, Verizon's claim that the *Order* found its rates to be TELRIC-compliant is nothing short of remarkable. Verizon's contention is particularly egregious because it *conceded* in the *Virginia 271* proceeding that new

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[123] *See id.* ¶¶ 70-73 (describing Verizon's methods of establishing "proxy" rates), 122-131 (discussion of non-recurring charges).

[124] *See id.* ¶ 70 (discussing history of arbitration and noting that "The cost portion of that arbitration is still pending").

[125] *See, e.g. id.* ¶¶ 74-77 & n.275, ¶ 83 n.296.

[126] *Id.* ¶ 88 (emphasis added).

rates might be established in this arbitration proceeding.[127] For example, in its application and other submissions to the Commission in the Section 271 proceeding, Verizon agreed to true-up its then-existing switching rates to the switching rates that would ultimately be adopted in the arbitration proceeding, effective as of August 1, 2002.[128] That promise is totally inconsistent with Verizon's current suggestion that its existing rates are shielded from change by the findings of the *Virginia 271 Order.* Verizon's 271 application had it right the first time: the Commission's analysis of its then-current UNE rates in: the *Virginia 271 Order* is not, and cannot be reasonably construed as, a conclusion by the Commission that those rates comply with TELRIC methodology.

E. Comparisons With Verizon Rates In Other States Provide No Basis For Overturning The Rates Set By The Bureau.

Verizon's assertion that the rates set by the Bureau must be illegitimately low because they are lower than Verizon's corresponding rates in most other states (Motion for Stay at 2, 6-7) is both legally and factually untrue.

First, interstate rate comparisons cannot establish that the rates in Virginia are unlawful. As the Commission repeatedly held in approving Verizon's Section 271 applications throughout

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[127] Equally egregious is Verizon's claim that the Bureau "decided to set new UNE rates as part of this arbitration" little more than a year after the Virginia State Corporation Commission set UNE rates. *See* Motion at 5. As Verizon knows, the Bureau did not "decide" to set new UNE rates. The Commission is conducting these arbitration proceedings pursuant to Section 252(e)(5) of the 1996 Act in lieu of the Virginia commission, which declined to conduct the proceedings after they were instituted by AT&T and other CLECs. *See Order* ¶ 2; *Virginia 271 Order* ¶ 70. Because the parties have requested the Commission to arbitrate cost issues related to Verizon's provision of UNEs, the Commission is *required* to resolve them, and to set new rates where necessary to make them compliant with the Act. *Order* ¶ 5; 47 U.S.C. § 252(b)(4)(C) (requiring State commission to "resolve every issue set forth in the petition and the response" in an arbitration proceeding).

[128] *See Virginia 271 Order* ¶ 114; Verizon 271 Application at 3, 52-53; *ex parte* letter from Ann D. Berkowitz to Marlene H. Dortch in WC Docket No. 02-214, dated October 3, 2002, at 1.

the Verizon footprint, "the mere fact of lower rates in another state, without further evidence, does not demonstrate that the state commission that adopted the challenged rates committed clear TELRIC error." Memorandum Opinion and Order, *Application by Verizon New England, et al. for Authorization to Provide in-Region, InterLATA Services in N.H. and Del.,* WC Docket No. 02-157 (rel. Sept. 25, 2002) ¶ 78 (citing *Verizon Vermont 271 Order*, 17 FCC Rcd at 7639, ¶ 26. Moreover, "as the United States Court of Appeals for the District of Columbia Circuit has recognized and the Commission has concluded many times, 'application of TELRIC principles can result in different rates in different states.'" *New Hampshire/Delaware 271 Order* ¶ 78 (quoting *AT&T Corp. v. FCC*, 220 F.3d 607, 615 (D.C. Cir. 2000)).[129] Logical consistency dictates the same rule when the out-of-state rate comparisons run in the opposite direction as well.

