

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554**

In the Matter of

Review of the Commission's Rules)	
Regarding the Pricing of Unbundled)	WC Docket No. 03-173
Network Elements and the Resale of)	
Service by Incumbent Local Exchange)	
Carriers)	

**REPLY COMMENTS OF ALLEGIANCE TELECOM, INC.,
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CHOICE ONE COMMUNICATIONS INC.,
CONVERSENT COMMUNICATIONS, LLC,
EL PASO NETWORKS, LLC,
FOCAL COMMUNICATIONS CORPORATION,
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SUMMARY

The Commission should retain a forward-looking long-run cost methodology, and, more specifically, TELRIC. The Commission understandably had concerns about TELRIC based on the rhetoric put forth by the regional Bell Operating Companies (“RBOCs”), but the record elicited in this proceeding should allay those concerns once and for all. TELRIC has largely succeeded in implementing the goal of Congress for a cost-based methodology that promotes competition and efficient economic entry while not being rooted in traditional rate-of-return regulation. Competition is still a work in progress, however, and a change in regulatory course by the Commission, particularly when such a change is not warranted, would imperil the success of TELRIC to date.

The Commission should be particularly wary of modifying TELRIC in the manner suggested by the RBOCs. The RBOCs are still seeking to transform TELRIC into an embedded cost methodology. The proposed RBOC modifications of TELRIC suffer from many flaws. First, they are not rooted in economic theory but are instead *ad hoc* alterations designed solely to increase UNE prices. Second, many of the RBOC arguments in support of change are simply recast versions of arguments that have been discredited by the U.S. Supreme Court, state commissions, and this Commission. Third, the RBOC modifications are premised on the fanciful notion that ILEC networks are currently efficient. If RBOC networks were efficient, the forward-looking/actual network debate would merely be an academic debate. The fact that RBOC networks are so inefficient is what makes the need for TELRIC all the more important. Finally, the RBOC modifications are based on a fundamentally flawed premise which is that a costing methodology should protect their revenues and allow them to recover their actual costs. TELRIC is designed to transition prices to competitive levels, and a competitive market provides

no such assurances to market operators. The RBOCs fail to understand a fundamental principle of valuation which is that their assets in a competitive market will not be valued at their actual costs, but on the cost of the most efficient technology that is currently available. Thus, the technology the RBOCs have actually deployed is irrelevant to the question of how that technology should be valued. The modifications proposed by the RBOCs would not improve upon TELRIC, but rather would propel prices above cost and imperil competitive entry.

The Commission, instead of considering ways to raise UNE prices, should be examining ways to lower UNE prices to reflect the reduced UNE access required by the *Triennial Review Order*. The Commission has largely confined UNEs to the ILECs' older networks which are lower cost networks. Even when CLECs are allowed access to fiber networks, there are significant limitations on use of those networks such that CLECs will only have access to a limited amount of the features and functionalities of those networks. The Commission should ensure that CLECs pay only for the cost of the UNEs they are obtaining, and that they are not required to subsidize the cost of facilities and functionalities to which they are denied access.

In regard to specific methodology inputs, the Commenters propose the following:

- The Commission should require that state commissions impute UNE prices to ILEC retail prices. Otherwise, ILECs will be able to provide below-cost retail pricing that will impede, if not preclude, competitive entry.
- The Commission should require a separate, lower cost of capital for lower-risk UNEs such as loops and transport. The Commission should require that capital structure be based on book value rather than market value and should reflect any short-term debt that an ILEC utilizes. The proxy group for determining the cost of equity should be based on

a comparable group of RBOCs. The Commission should not allow use of any risk premium in determining the cost of capital.

- The Commission should continue to rely on Commission-prescribed asset lives rather than GAAP lives.
- The Commission should continue to mandate the use of forward-looking fill factors and preclude use of fill factors based on actual utilization levels in the ILECs' networks.
- Expense factors should not be based on the ILECs' current actual expenses.
- Nonrecurring charges should reflect forward-looking, efficiently incurred costs. NRC cost models should assume a fully mechanized OSS. Nonrecurring charges should be limited to those activities that solely benefit the CLEC requesting the activity. Disconnection charges should be applied at the time of disconnection.
- The Commission should retain geographic rate deaveraging.

In regard to implementation, the Commission should refrain from setting a national timetable for implementation. Regardless of the methodology applied, cost proceedings require time, and a rush to implement new prices will only exacerbate the risk of error. Also a state commission should be given an opportunity to determine if its UNE prices conform to the Commission's revised methodology. It may very well be that some state commissions have already implemented some of the modifications the Commission may require. If this is the case, there is no need for a superfluous cost proceeding. Finally, an implementation timeframe is unnecessary because as parties negotiate new interconnection agreements, they may seek state commission arbitration of rates based on the new standards. The Commission should also not

impose a true-up mechanism because the rates currently in place are lawful rates. A true-up requirement will only introduce even more regulatory uncertainty.

The Commission should establish a “rule of thumb” that the information upon which an ILEC bases its UNE cost study is fully discoverable, otherwise it should not be considered by the state commission. CLECs seeking information through discovery, which was not provided with the ILEC’s cost study, should not have an initial burden of demonstrating the relevancy of their request. As a final matter regarding discovery, the Commission should reject ILEC requests that CLEC cost information be fully discoverable in UNE cost proceedings. These requests should be rejected because CLEC cost data is irrelevant to UNE prices.

