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January 6, 2004

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: WC Docket Nos. 02-33, 01-337, 95-20, and 98-10

Dear Ms. Dortch:

This letter addresses arguments that the Commission cannot extend Title I classification to wireline broadband services unless it first revises its accounting and cost allocation rules.[1] These arguments have no merit. As Verizon has already explained and expands upon here, there is no realistic threat of cross-subsidy between broadband and regulated services and, as a result, it makes no sense to change the accounting treatment of broadband services if broadband is classified under Title I.[2] The telecommunications network and the services offered today are vastly different from those the Commission used so many years ago to define the cost categories in the accounting rules.[3] Requiring carriers to separate the costs of broadband services from the costs of other services would require the Commission not only to identify broadband costs within an integrated modern network – itself almost an impossible task – but to extract those costs from accounting categories that were developed long before broadband was invented. Moreover, disputes about which costs may or may not be allocated to broadband services could delay (or possibly thwart) broadband deployment. The Commission should not let that happen. Broadband investment and deployment are too important to be held hostage to disputes over accounting and cost allocation. The Commission should leave the accounting treatment of broadband as it currently is, lest any potential accounting changes become a costly distraction from – or, worse, an obstacle to – the Commission's substantive broadband policy.

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1 Letter from Frank S. Simone, Government Affairs Director, AT&T, to Marlene H. Dortch, FCC, CC Docket Nos. 02-33 and 01-337 (filed Oct. 2, 2003); Letter from Richard S. Whitt, Director, Federal Advocacy, to William F. Maher, FCC, CC Docket No. 02-33 (filed Sept. 15, 2003) ("MCI September 15 Ex Parte"); Letter from Richard S. Whitt, Director, Federal Advocacy, to William F. Maher, FCC, CC Docket No. 02-33, (filed July 29, 2003) ("MCI July 29 Ex Parte").

2 Letter from W. Scott Randolph, Director, Regulatory Affairs, to Carol Mattey, Deputy Bureau Chief, FCC, CC Docket Nos. 02-33, 95-20 and 98-10 (filed June 26, 2003) ("Verizon June 26 Ex Parte").

3 See, e.g., Notice of Proposed Rulemaking, Jurisdictional Separations Reform and Referral to the Federal-State Joint Board, 12 FCC Rcd 22120, ¶ 9 (1997) (noting development of network since adoption of Part 36 separations rules).

Incentives for broadband deployment will also suffer if the Commission removes significant federal regulatory obstacles to broadband and the states reimpose regulations on broadband, either directly or indirectly by imputing revenues from or allocating costs to broadband service. These improper allocations of revenues or costs would deny broadband providers the opportunity to profit from their investments and, as a result, could reduce deployment and innovation in broadband. Most states have adopted price-cap or alternative regulation of local services, so the cost allocation will have no impact on the prices of regulated services in those states. And, in rate of return states, where rates are based on cost, rates may be based on the cost of a stand-alone voice network, regardless of how broadband is treated within the Commission's accounting system. As Verizon has repeatedly stated in this proceeding and elsewhere, the Commission should pre-empt state efforts to re-regulate, either openly or surreptitiously, the competitive broadband services that the Commission deregulates.

There is No Risk of Cross-Subsidy if the Commission Leaves the Accounting Treatment of Broadband As It Is Now

In reality, there is no realistic chance that incumbent carriers will be able to cross-subsidize broadband offerings by "misallocating" costs if the Commission continues the current accounting treatment of broadband. AT&T and MCI claim that this would allow incumbents to engage in behavior resembling "predatory pricing" by misallocating costs of broadband to regulated services and, through this cross-subsidization, setting broadband prices at predatory levels, driving its broadband competitors out of the market, and raising and sustaining prices above competitive levels.

Claims of the potential for this type of conduct ignore market realities. As numerous courts have noted in the "predatory pricing" context, it is not a rational business decision to price competitive services artificially low unless there is a probability that these amounts may be recouped.[4] Under these circumstances, an incumbent could recoup these short-term losses in one of only two ways: (1) by driving all competitors out of the market and then raising prices to monopoly levels; or (2) by increasing rates for other non-competitive services.

Neither of these options is possible given the current state of the broadband market. *First*, competition for broadband services cannot be eliminated. Competitors for ATM and Frame Relay services include financial giants such as AT&T and MCI that will not be driven out of the market by temporary efforts to under-price. Similarly, mass market broadband services like DSL and fiber-to-the-premises also face intense competition, primarily from the more dominant cable companies. Indeed, these competitors dominate this market with more than two-thirds of the market share.[5] Moreover, even in the unlikely event that an incumbent could drive AT&T, MCI, or cable companies into bankruptcy, the facilities of those carriers would remain in place and

4 See, e.g., Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 588-589 (1986) (conduct is predatory only where it would be economically irrational for the monopolist but for the conduct's adverse impact on competition).