Second, and in any event, Verizon's rate comparisons are selective and misleading. The two tables show the cost per line generated by the proposed switch-related rates in Virginia as well as switch-related rates in other states. Table 1 compares the cost per line based on the projected switch-related rates produced by the Bureau's input determinations for Virginia with the cost associated with the comparable switch-related rates in other states using 2002 Virginia ARMIS usage data in all states to provide an "apples-to-apples" comparison while Table 2 makes the same comparison using 2002 ARMIS data from each state to make the comparison.

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[129] *See also* Memorandum Opinion and Order, *In the Matter of Application by Verizon New England Inc., et al. for Authorization to Provide In-Region, InterLATA Services in R.I.,* 17 FCC Rcd. 3330 ¶ 37 (2002); Memorandum Opinion and Order, *In the Matter of Application by Verizon New England Inc., et al. for Authorization to Provide In-Region, InterLATA Services in Vt.,* 17 FCC Rcd. 7625 ¶ 26 (2002); Memorandum Opinion and Order, *In the Matter of Application by Verizon New Jersey Inc., et al. for Authorization to Provide In-Region, InterLATA Services in N.J.,* 17 FCC Rcd. 12275 ¶ 49 (2002); Memorandum Opinion and Order, *Joint Application by BellSouth Corp. et al., for Provision of In-Region, InterLATA Services In Ga. and La.,* 17 FCC Rcd. 9018 ¶¶ 24-25 (2002)

Table 1 --- Comparison of Switching Rates Using Virginia Call Information

	Virginia Inputs
Georgia – BellSouth	$2.43
Illinois – SBC/Ameritech	$2.52
Wisconsin – SBC/Ameritech	$2.84
Minnesota – Qwest	$3.12
South Dakota -- Qwest	$3.15
Indiana – SBC/Ameritech	$3.37
New Mexico -- Qwest	$3.45
Utah – Qwest	$3.55
Washington -- Qwest	$3.55
Oregon – Qwest	$3.62
Michigan – SBC/Ameritech	$3.67
California —SBC*	$3.82
Idaho – Qwest	$3.85
North Dakota -- Qwest	$4.02
Iowa – Qwest	$4.06
Colorado – Qwest	$4.15
Virginia –Verizon	**$4.19**
Arizona – Qwest	$4.25
Massachusetts —Verizon*	$4.38
Virginia (including DUF rate)--Verizon	**$4.57**
New Jersey -- Verizon	$4.83

*There is no separate cost for DUF in Massachusetts or California.

Table 2 --- Comparison of Switching Rates Using State Specific Information

State and RBOC	State Specific Inputs
Illinois -- SBC/Ameritech	$2.45
Wisconsin – SBC/Ameritech	$2.84
South Dakota -- Qwest	$2.95
Minnesota – Qwest	$3.12
California —SBC*	$3.34
Indiana -- SBC/Ameritech	$3.38
New Mexico -- Qwest	$3.42
Utah – Qwest	$3.55
Michigan – SBC/Ameritech	$3.57
Georgia – BellSouth	$3.66
Oregon – Qwest	$3.81
Massachusetts —Verizon*	$4.00
Washington – Qwest	$4.00
Idaho – Qwest	$4.08
Virginia –Verizon	**$4.19**
Colorado – Qwest	$4.20
New Jersey – Verizon	$4.22
Arizona – Qwest	$4.25
Virginia (including DUF rate)--Verizon	**$4.57**

*There is no separate cost for DUF in Massachusetts or California.

These two tables totally undercut Verizon's claims about the low switching rates. In Verizon's territory, the Massachusetts switching rate (where there is no separate cost for DUF) is lower than the projected Virginia switching rate (including DUF costs), and the Virginia rate is roughly comparable to the rate in New Jersey using New Jersey-specific inputs and within a quarter of the New Jersey rate with Virginia usage information. Verizon failed to mention switching rates established by state commissions in other jurisdictions, undoubtedly because the switching rates in many states are considerably lower than the Bureau's proposed switching rate for Virginia. The projected Virginia switching rates will exceed the existing switching rates in California (where there is no separate cost for DUF), the BellSouth state of Georgia, and almost