The Commission should not establish a mechanism for making automatic adjustments to UNE rates over time, in lieu of comprehensive UNE rate proceedings. If adjustment factors were applied, UNE rates would not be cost based as the Act requires and the adjustment would systematically disfavor CLECs because conservative adjustments would be used which would tend to overstate costs.

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TDS METROCOM, LLC**

Allegiance Telecom, Inc. ("Allegiance"), Cbeyond Communications, LLC ("Cbeyond"), ChoiceOne Communications Inc. ("ChoiceOne"), Conversent Communications, LLC ("Conversent"), El Paso Networks, LLC ("El Paso"), Focal Communications Corporation ("Focal"), McLeodUSA Telecommunications Services, Inc. ("McLeodUSA"), Pac-West Telecomm, Inc. ("Pac-West"), and TDS Metrocom, LLC ("TDS") ("Commenters") submit these reply comments in response to the September 15, 2003 Notice of Proposed Rulemaking.¹

¹ *In the Matter of Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*. WC Docket No. 03-173, Notice of Proposed Rulemaking, FCC 03-224 (September 15, 2003) ("TELRIC NPRM").

Commenters also attach the Reply Report of Bridger Mitchell of Charles River Associates that responds to the economist reports submitted by other parties.²

I. THE COMMISSION SHOULD RETAIN A FORWARD-LOOKING LONG RUN METHODOLOGY

A. “Real” or “Actual” Costs Are Simply Embedded Costs In Another Guise

The Supreme Court’s strong endorsement of TELRIC’s forward-looking approach, as well as the Commission’s continued endorsement of a forward-looking methodology in the *NPRM*, has forced the ILECs to alter their strategy. Instead of finally abandoning an embedded cost approach, the ILECs have recharacterized embedded costs as “real” and/or “actual” costs. Despite this sleight of hand, it is clear that “real” or “actual” costs as used by the RBOCs are simply embedded costs in another guise.

Qwest states that the Commission should assume the use of network designs, technologies, and practices that “are currently deployed on a scale and scope comparable to that of the ILEC.”³ Investment would be based on what would be required to build today a ubiquitous network based on the technologies, designs and practices actually deployed by the ILEC.⁴ Expenses would be the expenses that the ILEC currently incurs.⁵ Verizon argues that an ILEC’s costs should be based on its existing network configuration, fill factors, and investments. Operating expenses and non-recurring costs would be based on the ILEC’s actual out-of-pocket

² Attachment A, Reply Report of Bridger Mitchell (“B. Mitchell Reply Report”).

³ Qwest Comments at 16.

⁴ Qwest Comments at 20.

⁵ Qwest Comments at 20.

expenditures. Depreciation costs are to be based on the ILEC's depreciation lives.⁶ BellSouth calls for use of the ILEC's actual cable routes, remote terminal locations, cross-box locations, distribution termination locations and engineering guidelines.⁷

There is little, if anything, forward-looking about the ILEC proposals. The ILECs would firmly root pricing in their embedded networks which is fundamentally antithetical to TELRIC. It is clear that the ILECs, once again, are seeking to recover their embedded costs.⁸ While accounting costs may technically not be used, the existing network design would frame the costs, and ILECs would be compensated for their past and current inefficiencies.⁹ If the Commission endorses the ILECs' "actual" cost approach it would turn the clock back to 1996 and undermine the competitive strides made since then. As the Commission has previously recognized, to utilize a truly forward-looking approach it must detach its pricing rules from the ILECs' embedded costs.

B. ILEC Networks Are Not Efficient

The lynchpin of the ILEC argument that a forward-looking cost methodology can be reconciled with their embedded networks is that price cap regulation has rendered their networks efficient.¹⁰ SBC calls for a presumption of efficient networks in any state in which the ILEC is governed by price cap regulation.¹¹ SBC cites to two inapposite studies to support its

⁶ Verizon Comments at 35.

⁷ BellSouth Comments at 3, 19, and 22.

⁸ AT&T Comments at 20; MCI Comments at 4.

⁹ AT&T Comments at 48.

¹⁰ BellSouth Comments at 19.

¹¹ SBC Comments at 25-27.

proposition. The first study is extremely dated since it covers the period of 1988-1993. According to SBC's own table, no major local exchange carriers were under price cap regulation in 1989 and only three were in 1992.¹² Moreover, the report does not discuss what technical efficiency improvements were made, and whether any of the inefficiencies of the ILECs' embedded networks were addressed. Most importantly, the report does not cover the years 1993 to the present which has witnessed a sea change in the technology of underlying networks. Thus, there is no insight into whether ILEC efficiency improved during this period, and, if so, to what extent. The second study seems to analyze only the speed of regulatory approval of new services as opposed to providing any substantive evaluation of the services actually introduced. For all we know the new services could simply be new variations of a call feature designed to increase revenue as opposed to technological innovations. The Commission should not ascribe any weight to this meager evidentiary support. The fact that ILECs have been so slow to install DSL capability by itself shows that price cap regulation has not made them efficient.

