141. Like the New York Commission, this Commission itself has approved rates generated by Verizon's model as TELRIC-compliant in the context of 271 applications.[79]

The *Order* offers no basis for reaching a different conclusion here. While it criticizes Verizon VA's methodology for determining time and frequency estimates, it finds that Verizon VA provides "more support" for its estimates than does AT&T/WorldCom — thus, this criticism can hardly be a reason to choose AT&T/WorldCom's model over Verizon's. The *Order's* suggestion that Verizon's model does not assume sufficiently forward-looking technology, *Order* ¶ 568, makes no sense. The only example it cites is the low percentage of IDLC, yet the Bureau ultimately renders that point irrelevant since it concludes that non-recurring costs for unbundling loops should be based on the assumption "that all loops are copper or UDLC." *Id.* ¶ 601. Thus, the Commission should reject the *Order*'s decision to use AT&T/WorldCom's non-recurring cost model and adopt Verizon VA's instead.

IV. BEFORE THE *ORDER*'S RATES GO INTO EFFECT, THE COMMISSION MUST PROVIDE A MECHANISM TO COMPENSATE FOR THE SHORTFALL BETWEEN THOSE RATES AND VERIZON'S UNRECOVERED HISTORICAL COSTS AND ACTUAL FORWARD-LOOKING COSTS.

The Commission also is legally obligated to evaluate whether the *Order*'s UNE rates would result in confiscation. Both the Act and the Constitution require the Commission to provide for recovery of both Verizon VA's unrecovered historical costs and its actual forward-looking costs. The Bureau did not consider whether the UNE rates it adopted would enable Verizon VA to recover these costs. Accordingly, the Commission is obligated to evaluate

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[79] *New Hampshire/Delaware 271 Order* at 18711 ¶ 86; *see also* Memorandum Opinion and Order, *Application of Verizon Pennsylvania Inc., Verizon Long Distance, Verizon Enterprise Solutions, Verizon Global Networks Inc., and Verizon Select Services, for Authorization to Provide In-Region, InterLATA Services in Pennsylvania*, 16 FCC Rcd 17419, 17458-59 ¶ 67 (2001) ("*Pennsylvania 271 Order*"); *Maryland, Washington D.C., & West Virginia 271 Order* ¶¶ 44, 55, 80-83; *Massachusetts 271 Order* at 8998-99 ¶¶ 19-20.

whether application of the *Order*'s TELRIC rates produces a confiscatory outcome and provide a mechanism for compensation if they do so.

The Supreme Court has expressly established that a challenge to the constitutional adequacy of UNE rates becomes ripe at the time that specific rates are set, and the Commission itself has invited incumbents to provide precisely such information.[80/] Indeed, the law is clear that the Commission must consider this evidence and establish such a mechanism simultaneously with the setting of the rates themselves.[81/] In *Verizon Communications*, the Supreme Court concluded that it was premature to consider the ILECs' contention that TELRIC would produce a confiscatory result, because they did not challenge "particular, actual TELRIC rate[s]" and therefore it was uncertain whether TELRIC rates would enable incumbents to recover their past prudent investment or actual forward-looking costs. *Verizon Communications*, 535 U.S. at 525-28. The Court made clear, however, that once a state has determined specific UNE rates, those rates are subject to challenge on the basis that they fail to provide adequate compensation. *Id.* at 524. The Court further observed that the Commission had committed to considering "a challenge to TELRIC *in advance of a rate order*," provided that the challenge specifically showed how "a confiscatory rate is bound to result." *Id.* at 528 n.39 (emphasis added).[82/]

80/ *See Verizon Communications*, 535 U.S. at 524 (stating that UNE rates are subject to challenge as a taking at the time they are set); *Local Competition Order* ¶ 739 (recognizing that incumbents have a right to petition the Commission if TELRIC rates fail to provide sufficient compensation).

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

82/ The Due Process Clause of the Fifth Amendment also requires that a utility be afforded a meaningful opportunity to challenge rates as confiscatory. *See, e.g., Michigan Bell Tel. Co. v.*

Accordingly, *before* implementing the rates produced by the *Order*, the Commission must evaluate Verizon VA's contention that those rates would produce a confiscatory result. Although the Supreme Court upheld the Commission's decision not to include past prudent investment as part of the *methodology* for determining UNE rates, the Court did not relax the bedrock requirement of the Act and the Constitution to consider incumbents' claims that the *outcome* of that methodology is a confiscatory rate.

Under sections 251(c)(3) and 252(d)(1), UNE rates must be "just and reasonable" — a standard that has long been interpreted to require rates that are compensatory within the meaning of the Fifth Amendment.[83/] In other words, the Act does not authorize the establishment of a confiscatory rate for UNEs.[84/]

The standard for determining whether UNE rates have a confiscatory effect is whether they permit the incumbent to recover its unrecovered historical costs and its actual forward-looking costs.