every one of the SBC/Ameritech states (Illinois, Indiana, Michigan, and Wisconsin). Moreover, Virginia's anticipated switching rate is higher than the switching rates in several Qwest states. Given these various switching rates in different parts of the country, Verizon has no claim that the Order's switching rates are too low. Indeed, Qwest is a much smaller entity than Verizon, generally serves states with smaller populations, and thus lacks the economies of scale of Verizon in switch purchasing or sizing. Qwest's ability to provide service with lower switching rates belies any claim that the anticipated switching rate in Virginia will be too low.

F. Verizon's Takings Claim Is Frivolous.

Verizon asserts that the Commission is "legally obligated" stay the rates set by the *Order* until the Bureau "evaluate[s] whether those rates would result in confiscation." Motion for Stay at 30-36; Application for Review at 72-77. The Commission "lacks authority to adopt UNE rates," Verizon maintains, until the Commission has "define[d] the legal standard for determining whether the UNE rates have a confiscatory effect" and "evaluate[d] whether the *Order's* UNE rates are confiscatory under this standard." Motion at 34.

Every one of these propositions is false. The legal standard for determining whether rates prescribed by a regulator "have a confiscatory effect" has already been defined by the Supreme Court. The burden of satisfying this standard rests with Verizon, not the Bureau or the Commission. Verizon has not begun to make the requisite showing. Unless and until Verizon does so, the Commission has no obligation to consider whether the rates set by the *Order* are confiscatory—let alone to suspend their enforcement in the interim.

1. The Legal Standard For Confiscatory Pricing Is Well Established.

The legal standard for determining whether rates prescribed by a regulator are confiscatory is firmly defined by Supreme Court precedent. A regulatory scheme is confiscatory

only when its "total effect" diminishes the regulated company's revenues so severely as to "destroy the *value* of [the] property for all the purposes for which it was acquired." *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 307 (1989) (emphasis added). Merely showing that the regulatory scheme will prevent the firm from recovering all of its *historic* costs, or that *some* of the rates fail to cover even forward-looking costs, is insufficient to satisfy the *Duquesne* standard. *Local Competition Order* ¶¶ 733-738 (discussing Supreme Court precedent).

First, a regulated firm does not establish a taking merely by showing that some (or even all) of its rates will be too low to recover all of the firm's historical costs or "prudently incurred investment." *Cf.* Motion at 31-33. It has been settled for a century that just compensation does not equal the historical "costs" incurred by an owner in acquiring or developing property. The Fifth Amendment requires just compensation only for the *current* value of property. *Market Street Ry.* v. *Railroad Comm'n of State of Cal.*, 324 U.S. 548, 564-65, 569 (1945); *United States ex rel. and for Use of Tenn. Valley Auth.* v. *Powelson*, 319 U.S. 266, 285 (1943) ("the Fifth Amendment allows the owner only the fair market value of his property; it does not guarantee him a return on his investment"). *Accord*, *United States* v. *Miller*, 317 U.S. 369, 374 (1943); *Olson* v. *United States*, 292 U.S. 246, 255 (1934).

The Supreme Court has repeatedly applied this rule to regulated monopolies such as Verizon. In *Smyth* v. *Ames*, 169 U.S. 466 (1898), the Supreme Court rejected a claim that a railroad was entitled to rates that would fully compensate it for its historical investment in property dedicated to public use. *Id.* at 543. It held that this property must be valued—like ordinary property taken for public use—based on the current "fair value" of utility property rather than its historical cost. *Id.* at 546-47. Recognizing that in most circumstances there is no ready market for such property and hence no established fair market value, *Smyth* required courts to determine value by considering a variety of types of evidence – including the "original cost of

construction" and the "present" cost of reproducing the plant – and to compute the depreciation and return on investment components of rates based on this valuation. *Id.* at 547.