Price cap regulation is by no means a guarantee of efficiency. Even when price cap regulation works ideally it does not provide the same incentives that a competitive market does. For instance, a price cap carrier does not face a loss of significant demand if it fails to become efficient or it fails to innovate.¹³ Also since the price caps are based on the ILEC's original costs, the ILEC simply has only to become more efficient than it originally was. There is no requirement that it actually become an efficient carrier. In addition, many of those original costs were embedded fully distributed costs that were then increased by a significant percentage to recover the rate-of-return monopoly revenue requirements. Even in the current embedded cost

¹² SBC Comments, Exhibit A, Dr. Debra J. Aron and William Rogerson, The Economics of UNE Pricing at 42 (Dec. 16, 2003) ("SBC Report").

¹³ AT&T Comments at 49-50.

base, much of the technology underlying these original costs has been fully replaced with lower cost equipment thus exacerbating this over-recovery of costs.

In fact, another way to increase profits under price caps is by increasing demand which the SBC economists concede.¹⁴ Thus, a carrier can increase profits under a price cap regime while still maintaining the same level of efficiency, or perhaps even becoming more inefficient. A fortuitous increase in demand can help a price cap carrier greatly increase their profits despite their inefficiency. The period of price cap regulation has generally coincided with the increased demand for telecommunications services which was largely spurred by the 1996 Act. Presumably, even the ILECs would not suggest that they spurred the “tech boom” from 1996 to 2000, although they certainly did benefit from the increased demand which had a “rising tide lifts all boats” effect on the industry. This increased demand fueled increased profits for the ILECs without any need for increased efficiency on their part (and given the by now legendary service quality problems carriers like Ameritech displayed in both retail and wholesale sectors post-1996 it is unlikely that they were becoming more efficient). The bursting bubble in the last several years will likely finally force ILECs to try and become more efficient since increased demand will no longer be an easy route to profits, but any effects of this streamlining will not be felt for several years.

Price cap regulation as applied is even less of a guarantee of efficiency. As the Supreme Court has observed, price cap regulation has not eliminated regulatory gamesmanship “since there are still battles to be fought over the productivity offset and allowable exogenous costs.”¹⁵ The productivity offset is a prime avenue through which to increase profits without necessarily

¹⁴ SBC Report at 40-41.

¹⁵ *Verizon Communications, Inc. v. FCC*, 122 S.Ct. 1646, 1660 (2002) (“*Verizon*”).

increasing efficiency. For instance, in the Wisconsin PSC's review of the productivity offset, the proposed offset ranged from one economist's rate of 2.0-2.5% to another's rate of 8% with the final rate set at 3%.¹⁶ Thus, depending on which economist you believe, SBC is either getting very efficient or could be making windfall profits without having to become more efficient at all. Since many alternative regulation plans freeze basic rates, the plans may not necessarily be encouraging efficiency with the rising productivity rates throughout the nation.

In fact, price cap regulation has been shown to be essentially a modified form of rate-of-return regulation.¹⁷ Under price cap regulation, efficiency is not the only route to higher profits. A carrier can still be wasteful if it convinces the regulator to increase the price cap. For instance, it could deploy excess spare capacity and use this as a basis to argue for higher local rates.¹⁸

Finally, much of the ILEC network was deployed under rate-of-return regulation, particularly the older portions of the ILEC network which will comprise many of the UNEs in the post-*Triennial Review* world.¹⁹ ILECs had tremendous incentives under rate-of-return regulation to be wasteful and inefficient since their returns would be assured. The Illinois Commerce Commission cautions against assuming the ILECs' practices are efficient. It notes:

¹⁶ See *Administration of the Mechanics of Price Regulation Pertaining to Wisconsin Bell, Inc., d/b/a SBC Wisconsin*, Wisconsin Public Service Commission Docket No. 6720-TI-184, Final Decision (Oct. 29, 2003); *In the Matter of Rulemaking to Revise Wis. Admin. Code Chapter PSC 163, Telecommunications Utility Price Regulation, Regarding the Productivity Offset Factor*, Wisconsin Public Service Commission Docket No. 1-AC-193, A Study of Total Factor Productivity in the Wisconsin Local Exchange Carrier Industry by Economics and Technology, Inc. (2003) and Productivity Performance of the Wisconsin Local Exchange Carrier Industry by Christensen Associates (Jan. 10, 2003).

¹⁷ AT&T Comments at 49.

¹⁸ AT&T Comments at 49.

¹⁹ AT&T Comments at 50.

Most ILEC facilities were placed when the telecommunications industry was a regulated monopoly, and placement of an efficient network was not necessarily a primary objective. Presuming an ILEC's network is efficient will probably tend to increase UNE rates. For example, high fill factors would exist in an efficient network, while a fill factor of less than 50% would indicate that the network was not designed for efficiency.²⁰

This candid assessment by the Illinois Commerce Commission of its ILEC retail rate regulation demonstrates that ILEC networks cannot be presumed to be efficient.²¹ If anything, there should be a presumption of inefficiency.