For nearly a century, the courts have evaluated claims that rates are confiscatory by determining whether they permit the utility *to recover its investment*, along with a return.[85/] Thus, in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), the Court considered whether a

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Engler, 257 F.3d 587, 593 (6th Cir. 2001); *Guaranty Nat'l Ins. Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990); *Calfarm Ins. Co. v. Deukmejian*, 771 P.2d 1247, 1254 (Cal. 1989).

[83/] *See, e.g.*, *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 769-70 (1968); *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942).

[84/] *See Verizon Communications*, 535 U.S. at 489 (Act permits "novel ratesetting designed to give aspiring competitors every possible incentive to enter local retail telephone markets, *short of confiscating the incumbents' property*") (emphasis added).

[85/] *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 601-04 (1944); *see also Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 290 (1923) (Brandeis, J., joined by Holmes, J., concurring).

slight modification of a historical cost ratemaking methodology would produce a confiscatory result by determining whether the shift adversely affected investors' opportunity to recover all their previous prudent investment and an appropriate rate of return under the old methodology. The Court determined that the new method was still projected to produce recovery that was "within the constitutional range of reasonableness" *as measured under the old methodology. Id.* at 312. Under *Duquesne*, in other words, the new system must still provide for recovery of the investments made under the prior system *and* a return on that investment that would have been constitutionally sufficient under the old system. Indeed, in a concurrence, Justice Scalia, joined by Justices White and O'Connor, observed that, for courts to determine whether a rate methodology provided a constitutionally adequate "fair return," "all prudently incurred investment may well have to be counted." *Id.* at 317.[86/]

In addition to unrecovered historical costs, a rate must also cover the actual forward-looking operating costs that the regulated entity will incur going forward. Thus, when the government compels the ongoing production of a good or service by a private party, the compensation provided must, at a minimum, cover the unavoidable costs of producing the good or service it has requisitioned and not force the entity to operate at a loss. In the case of UNEs, the incumbent is compelled to offer, maintain, and operate a portion of an *existing* network for

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86/ Likewise, the Commission itself has repeatedly recognized that incumbents are entitled to recover their unrecovered historical costs and stated its intention to provide such compensation. In the *Local Competition Order*, the Commission pledged that ILECs may "seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates" and stated that it intended to consider in its Access Reform Proceeding the creation of "a mechanism separate from rates for interconnection and unbundled network elements" to provide recovery of ILECs' historical costs. *Local Competition Order* at 15872 ¶ 739; *Access Reform NPRM* at 21360-61 ¶ 7. In its *Universal Service Order*, the Commission again promised that it would address "legacy costs" in its Access Reform Proceeding. Report and Order, *Federal-State Joint Board on Universal Service*, 12 FCC Rcd 8776, 8901-02 ¶ 230 n.593 (1997) ("*Universal Service Order*").

the benefit of a third party. The ongoing capital costs and operational expenses of using that network in order to comply with this governmental mandate are unavoidable — they must be incurred in order to offer the required facilities and services on an ongoing basis. These are costs that the government is not constitutionally free to ignore.[87]

The Commission, therefore, now has the duty to compare the *Order*'s UNE rates to Verizon VA's past prudent investment and the actual forward-looking costs that Verizon VA can achieve in order to determine if the rates are confiscatory. The Commission cannot defer its evaluation of Verizon VA's confiscation claim; it must ensure that Verizon VA is fully compensated within the meaning of the Constitution and the Act before it allows the *Order*'s UNE rates to go into effect.[88] This requires the Commission (a) to define the legal standard for determining whether the UNE rates have a confiscatory effect, (b) to evaluate the evidence to determine whether the *Order's* UNE rates are confiscatory, and (c) to provide an appropriate mechanism for recovery if they are.

And it is clear that the *Order*'s rates are in fact confiscatory. As the Commission Staff has now concluded, even TELRIC-compliant rates do not provide appropriate cost recovery. As its policy paper concludes, "if investment costs are falling over time, and the period between

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[87] *United States v. Pewee Coal Co.*, 341 U.S. 114, 117-18 (1951) (plurality opinion) ("When a private business is possessed and operated for public use, no reason appears to justify imposition of losses sustained on the person from whom the property was seized."); *United States v. General Motors*, 323 U.S. 373, 379-83 (1945) (holding that when property is occupied by government mandate, the owner is entitled to recover his actual costs based on his particular circumstances).