In *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944)—a case that Verizon miscites on page 32 of its Motion for Stay—the Court abandoned the rule of *Smyth v. Ames* as a constitutional requirement, stating that, strictly speaking, "'fair value' is the end product of the process of rate-making not the starting point." *Id*. at 601. *Hope* thus upheld rates that had been set under a historical-cost method, but expressly declined to adopt prudent investment as a constitutional requirement or to prohibit use of forward-looking replacement cost methods. It stated that a rate order is constitutional if its "end result" is to provide the opportunity for a return on investment "commensurate with returns on investments in other enterprises having corresponding risks." *Id.* at 603. The Court held that the choice of ratemaking methodology itself raises no constitutional issue. *Id*.

Since *Hope* was decided, the Supreme Court has repeatedly rejected claims that utilities are entitled to recover their "prudent investments" and that the use of a "fair market value" method is impermissible. In *Market Street Railway* v. *Railroad Commission of State of Cal.*, 324 U.S. 548, 564-65, 569 (1945), the Court upheld a rate order that limited the carrier's compensation to the fair market value of its assets, which (due to declining demand) were less than a third of its historical costs and were also less than the estimates of replacement costs. The Court has similarly rejected claims that a regulated firm has a right to have its rates "'base[d] . . . on [its] own [historic] costs.'" *FERC* v. *Pennzoil Producing Co.*, 439 U.S. 508, 517 (1979).

More recently, in *Duquesne*—another case that Verizon miscites in its Motion for Stay—the Supreme Court upheld a decision of the Pennsylvania Supreme Court which (based on an intervening change in state law) had revised a rate order so that it denied the utility any return on certain investments that had been prudent when made, but that were no longer "used and useful."

488 U.S. at 312 n.7. The Court noted that Pennsylvania had thereby adopted elements of fair value ratemaking, which attempts more closely to "mimic[]" a competitive market. *Id*. at 308, 315. The Court again rejected the claims that prudent historical investment should be adopted as the constitutionally required ratemaking methodology because, among other things, such a rule would "unnecessarily foreclose alternatives which could benefit both consumers and investors" – such as "a return to some form of the fair value rule just as its practical problems may be diminishing." *Id.* at 316 & n.10.

The Supreme Court thus held that a rate order will be confiscatory only if the "rates jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital." *Id.* at 312. In this regard, the Court noted that the "impact of certain rates can only be evaluated in the context of the system under which they are imposed," for "[t]he risks a utility faces are in large part defined by the rate methodology." *Id.* at 314-15. And it reaffirmed that the method adopted to value the utilities' investment presents no constitutional issue, for errors in valuation "may well be canceled out by countervailing errors or allowances in another part of the rate proceeding": *e.g.* by the authorized rates of return and depreciation. *Id.* at 314; see *id.* at 317 (Scalia, J., concurring) (no substantial takings questions are presented in a case that "challenges techniques rather than consequences"). Since *Duquesne*, the Supreme Court has upheld rate orders that used forward-looking replacement cost methods to set "just and reasonable" rates. *Mobil Oil Exploration & Producing S.E., Inc.* v. *United Distribution Cos*., 498 U.S. 211, 224 (1991).

The Supreme Court's general refusal to find a constitutional taking in the nonrecovery of embedded costs is buttressed by the Court's specific findings in *Verizon Communications Inc.* v. *FCC*, 535 U.S. 467 (2002)—another case that Verizon miscites in support of its takings claim—

about the unreliability of incumbent local carriers' book costs as a measure of economic value. As the Court commented, the incumbents' historical costs numbers have proven notoriously unreliable. Those cost estimates "were geared to maximize the rate base with high statements of past expenditures and working capital, combined with unduly low rates of depreciation," *Verizon*, 535 U.S. at 469, 499. Hence, the

> "book" value or embedded costs of capital presented to traditional ratemaking bodies often bore little resemblance to the economic value of the capital. See FCC Releases Audit Reports on RBOCs' Property Records, Report No. CC 99-3, 1999 WL 95044 (FCC, Feb. 25, 1999) ("[B]ook costs may be overstated by approximately $5 billion"); Huber et al. 116 (We now know that "[b]y the early 1980s, the Bell System had accumulated a vast library of accounting books that belonged alongside dime-store novels and other works of fiction... . By 1987, it was widely estimated that the book value of telephone company investments exceeded market value by $25 billion dollars").