C. A Short Run Approach Would Be Problematic

Various short run cost approaches have been proposed by the RBOCs. About a year and a half ago, Verizon suggested one based on a three to five year planning period.²² SBC proposes one in its comments in this proceeding. UNE rates, under SBC's approach would reflect the present cost of building and maintaining the ILEC network as it will be constituted at the midpoint of a three to five year planning period of network evolution as documented by actual ILEC engineering plans and guidelines.²³ SBC claims that its approach is not based on embedded costs, because it is not based on how much the ILECs paid for the UNE facilities, but how much it would cost the ILEC today to replace and maintain the facilities consistent with the technology choices and network configuration in the ILEC's actual network.²⁴

²⁰ ICC Comments at 33-34. Most of the RBOC fill factors are far below 50%. *See, e.g.,* SBC Comments at 66-65; *Joint Application by BellSouth Corporation, et al., for Provision of In-region, InterLATA Services in Georgia and Louisiana*, CC Docket No. 02-35, Memorandum Opinion and Order, 17 FCC Rcd. 9018, ¶¶ 66-70 (2002).

²¹ *See also*, B. Mitchell Reply Report at 6-7.

²² CC Docket No. 01-338, Letter from William Barr, Executive Vice President and General Counsel, Verizon to the Honorable Michael Powell at 4-5 (July 16, 2002).

²³ SBC Comments at 27.

²⁴ SBC Comments at 33.

As a threshold matter, for all the reasons discussed earlier, it is a misnomer to say that the cost of replacing the existing ILEC network is not an embedded cost approach. Any approach tethered to the ILEC's existing network is ultimately an embedded cost approach. Instead of modeling the forward-looking costs of an efficient network, the ILECs' approaches ask the Commission to model the costs of their existing inefficient network. Thus, cost models have to take as a given the inefficient network deployment, excess spare capacity, outdated UDLC technology, load coils/bridged tap, and other inefficiencies in the ILEC network. Basing UNE rates on the existing network is essentially a reproduction cost approach that requires CLECs to compensate ILECs for past inefficiencies.²⁵

As AT&T notes, a pure short run cost approach would most likely lead to significantly lower UNE prices since the costs of sunk investment in assets with lives longer than the three-to-five year planning period and that are not expected to run out of capacity or need replacement during the planning period are close to zero. Since these short run incremental costs are much lower than the full costs of the assets, a pure short run approach would likely lead to significantly lower UNE prices.²⁶

This is obviously not what SBC is advocating, however. SBC is seeking a hybrid approach that would tack on the full reproduction costs of existing assets to short run incremental costs. This approach would actually end up being worse than an embedded cost approach as CLECs would be paying for the sunk costs of the ILEC network as well as the incremental piecemeal costs of expanding this network.²⁷ This approach has no basis in rational economic theory

²⁵ AT&T Comments at 48.

²⁶ AT&T Comments at 42-43.

²⁷ AT&T Comments at 44.

as no efficient firm would base its investment decisions on such an approach.²⁸ The approach does not provide any benefit in terms of valuing the ILEC's network.²⁹ Nor would this approach address any of the purported "problems" with TELRIC as short-run pricing is more volatile and would be more subject to gamesmanship and abuses.³⁰ As the Illinois Commerce Commission astutely observes, use of a specific planning cycle, such as three to five years, can easily be manipulated to increase UNE rates.³¹ For instance, ILECs could factor in extensive investment into this three-to-five year planning period, and when the time comes for deployment, retract the plans. One needs to look no further than the history of paper promises of increased investment by the ILECs to see how the process could be easily gamed.

Particularly telling is the fact that BellSouth counsels *against* a short-run approach arguing that the Commission should retain a long-run orientation.³² BellSouth states that a short run approach would not allow it to adequately recover the costs of all the components of its network and does not provide a sufficient time frame to work through all the cost changes that will be encountered.³³ The Illinois Commerce Commission also urges that the Commission stick with a long-run methodology noting that it should not assume that ILEC practices are efficient.³⁴

The modified short run approach proposed by SBC clearly is designed not to send economically efficient signals, but to maximize UNE rates. The Commission should reject any

²⁸ AT&T Comments at 44.

²⁹ MCI Comments at 19.

³⁰ AT&T Comments at 46.

³¹ ICC Comments at 32.

³² BellSouth Comments at 3.

³³ BellSouth Comments at 15.

³⁴ ICC Comments at 33.

calls to abandon a time-tested long run approach for the vagaries of the short run approach proposed by SBC.

II. IMPACT OF TRIENNIAL REVIEW ORDER

A. CLECs Should Not Have to Pay for Network Facilities That They Are Not Able to Purchase

Rather than seeking ways to modify TELRIC to increase UNE prices, the Commission should be examining ways to lower UNE prices in the wake of the *Triennial Review Order*. Under the terms of the Order, CLECs will be largely relegated to use of copper facilities and limited use of fiber facilities. For many UNEs, CLECs will not have access to the full features and functions of the facilities. In addition, ILECs will be getting a windfall because CLECs will be leasing facilities that have most likely been largely depreciated and would have been retired soon. By obtaining UNE prices for facilities whose costs are likely largely limited to operations and maintenance costs, the ILECs will be obtaining a significant premium in regard to these facilities. Methodological consistency may suggest that UNE prices for these facilities be based solely on forward-looking costs, but as noted below, numerous “real world” considerations have already been factored into TELRIC, and ILECs are seeking even more concessions to the “real world.” Any consideration of “real world” attributes mandates a corresponding consideration of the limitations on access to UNEs effected by the *Triennial Review Order*.