5 See Merrill Lynch, 3Q03 Broadband Update (November 3, 2003).

intact, ready for another firm to acquire and operate to undercut the incumbent's prices once they are raised to monopoly levels.

Second, incumbents cannot recoup these losses by increasing rates for other non-competitive services. Incumbents compete head-to-head with wireless, cable, and other providers for minutes of use and these competitors constrain the ability of incumbents to raise prices for regulated services. And, rates charged by Verizon and other large carriers are largely set by price caps rather than by accounting costs. *Verizon June 26 Ex Parte* at 5-6. "Rather than focusing on costs, price cap regulation focuses primarily on the rates incumbent LECs may charge and the revenues they may generate from interstate access services. By severing the direct link between authorized rates and realized costs, the price cap system was intended to create incentives for LECs to reduce costs and improve productivity, while maintaining affordable rates for consumers through the caps on prices."[6] Thus, adding costs to the rate base for regulated services no longer allows carriers to increase the price of those services because those prices are set by a formula that does not take costs into account. And, even in those few states that still rely on rate-of-return regulation, state commissions can base regulated voice rates on the standalone costs for narrowband services. Because there is simply nowhere for incumbent carriers to cross-subsidize *from*, consequently, there is no potential for regulated services to be burdened with non-regulated expenses.

Section 254(k) Does Not Require The Commission To Apply Old Accounting Rules to the New Regulatory Scheme

MCI has argued that "[i]f the BOCs were permitted to reclassify DSL services as non-regulated, and also were allowed to treat those services as regulated for accounting purposes, that clearly would constitute a serious violation of Section 254(k)." *MCI July 29 Ex Parte* at 4; *MCI September 15 Ex Parte* at 3. MCI is wrong.

First, nothing in the text of Section 254(k) requires that any service be treated as regulated or non-regulated for accounting purposes. Instead, Section 254(k) has two parts: the first sentence in this section prohibits cross-subsidization of competitive services, and the second prohibits the imputation of excessive joint and common costs to services supported by universal service. Neither of these problems – subsidization of competitive services and burdening of services supported by universal service – is implicated here.

The first sentence of Section 254(k) prohibits the use of non-competitive services to subsidize services subject to competition. As explained above and in Verizon's *June 26 Ex Parte*, it is not possible for incumbents to use regulated services to subsidize broadband services. MCI points to two circumstances under which it claims prices are nonetheless "tied" to costs, even under a price-cap regime. Neither of these arguments has merit.

First, MCI suggests that BOCs operating under price cap regulation still retain the right to file rates that exceed the price cap indices, based on their costs. This argument is beside the point.

6 Access Charge Reform Price Cap Performance Review for LECs, 18 FCC Rcd 14976 ¶ 3 (2003) (footnotes omitted).

To date, no LEC has received approval for an "above cap" tariff filing and even if a LEC were to attempt one, such a tariff change would not take place automatically; the Commission would be required to review and approve the tariff and its cost support, and MCI as well as all other carriers would have an opportunity to oppose it. It is absurd for MCI to suggest that the Commission should delay decision on a topic as important as broadband classification based on this remote hypothetical.

Second, MCI disingenuously claims that the exogenous cost adjustments required by Section 61.45(d) prove that interstate access rates "continue to be linked to cost," and would allow LECs to cross-subsidize regulated and non-regulated services. *MCI September 15 Ex Parte* at 2. As MCI is well aware, interstate rates are governed not by costs, but by the price cap indices, which are in turn affected by (1) inflation as measured by the GDP-Productivity Index; and (2) downward pressure on prices due to an "X" factor, an incremental number that historically captured the productivity of the telecommunications industry above and beyond the productivity of the general economy, but for the last three years has operated as a transition mechanism to reduce prices at a certain pace.[7] These two factors are the driving forces behind interstate prices, not the relatively small annual or extraordinary exogenous cost adjustments that carriers may or may not file.

In particular, MCI misunderstands Section 61.45(d)(1)(v), which treats "[t]he reallocation of investment from regulated to nonregulated activities pursuant to § 64.901" as an exogenous cost change.[8] MCI claims that if the Commission deregulates broadband, carriers would be required to file exogenous cost changes to adjust the price cap indices. MCI's argument is way off the mark. In the first place, if the Commission freezes the accounting treatment of broadband, as Verizon has requested, then there will be no reclassification of investment pursuant to Section 64.901, and consequently, by its plain terms, Section 61.45(d)(1)(v) would not be implicated.