Id. at 517-18.

Even today, for incumbents "the temptation would remain to overstate book costs to ratemaking commissions." *Id.* at 512; *see also id.* at 522 (noting that the "asymmetry of information" about true historical costs works "much to the utilities' benefit"). Not only did the incumbent LECs like Verizon overstate the book value of the assets to begin with, but, as the Supreme Court declared, they have purposefully underdepreciated their assets relative to actual economic depreciation "as a means to keep the rate base inflated under the public-utility model of regulation." *Id.* at 518 n. 34. Because "the incumbents have already benefited from underdepreciation in the calculation of retail rates, … there is no reason to allow them further recovery through wholesale rates," *id.*, and the absence of such unwarranted recovery in wholesale UNE rates cannot constitute a constitutional violation. Finally, aside from the manipulation of the rate base and depreciation rates, any overinvestment representing a "cost difference" between embedded costs and current costs

> is an inefficiency, whether caused by poor management resulting in higher operating costs or poor investment strategies that have inflated capital and depreciation. If leased elements were priced according to embedded costs, the incumbents could pass these inefficiencies to competitors in need of their wholesale elements, and to that extent defeat the competitive purpose of forcing efficient choices on all carriers whether incumbents or entrants. The upshot would be higher retail prices consumers would have to pay.

Id. at 511-12.

There is no constitutional taking in requiring the utility, rather than the public, to absorb any inefficiency in its investment, just as private companies routinely do in competitive markets, *see id.* at 486 n.9. In sum, the Takings Clause of the Fifth Amendment requires just compensation only for the *current* value of the property, which in this circumstance is measured by TELRIC, *id.* at 483 n.5. Embedded costs are irrelevant to the equation.

As noted above, a successful takings challenge must surmount a further legal hurdle: the regulated company must show that the rates set by the regulator will jeopardize the company's *overall* financial integrity. Merely showing that a subset of the carrier's regulated rates will be noncompensatory is insufficient. *Local Competition Order* ¶ 737 (citing *Hope Natural Gas*).

In *Duquesne*, *supra*, the Supreme Court made clear that a taking occurs only when the "total effect" of the regulatory scheme diminishes the regulated revenues that can be earned by a utility so severely as to "confiscate" the utility's property. *Duquesne* arose from a state commission order requiring the utility to write off entirely more than $35 million in prudently incurred nuclear power plant costs. *Id.*, 488 U.S. at 312. Although the new regulation rendered that large investment a *total loss* for the utility, the Supreme Court found no taking: the loss, although substantial, "did not jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital." *Id.*

2. Verizon Has Failed To Show That *Any* Of The Individual Rates Set By The *Order* Are Noncompensatory, Let Alone That The "Total Effect" Of The *Order* On Verizon's Aggregate Revenues Amounts To A Taking.

Verizon has failed to make any of the showings required for a *prima facie* takings claim. Indeed, Verizon did not even raise the possibility that the rates at issue in this case might raise a takings issue until more than a year after the close of the record.[130] As noted above, an application for review of a Bureau decision may not rely on "questions of fact or law upon which the designated authority has been afforded no opportunity to pass." 47 C.F.R. § 1.115(c).

Even if Verizon's takings claim were properly before the Commission, however, Verizon has not begun to establish that the Bureau-prescribed rates will be confiscatory. Verizon asserts that the loop "and UNE-P" rates "produced by" the *Order*, if applied to the volume of UNE loops and platforms sold to CLECs in Virginia in 2003, would (1) produce less *revenue* than Verizon receives from its retail rates for the same access lines[131]; (2) cover "less than half the unrecovered *historical cost* of providing the UNE-P"[132]; and (3) "not even cover Verizon's actual forward-looking costs."[133] None of these claims even pass the red-face test.