Other parties have echoed Commenters call for appropriate cost allocation in regard to UNE facilities to which CLECs do not have full access.³⁵ AT&T correctly contends that TELRIC cost models cannot include any of the costs of diverse network facilities that are no longer available to CLECs, including overhead costs allocated to those facilities. This is to

³⁵ AT&T Comments at 54.

ensure that CLECs are not forced to pay for network facilities and capabilities that they are not allowed to purchase.³⁶ The Illinois Commerce Commission also concurs that if a CLEC is not entitled to certain features, functions and capabilities of a UNE, the CLEC should not be compelled to absorb any of the costs for those features, functions and capabilities.³⁷ For instance, if loop rates are kept at current levels, CLECs will be subsidizing the ILEC deployment of broadband services to which they are denied access. Since the demand for broadband services is outstripping the demand for narrowband services, the forward-looking costs for “narrowband” loops should reflect a declining proportion of the common costs.³⁸

Moreover, as the Illinois Commerce Commission astutely contends, UNE rates should recover only those forward-looking costs associated with providing features, functions and capabilities that the ILEC is providing through its existing network elements and this recovery should not include costs associated with providing features, functions and capabilities that the ILEC is not providing through existing UNEs.³⁹

B. Costs for Access to the ILEC’s “Older” Network Should Be Limited to Operation and Maintenance Costs

If the Commission, however, continues to allow, or expand, the consideration of “real world” network attributes, the Commission should prescribe lower prices for copper loops. As MCI notes, the rental price for obsolete assets for which there is abundant supply is the long run incremental cost (LRIC) of serving additional demand. When there is excess supply of this asset, the only LRIC component will be the variable cost of maintaining and operating these

³⁶ AT&T Comments at 53.

³⁷ ICC Comments at 16.

³⁸ AT&T Comments at 55.

³⁹ ICC Comments at 21.

assets.⁴⁰ The ILEC has an incentive to lease this facility if it recovers its operating cost, so the rental rates for these facilities should be their long run variable cost, which would be the costs of operating and maintaining these facilities. This should lead to significantly lower prices for copper loops. To allow higher prices would provide ILECs with a significant windfall.

III. ILEC CRITICISMS OF TELRIC HAVE BEEN DISCREDITED

As MCI correctly notes, many of the criticisms leveled by ILECs against the TELRIC methodology are not new, but are simply recast versions of arguments that they have been making for years.⁴¹ The ILECs invoke their well-worn mantra of the ills of TELRIC, *i.e.*, it does not promote investment, it impedes ILEC cost recovery, it is a “black box”, and, of course, it relies on “fantasy networks.” The record elicited in this proceeding will finally put to rest these arguments.

A. TELRIC Is More Transparent and Verifiable Than an Actual Cost Approach

A common ILEC criticism of TELRIC is that it is a “black box” permitting states to set prices in which rates are set “without any real world, objective criteria.”⁴² ILECs also contend that the inner workings of TELRIC are known to only a few people.⁴³ The ILECs are understandably upset. For years they have used their control over cost information, and the information asymmetry that it creates, to dominate the ratemaking process. The ILEC experts were the sole experts when it came to costs. TELRIC has leveled the playing field. By basing

⁴⁰ MCI Comments at 14.

⁴¹ MCI Comments at i.

⁴² Verizon Comments at 7.

⁴³ SBC Comments at 34; Verizon Comments at 8.

UNE prices on forward-looking costs, TELRIC mitigates the ILEC informational advantage and allows any party access to the relevant information needed to set prices.

The ILECs, in an attempt, to regain their informational advantage portray TELRIC as unverifiable and detached from real-world criteria. The modeling required in TELRIC is by no means unique or extraordinary. Agencies increasingly use forward-looking cost methodologies based on economic modeling to set rates.⁴⁴ An approach based on the ILEC's "actual" costs would require much modeling as well. As MCI notes, "state commissions simply cannot go out with a measuring tape, pencil and paper and count outside plant; nor can they inspect the ILECs' checkbooks for entries under "loop," "switch" and "transport" and see how much the ILECs paid for each of these items."⁴⁵ In fact, the ILEC cost data is not sufficiently granular to ascertain the values of the particular elements of its network.⁴⁶ Regulators would have to engage in complex modeling, sampling techniques, and arbitrary assumptions with ILEC "actual" cost data.⁴⁷ The ILECs have not maintained their records of their outside plant that are accurate and complete enough to "model the forward-looking costs of the ILECs' 'actual' network."⁴⁸ A recent Commission audit of ILECs' central offices was unable to locate central office equipment recorded in the companies' books and accounts.⁴⁹ The reliability of a cost model is dependent on the data that underlies it. It is clear that the ILEC cost data is far from accurate and granular

⁴⁴ *American Public Gas Ass'n v. FPC*, 567 F.2d 1016, 1036-1037 (D.C. Cir. 1977) (courts "have approved the use of . . . hypothetical cost projection for some producers, as a means of arriving at a reasonable individual rate").