In any event, MCI is wrong that if broadband is deregulated, price cap indices must be adjusted. The Commission has already determined that when services are removed from price caps because they have been shown to be competitive, no adjustments in the price cap indices are warranted.[9] Indeed, when Verizon's DSL and other packet-switched services were removed from price cap baskets, there was no corresponding change in the price cap indices. Similarly, when special access services that qualified for price flexibility were removed from special access, no adjustment to the price cap indices through exogenous cost changes were made. In both cases, the only things in price caps that changed were the demand for the rate elements and the price cap total revenues or "R" value revenues. If there is no need to adjust price caps when a service becomes competitive enough to be removed from price caps, then there is certainly no

7 Access Charge Reform, 15 FCC Rcd 12962, ¶¶ 135, 140-143 (2000).

8 MCI July 29 Ex Parte at 6 ("[i]f DSL were treated as non-regulated, Part 61 of the Commission's rules would also require certain downward adjustments to the price cap indices (PCI), which likely would lead to downward adjustments to interstate access rates").

9 See Access Charge Reform, 14 FCC Rcd 14221, ¶¶ 158-159 (1999) ("Pricing Flexibility Order") ("We have determined that no adjustment to price cap LECs' PCIs is warranted . . . when an entire service is removed from price cap regulation pursuant to a Phase II showing").

need to do so when a competitive service *already* outside of the price cap indices is moved from Title II to Title I.[10]

MCI is also wrong in its suggestion that LECs can use exogenous cost adjustments to manipulate interstate access rates in order to subsidize competitive services with regulated services. Exogenous cost adjustments are intended to take into consideration specific costs that are beyond the control of the carrier and are not already accounted for in the price cap formula.[11] In fact, several of the specific exogenous cost adjustments in Section 61.45(d) – amortization of equal access expenses, adjustments to the subscriber plant factor, and inside wire amortization – are no longer being applied because the circumstances that justified the changes no longer exist.[12] *MCI September 15 Ex Parte* at 2.

The second sentence of Section 254(k) – which prohibits the imputation of excessive joint and common costs to services supported by universal service – is likewise not implicated. The obvious purpose of this sentence is to ensure that the costs of providing universal service are not borne disproportionately by the universal service fund. But no particular accounting treatment of broadband in Part 64 is necessary to avoid improper subsidization of carriers with universal service fund monies. This is because, as BellSouth noted in a recent *ex parte*, contributions to the Federal Universal Service Fund are based on interstate retail revenues, and distributions from the fund for non-rural carriers are based on a hypothetical cost model that operates independently from the Part 64 or Part 32 accounting rules.[13]

Verizon has explained that the Commission's accounting treatment of billing and collection services demonstrates that a given service's accounting treatment does not always track its actual regulatory status. *Verizon June 26 Ex Parte* at 3-4. MCI quibbles that broadband differs from billing and collection in that there is a separate Part 69 rate element for billing and collection, but no corresponding single rate element for broadband. *MCI July 29 Ex Parte* at 7-8. But the number of Part 69 rate elements for a given service is not the decisive question. The question is whether there are any adverse consequences from leaving the Part 64 treatment of costs alone. For all the reason discussed above, in this context, the answer to this question is unequivocally no.

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10 MCI initially claimed that the low-end price adjustment (or "LFAM") also linked prices to costs. MCI July 29 Ex Parte at 5. In its September letter, MCI now appears to recognize that the LFAM has been phased out for carriers, including Verizon, that have received pricing flexibility. See Pricing Flexibility Order, ¶ 162; MCI September 15 Ex Parte at 2.

11 See generally Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786, ¶¶ 166-190 (1990).

12 Jurisdictional Separations Reform and Referral to the Federal-State Joint Board, 15 FCC Rcd 13160, ¶ 13, n.40 (2000) (subscriber plant factor replaced by gross allocator of 75% state and 25% interstate); Detariffing the Installation and Maintenance of Inside Wiring, 1 FCC Rcd 1190, ¶ 8 (1986) (inside wire amortization to be completed by September 30, 1994); Petitions for Recovery of Equal Access and Network Reconfiguration Costs, 1 FCC Rcd 434, ¶ 25 (1986) (equal access expenses to be amortized over 8 year period with a definite termination point at Dec. 31, 1993).

13 Letter from Stephen L. Earnest, Regulatory Counsel, BellSouth Corporation, to Marlene H. Dortch, FCC, CC Docket No. 02-33, at 7-8 (filed Aug. 26, 2003); see also Federal-State Joint Board on Universal Service, 14 FCC Rcd 20156, ¶¶ 29-31 (1999).

In conclusion, the Commission faces momentous decisions about the proper regulatory classification for broadband services. Freezing the Part 64 accounting treatment of broadband would prevent Verizon and other BOCs from being hamstrung by archaic accounting rules that (1) their main broadband competitors do not have to comply with; and (2) could have a serious negative effect on their incentives to invest. The Commission's accounting rules should serve and support its regulatory policies, not *vice versa.* Verizon respectfully urges the Commission to continue the accounting treatment of broadband for purposes of its Part 64 rules only, and to reject efforts to use trumped-up accounting disputes as an excuse to delay meaningful regulatory reform.

Sincerely,

cc: Carol Mattey
Jane Jackson