Verizon's first comparison—between Verizon's current retail revenues and the revenues that Verizon projects to earn from the Bureau-set rates—is irrelevant. Even the court decisions cited by Verizon do not claim that the First Amendment entitles a regulated firm to perpetuate its

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[130] The *only* takings-related argument advanced by Verizon in any of its post-trial briefs on costing issues was a one-sentence assertion that a taking would occur if "Verizon VA were forced to bear all its own costs" of providing access to OSS "when it provided *any* UNE to CLECs." Verizon Post-Hearing Reply Br. (Jan. 31, 2002) at 124. The *Order* agreed with Verizon, however, that "incumbent LECs should be permitted to recover the forward-looking costs of providing access to OSS solely from competitive LECs." *Order* ¶ 543.

[131] Garzillo Decl. ¶¶ 27-28.

[132] Motion at 35 and Garzillo Decl. ¶ 29 (citing supplemental Garzillo testimony proffered on April 15, 2003).

[133] Motion at 35 and Garzillo Decl. ¶ 31.

existing *revenue.* The benchmark for a takings analysis is whether the regulated firm can recover its relevant *costs*. *See* Motion at 32-34; *cf.* Section II.F.1, *supra*.

Verizon's second comparison—between the "UNE-P rates produced by the *Order*" and the "the unrecovered historic cost of providing the UNE-P"—is both speculative and irrelevant. As previously noted, the *Order* did not set rates for "UNE-P"; it set rates for loops only. Rates for the other network elements comprising the platform remain to be set in the future. *Order* ¶¶ 694-702. More fundamentally, the cost basis for Verizon's comparison consists of *embedded* or *historic* cost data derived from "the same accounting records that Verizon VA uses to prepare its ARMIS reports." Garzillo Decl. (proffered Apr. 15, 2003) at 4. The Supreme Court has held repeatedly that the mere failure to recover embedded or historic costs does not establish a taking; and the incumbent LECs' ARMIS records have no credibility even as a measure of the incumbents' prudently incurred *historic* costs. *See* Section II.F.1, *supra* (citing Supreme Court precedent); *Verizon*, 535 U.S. at 483, 489, 511-12, 517-18, 522.

Verizon's third proposed benchmark—its "actual forward-looking costs"—is just another name for the purportedly TELRIC-compliant cost estimates that Verizon advocated unsuccessfully in its testimony and briefs during the proceedings below. The Bureau rejected those estimates for the myriad reasons set forth in its *Order*—many of which Verizon has not challenged in its Application for Review—and found that Verizon's TELRIC-based costs were actually much lower. If the Commission finds errors in the Bureau's cost findings, the Commission presumably will alter them. Beyond that, however, the takings inquiry is at an end.

The Telecommunications Act of 1996 specifically requires that rates set by state commissions for unbundled network elements be "just and reasonable." 47 U.S.C. § 252(d)(1). Rates that are "just and reasonable" in this statutory sense are, by definition, not confiscatory. *See Banton v. Belt Line Ry. Corp.*, 268 U.S. 413, 423 (1925); *Verizon Communications Inc. v.*

FCC, 535 U.S. 467, 489 (2002) (noting that the 1996 Act calls for "novel ratesetting designed to give aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbents' property"). The Commission and the Supreme Court have further held that the FCC's TELRIC methodology satisfies the "just and reasonable" rate standard of Section 252(d)(1). *Verizon*, 535 U.S. at 523. Unless the Commission sets rates below TELRIC, the just compensation standard of the Constitution is satisfied as a matter of law. *Accord*, *Local Competition Order* ¶ 740.[134]