⁴⁵ MCI Comments at 4.

⁴⁶ MCI Comments at 6-7.

⁴⁷ MCI Comments at 22.

⁴⁸ AT&T Comments at 56.

⁴⁹ *Continuing Property Reports Audit*, Notice of Inquiry, 14 FCC Rcd. 7019, ¶ 1 (1999).

enough to provide insight into ILEC costs. TELRIC, based on data that is independently verifiable, *i.e.*, the cost of currently available technology, will be more reliable and less susceptible to manipulation than ILEC “actual” cost data.

It is very telling that state commissions who have experience with ratemaking based on both ILEC cost data and TELRIC costs advocate for a continuation of TELRIC.⁵⁰ If TELRIC was too complex or unverifiable surely the state commissions would not be defending the methodology. In fact, as the Illinois Commerce Commission notes a lot of the complexity involved with TELRIC come from the ILEC cost models themselves.⁵¹ ILECs are very adept at making TELRIC proceedings more difficult than they need to be by denying access to vital discovery and using cost models that are not transparent.⁵²

Thus, ILECs in invoking “real costs” are simply seeking a return to ratemaking based on their books, sampling techniques, and cost adjustments.

B. TELRIC Is Not Based On Hypothetical Networks Nor Instantaneous Replacement of Technology

Perhaps the most pejorative criticism of TELRIC is that it is based on hypothetical networks and the instantaneous replacement of technology. Qwest claims that CLECs have used “currently available” technology as a license to propose the use of models that bear no

⁵⁰ See, *e.g.*, ICC Comments at 36-39.

⁵¹ ICC Comments at 40.

⁵² See AT&T Comments at 37; *In re: Investigation into Pricing of Unbundled Network Elements (Sprint/Verizon Track)*, Florida Public Service Commission Docket No. 990649B-TP, Rebuttal Testimony of Dr. August H. Ankum at 18 (Jan. 30, 2002) (Noting that cost analysts cannot verify Verizon’s cost model itself because it is nearly impossible to audit the algorithms without extraordinary effort and that certain types of assumptions are essentially “embedded” in the software program and cannot be altered without rewriting and recompiling the programming code.)

relationship to reality.⁵³ Verizon claims that TELRIC is based on a hypothetical network that assumes false efficiencies that no actual carrier could achieve.⁵⁴ BellSouth contends that no rational firm instantaneously replaces all of its facilities with every change in technology.⁵⁵

This invocation of “hypothetical” networks is a mere smokescreen to attempt to deflect the Commission’s attention from what is the relevant inquiry, *i.e.*, how assets should be valued. Regardless of how often a carrier implements new technology, the value of its assets will be based on the valuation of “currently available technology.”⁵⁶ It does not matter how prevalent a particular technology is. For instance, the use of digital television tuners is still generally limited but its availability drives the cost of televisions. The 56” widescreen analog tuner that was state-of-the-art a few years ago and cost thousands of dollars is no longer the standard bearer and will no longer dictate the value of other televisions. The advent of new technology causes older assets to be revalued.⁵⁷ Thus, as AT&T notes, the “Bells are quarrelling with the very concept of pricing based on economic costs.”⁵⁸

The characterization of TELRIC as being based on hypothetical networks and instantaneous replacement of technology is also patently false. Numerous state commissions have utilized network assumptions that deviate far from “hypothetical fantasy networks.” In fact, the use of universal digital loop carrier technology is still quite prevalent in TELRIC cost

⁵³ Qwest Comments at 5.

⁵⁴ Verizon Comments at 3.

⁵⁵ BellSouth Comments at 11, 24.

⁵⁶ B. Mitchell Reply Report at 2-4.

⁵⁷ AT&T Comments at 22.

⁵⁸ AT&T Comments at 24.

models even though their have been subsequent generations of new digital loop carrier technology. For instance, the Florida Public Service Commission allowed Sprint to model UNE loop rates based on 100% use of UDLC despite the fact that Sprint was using IDLC for its retail loops.⁵⁹ Other cost inputs such as demand and customer locations are based on actual network data.⁶⁰ TELRIC prices are based on technologies and practices that ILECs are actually deploying today.⁶¹ If anything, state commissions may have erred on the side of rooting costs too much in the ILECs' existing networks.

C. TELRIC Promotes Investment

Perhaps the most fanciful of the ILEC arguments is the argument that TELRIC stifles investment. As Commenters noted in their initial Comments, the period subsequent to the implementation of TELRIC witnessed unprecedented telecommunications investment by both CLECs and ILECs. This investment far exceeded even the rosier of expectations.⁶² In fact, if anything, there may have been too much investment as this led to excess network capacity that out-paced demand.⁶³

The ILECs, of course, conveniently seek to ignore the first few years of robust investment under TELRIC, and instead focus on the last couple of years. Verizon contends that

⁵⁹ Order No. PSC-03-0058-FOF-TP, Final Order On Rates for Unbundled Network Elements Provided by Sprint-Florida Incorporated in Docket No. 990649B-TP, *In re: Investigation into Pricing of Unbundled Network Elements (Sprint/Verizon Track)* at 114 (January 8, 2003).