[88] *See, e.g.*, *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1176-79 (D.C. Cir. 1987) (when a party raises allegations that particular rates are confiscatory, or are not "just and reasonable," the agency entrusted with that decision *must* evaluate that claim); *Preseault v. ICC*, 494 U.S. 1, 11 (1990) (Constitution requires "'reasonable, certain, and adequate provision for obtaining compensation' at the time of the taking") (quoting *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 124-25 (1974)).

TELRIC price adjustments is shorter than asset lives, then traditional TELRIC pricing will not permit incumbents to recover the cost of their investment."[89] That shortfall is of course exacerbated by the *Order*'s radical interpretation of TELRIC here. Indeed, the rates resulting from the *Order* will permit Verizon VA to recover neither its unrecovered historical costs nor its actual forward-looking costs. For example, based on Verizon VA's preliminary calculations, UNE-P rates produced by the *Order* are less than *one-half* the historical cost of providing the UNE-P. And those rates likewise are well below Verizon VA's *actual* forward-looking costs.

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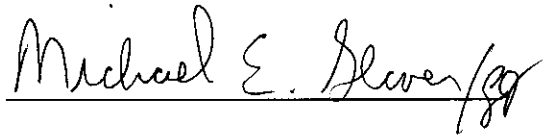
[89] OSP Working Paper at 1; *see also id.* at 1-2 ("Indeed, when investment costs are falling over time and TELRIC price reviews are conducted at intervals shorter than expected asset lives, the firm will earn less than its target rate of return under traditional implementations of TELRIC."); *id.* at 43 ("When investment costs are falling by 11% per year (as is assumed for switching assets in the FCC Synthesis Model), the TELRIC correction factor is approximately *50%*. That is, switching prices should be increased by *50%* from those suggested by Synthesis Model runs.") (emphasis added).

CONCLUSION

For the reasons stated above, the Commission should grant Verizon VA's application for review.

Submitted by



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CERTIFICATE OF SERVICE

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Comparison of 2-Wire, DS1, and DS3 Loop Rates

	2-Wire Loop Rates	DS1 Loop Rates	Ratio of DS1 to 2-Wire	DS3 Loop Rates	Ratio of DS3 to DS1 Rates	Source
Massachusetts						
Metro	$ 10.81	$ 54.44	**5.0**			Docket DTE 01-20;
Urban	$ 11.37	$ 73.61	**6.5**			Revised Compliance Filing
Suburban	$ 15.41	$ 83.85	**5.4**			(7/2/2003)
Rural	$ 24.32	$ 130.71	**5.4**			
Statewide	$ 13.93	$ 79.99	**5.7**	$762.68	**9.5**	
Pennsylvania						
Density Cell 1	$ 10.25	$ 117.90	**11.5**			PA Effective Rates
Density Cell 2	$ 11.00	$ 120.62	**11.0**			216 Tariff
Density Cell 3	$ 14.00	$ 146.42	**10.5**			(10/1/2000)
Density Cell 4	$ 16.75	$ 191.17	**11.4**			
Statewide	$ 13.81	$ 155.68	**11.3**	$915.64	**5.9**	
New York						
Density Zone 1a	$ 7.70	$ 82.92	**10.8**			NY - VIP Agreement
Density Zone 1b	$ 11.31	$ 98.18	**8.7**			(Effective March 2002)
Density Zone 2	$ 15.51	$ 129.39	**8.3**			
Statewide	$ 11.49	$ 102.75	**8.9**	$852.79	**8.3**	
Maryland						
Rate Group A1	$ 9.51	$ 75.65	**8.0**			MD PSC - Compliance
Rate Group A2	$ 9.55	$ 76.96	**8.1**			Case No. 8879
Rate Group B1	$ 20.57	$ 99.44	**4.8**			Order 78552 (6/30/03)
Rate Group B2	$ 13.56	$ 89.15	**6.6**			(Retroactive to 12/18/02)
Statewide	$ 11.26	$ 79.54	**7.1**	$860.77	**10.8**	
New Jersey						
Density Cell 1	$ 8.12	$ 68.88	**8.5**			NJ BPU - Compliance
Density Cell 2	$ 9.59	$ 70.99	**7.4**			Docket TO00060356
Density Cell 3	$ 10.92	$ 75.89	**6.9**			(12/17/01)
Statewide	$ 9.52	$ 71.34	**7.5**	$754.83	**10.6**	
Virginia						
Density Cell 1	$ 11.89	$ 51.13	**4.3**			VA FCC Arbitration
Density Cell 2	$ 15.26	$ 65.62	**4.3**			Docket Nos. 00-218 and
Density Cell 3	$ 28.43	$ 122.25	**4.3**			00-251
Statewide	$ 14.43	$ 62.05	**4.3**	$595.96	**9.6**	Order DA 03-2738 ('8/28/03)

Note

(1) DS3 loop rates for Massachusetts, New York, and Virginia assume that customer is located 2 miles from the central office.