Apart from these shortcomings, Verizon's three "takings" comparisons share another fatal flaw: Verizon has also failed to show that the *Order* will jeopardize the company's *overall* financial integrity. Verizon's overall earnings today—six years after state commissions throughout the company's footprint began setting UNE prices under the TELRIC standard—remain fulsome by any measure. Thanks to its many monopoly services, Verizon may be the most profitable telecommunications carrier in the United States today. *See* Verizon Communications Reports Strong Yearly Operational Growth and Gives Outlook for 2003 (Jan. 29, 2003) (reporting earnings of $8.4 billion for 2002, up from $8.2 billion in 2001).[135] Publicly available information shows that Verizon is among the most financially sound companies in the nation. *See* Standard & Poors Credit Rating List (giving Verizon an A+ credit

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[134] Verizon cites the September 2003 OSP Working Paper by David Mandy and William Sharkey for the proposition that TELRIC-based based switching rates may be noncompensatory—and thus require a "correction factor" of "approximately 50%"—because switching investment costs are falling. Motion at 34-35 & n. 41 and Garzillo Decl. ¶ 30 n. 2. As noted above, the Mandy-Sharkey paper was not part of the evidentiary record in this case, and can be given no weight in resolving it. In any event, Verizon has flagrantly miscited the paper. The *Order* set rates for loops, not switching. *Order* ¶¶ 694-95. For *loop* rates, where Mandy and Sharkey posit that "investment costs are rising at the rate of inflation," UNE prices should be "*reduced* by 20 % from those suggested by model inputs." OSP Working Paper at 43 (emphasis added).

[135] Verizon's Communications Report is available at http://investor.verizon.com/news/VZ/2003-01-29_X218962.html).

rating, which means that Verizon has a "strong" capacity to meet its financial commitments).[136] And, on August 4, 2003—less than two months before Verizon filed its motion for stay—a report in *Business Week* characterized Verizon as "one of the great cash machines of Corporate America," with a capital spending plan to rival "the construction of the Roman aqueducts":

> Verizon plans to roll out fiber-optic connections to every home and business in its 29-state territory over the next 10 to 15 years, a project that might reasonably be compared with the construction of the Roman aqueducts. It will cost $20 billion to $40 billion, depending on how fast equipment prices fall. . . . The company says it will pump $12.5 to $13.5 billion into capital expenditures this year, the third-largest capital budget in the world after DaimlerChrysler and General Electric Co. That's on top of the $3 billion a year it's paying in yearly interest because of its $54 billion debt load. How can Verizon pay for all this? *Its business is one of the great cash machines of Corporate America.* The largest local-phone operator and the largest wireless company, Verizon generates about $22 billion a year in cash from operations. That's 50% more than SBC, twice as much as BellSouth, and nearly three times as much as AT&T. . . . [Verizon CEO] Seidenberg expects to cover the fiber-optic initiative without raising the capital budget above the current level, while he continues to reduce the company's debt. *'Funding is not an issue,'* he says."

Business Week (August 4, 2003), at 53-55 (emphasis added). This, in short, is not a company whose "ability to raise future capital" is being "impeded." *Duquesne*, 488 U.S. at 312.

Verizon has offered no reason to believe that the *Order* will change matters much. The Virginia loop rates about which Verizon complains here, like the nuclear power plant costs about which the utility complained in *Duquesne*, are but a small part of the company's overall revenue in Virginia alone. Indeed, Verizon has not even shown that its *aggregate* "shortfall" projections, which rely largely on projections about non-loop rates that the Bureau has not yet set, would impair Verizon's ability to raise capital. The prospect of such an impairment is certainly not self-evident: even the largest of the "shortfalls" alleged by Verizon represents only a small

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[136] *See* http://www2.standardandpoors.com/NASApp/cs/ContentServer?pagename=sp/Page/FixedIncomeRatingsListPg&r=1&b=2&s=&ig=&i=.

percentage of Verizon's total regulated revenue from Virginia ratepayers each year. *See* Garzillo Decl. ¶¶ 27, 29, 32.