⁶⁰ MCI Comments at 21.

⁶¹ AT&T Comments at 26.

⁶² Comments of Allegiance Telecom, Inc., *et al.*, at 18 (“CLEC Comments”).

⁶³ MCI Comments at 2; AT&T Comments at 33.

declining UNE prices caused a 60% decline in wireline investment between 2000 and 2002.⁶⁴ Somehow missing in this contention is any demonstration of a causative link between lower UNE prices and declining wireline investment. Also missing is consideration of the fact that capital expenditures declined across the economy during that period. Verizon provides no indication that it was declining UNE prices that fueled the downturn in investment. Moreover, the increased ILEC investment after implementation of TELRIC belies the claim that TELRIC stunts ILEC investment.

After the increase in investment, it was only natural that the levels would decline, particularly during an economic recession. In fact, as Commenters noted, telecommunications investment is caused by economic growth, but not vice versa.⁶⁵ Thus, if the economy is in a recession, telecommunications investment will understandably lag. Perhaps the most telling proof of this proposition is that, in statements to their investors, both BellSouth and Verizon ascribed declining capital expenditures to decreased network demand.⁶⁶

This decline in investment is not only to be expected, but economically rational. If there is excess capacity, and declining demand, it makes no sense to invest for investment's sake. The Commission's oft-stated goal is to promote efficient economic entry. This is the standard by which to judge TELRIC, and there is no indication that TELRIC is not meeting this goal. In fact, there is every indication that TELRIC is operating as intended by not promoting investment for investment's sake but promoting smart investment.

⁶⁴ Verizon Comments at 9; *see also*, Qwest Comments at 3 (Focusing on investment in the last three years.)

⁶⁵ CLEC Comments at 19.

⁶⁶ CLEC Comments at 19.

SBC argues that cost-based prices can only send accurate pricing signals if the Commission, in applying the impairment standard, has restricted the list of UNEs to elements linked to natural monopoly. SBC claims that otherwise CLECs would be inclined to lease elements for which it would be more in the public interest for them to build.⁶⁷ Presumably the Commission is confident that in the *Triennial Review Order* it has adequately applied the impairment standard. And the ILECs appear to be the only parties to dispute that loops and transport facilities are hard-to-duplicate facilities for which it would make more sense for CLECs to lease as opposed to build. Thus, there should be no issue of TELRIC sending accurate price signals to frame investment decisions even under the ILEC conceptualization of “accurate” pricing signals. Under SBC’s reasoning, the Commission should maintain unmodified TELRIC pricing at the very least for “hard-to-duplicate” facilities such as loops and transport.

Modifying TELRIC to raise UNE prices would be inimical to the goals of the Act. Such a modification would not promote CLEC investment as by definition UNEs are elements for which CLECs face impairment in regard to self-provisioning. A rise in prices will fuel market exit more than market entry.⁶⁸ A rise in UNE prices may not even promote ILEC investment as the record demonstrates that it is competition that spurs ILEC investment.⁶⁹ In fact, if intramodal competition is stunted, there will be at most a duopoly with little incentive for investment. Even if ILEC investment is promoted, this is not a legitimate purpose for TELRIC pricing. As AT&T

⁶⁷ SBC Comments at 7.

⁶⁸ AT&T Comments at 34.

⁶⁹ See AT&T Comments at 36.

notes, “the obvious motive for the incumbents’ advocacy of higher UNE prices is not a wish for more facilities-based competition, but a desire to suppress it.”⁷⁰

Verizon claims that it would welcome CLECs as wholesale customers if more rational wholesale pricing was in place.⁷¹ If ILECs were sincerely concerned about responding to intermodal competition and increasing use of their facilities, they would be seeking to maintain CLECs as wholesale customers by providing the lowest possible price. It is clear that they have no such interest. The Commission may have rendered this dispute academic, however, because CLECs no longer retain access to much of ILEC new investment.⁷² Thus, there is no reason to provide any further incentive for ILEC investment. In fact, since CLECs are being relegated to older facilities for which ILECs will have little retail demand and which are lower cost facilities, it is more rational to lower pricing for these facilities since the UNE revenues will provide a windfall to ILECs.

D. TELRIC Allows for ILEC Cost Recovery

Amazingly, despite the Supreme Court’s absolute repudiation of the argument, the ILECs continue to contend that TELRIC precludes recovery of their costs. Qwest contends that some state prices only compensate Qwest for 30% of its costs.⁷³ The ILECs, however, do not buttress this argument with any particularized cost data, but simply invoke generalized reports. For instance, Verizon cites to analysis by two financial analysts.⁷⁴ There is no indication of what

⁷⁰ AT&T Comments at 32.

⁷¹ Verizon Comments at 18.

⁷² CLEC Comments at 3; MCI Comments at 2-3.

⁷³ Qwest Comments at 12.