Moreover, the dollar shortfalls projected by Verizon for 2004 and 2005 are fantasy. *Id*. Verizon has provided no workpapers for these calculations. In other recent cases, however, Verizon has arrived at similar projections only by arbitrarily assuming that the historical trend of growth in demand for unbundled loops and platforms from 1996-2003 will continue at the same rate through 2005. There is obviously no basis for this simplistic assumption—particularly after the issuance of the *Triennial Review Order* a month ago. The *Triennial Review Order* drastically curtails the obligation of incumbent LECs to unbundle the broadband capabilities of their loops. Henceforth, incumbent LECs will not be required to provide "unbundled access to hybrid loops for the provision of packetized broadband services." *Id.*, ¶¶ 285-97. This change in standards, unless overturned on review, markedly reduces the attractiveness of unbundled loops and platforms as a vehicle for competitive entry.

Furthermore, Verizon's analysis ignores the offsetting *increases* in revenue that are likely to occur during the same period—including revenue from broadband, internet and other nonregulated services, and the long distance revenue that Verizon is likely to gain from offering interexchange service to Virginia residents. Companywide, Verizon's total revenue is expected to increase, not decrease, to "$70 billion in 2005." *Business Week* (Aug. 4, 2003) at 58. For all of these reasons, the "shortfalls" projected by Verizon for 2003, 2004 or 2005 do not begin to support a takings claim, *Verizon*, 535 U.S. at 515-19.

3. The Commission Has No Reason To Consider The Takings Issue—Let Alone Stay The Rates Set By The Order—Until Verizon Properly Raises The Issue.

Verizon, undoubtedly aware that it has not begun to establish a *prima facie* takings claim, tries to invert the burden of proof. The Bureau erred, Verizon contends, by failing to consider

the takings issue even though Verizon never submitted any takings-related evidence before the close of the record. Motion at 30. The Supreme Court decision in *Verizon* requires the Commission to resolve Verizon's takings claim, no matter how inchoate or unsupported, "*before* permitting the rates produced by the *Order* to go into effect" (Motion at 31; emphasis in original). The Commission "cannot allow the *Order's* UNE rates to be made effective unless the Commission completes this evaluation." *Id*. at 34.

Needless to say, Verizon's Alice-in-Wonderland jurisprudence is not the law. The Supreme Court's actual holding in *Verizon* was that regulatory takings claims are normally unripe for adjudication until *after* the regulatory commission has implemented the "specific rate orders alleged to be confiscatory." *Verizon*, 535 U.S. at 524. The "implication" of "much of what the" Supreme Court "has said," the *Verizon* opinion added, is that "a utility must have rates in hand *before* it can claim that the adoption of a new method of setting rates will necessarily produce an unconstitutional taking." *Id*. Hence, regulatory commissions are obligated to adjudicate takings claims only *after* they are properly raised. The "general rule is that any question about the constitutionality of ratesetting is raised by rates, not methods," *id*.

As Verizon notes, the *Local Competition Order* invited incumbent LECs to "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." *Local Competition Order* ¶ 739; Motion at 31 n. 37 (citing *Verizon*, 535 U.S. at 528 n. 39). The Supreme Court emphasized, however, that this provision of the *Local Competition Order* was "more hospitable to early takings claims than any court would be under *Duquesne*." *Verizon*, 535 U.S. at 528 n. 39. Moreover, "any challenger" that wishes to seek relief under ¶ 739 "needs to go beyond general criticism of a method's tendency, and to show with 'specific information'

that a confiscatory rate is bound to result." *Id*. For the reasons discussed above, Verizon has not begun to make such a showing.

Accordingly, unless and until Verizon (1) identifies a specific body of rates that fail to cover forward-looking costs, and (2) demonstrates that the resulting revenue shortfall will jeopardize Verizon's overall financial integrity, the takings issue remains unripe. No amount of rhetoric *ad nauseam* about the "confiscatory outcome" of the *Order* can overcome this deficiency.

CONCLUSION

For the foregoing reasons, AT&T and WorldCom respectfully request that the Commission deny both Verizon's motion for stay of the August 29 Bureau *Order*, as well as Verizon's application for review of the Order.

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