⁷⁴ Verizon Comments at 5.

cost data the financial analysts relied upon much less whether they conducted a granular analysis of these costs. Likewise, Verizon and Qwest rely on their own self-reported ARMIS data.⁷⁵ By contrast, substantial weight should be given to the findings of state commissions in regard to ILEC cost recovery. State commissions have conducted extensive cost proceedings and analyzed particularized cost data at the end of fully-contested proceedings. Their findings are entitled to more weight than generalized reports. The ILECs have not been able to demonstrate that the rates set by the state commissions do not adequately allow recovery of their costs. This fact alone should be sufficient to dispense with the cost recovery issue. As MCI notes, despite their repeated invocation of TELRIC “errors” the ILECs have never attempted to attach a dollar amount to the TELRIC errors they identify.⁷⁶ The ILECs fail to support their contentions of unrecovered costs with a granular analysis.⁷⁷ Instead, they proffer unsubstantiated generalized figures and expect the Commission to accept them without more.

ILEC contentions of unrecovered costs have primarily been based on a comparison of the book value of their networks with TELRIC valuations.⁷⁸ The book value cost of their network, however, is the cost of “their entire local phone network, their interLATA toll network, and their interLATA networks.”⁷⁹ The network TELRIC values is the network used to provide UNEs, a network that is also used by ILECs to provide their own local services.⁸⁰ The portion of the ILEC network used to provide UNEs is becoming increasingly smaller. Meanwhile, RBOCs

⁷⁵ Qwest Comments at 12.

⁷⁶ MCI Comments at 9.

⁷⁷ MCI Comments at 8.

⁷⁸ MCI Comments at 7.

⁷⁹ MCI Comments at 8.

⁸⁰ *Id.*

have been provided the opportunity to provide lucrative interLATA services over their network. In addition, as Commenters noted in their initial comments, for years, ILECs were given significant subsidies to build their networks.⁸¹ Thus, there appear to be little, if any, unrecovered costs.

The ILECs attempt to find other sources of unrecovered costs. For instance, Verizon cites to the FCC Staff Paper that noted that periodic reevaluation of TELRIC rates may lead to under recovery of ILEC costs.⁸² This is no justification, however, for a blanket increase in UNE rates. In fact, Commenters noted that a more dynamic application of TELRIC would alleviate many of these issues.⁸³ SBC points to its carrier of last resort obligations. As noted above, and in Commenters' initial comments, ILECs have received numerous subsidies to meet their carrier of last resort obligations. Moreover, carrier of last resort obligations are properly addressed by universal service programs. To use UNE pricing as a vehicle to offset carrier of last resort obligations would lead to a return to a system of implicit subsidies that Congress explicitly proscribed in the 1996 Act.

The Commission should reject out of hand Verizon's call for a mechanism to recover ILEC unrecovered costs. Verizon's call begs the question of whether there are in fact any unrecovered costs, and until an ILEC can demonstrate this there is no basis for such a mechanism. Verizon contends that TELRIC rates are confiscatory. The Supreme Court, however, rejected this challenge. The Court found fault with the generalized numbers put forward by the RBOCs. As the Court noted, "the numbers being thrown out by the incumbents

⁸¹ CLEC Comments at 22-23.

⁸² Verizon Comments at 5.

⁸³ CLEC Comments at 29-33.

are no evidence that TELRIC lease rates would be confiscatory, sight unseen.”⁸⁴ The Court went on to add:

the incumbent carriers here are just like the electric utilities in *Duquesne* in failing to present any evidence that the decision to adopt TELRIC was arbitrary, opportunistic, or undertaken with a confiscatory purpose. What we do know is very much to the contrary. First of all, there was no "switch" of methodologies, since the wholesale market for leasing network elements is something brand new under the 1996 Act. There was no replacement of any predecessor methods, much less an opportunistic switch "back and forth." And to the extent that the incumbents argue that there was at least an expectation that some historically anchored cost-of-service method would set wholesale lease rates, no such promise was ever made. First Report and Order ¶ 706 ("[C]ontrary to assertions by some [incumbents], regulation does not and should not guarantee full recovery of their embedded costs. Such a guarantee would exceed the assurances that [the FCC] or the states have provided in the past").⁸⁵

Since the Court has conclusively rejected the argument that the TELRIC methodology is confiscatory on its face, the Commission should summarily reject the RBOCs' recycled arguments. The RBOCs retain the opportunity to pursue takings challenges to particular rates in federal court.

Verizon contends that the Commission compelled the ILECs to enter into the UNE business and therefore should provide adequate compensation. There was surely no compulsion in 1996 with RBOCs pushing for the ability to enter into interLATA markets. The trade-off for this opportunity was the opening of local markets competition.⁸⁶ Now having obtained the benefits of the bargain, the RBOCs cannot shrug off the cost.

⁸⁴ *Verizon*, 122 S.Ct. at 1680.

⁸⁵ *Id.*

⁸⁶ *See, Qwest Corporation v. U.S.*, 48 Fed.Cl. 672, 696 (2001). The Court of Federal Claims noted that Plaintiff Qwest's physical takings claim must be considered in the "context of the comprehensive legal framework established by the Telecom Act." *Id.* The court noted that the Telecom Act "created a matrix of interlocking opportunities for ILECs" where "they

E. State Commissions Have Already Addressed Many of the Issues ILECs Have Raised

The state commissions have been unfairly maligned by the ILECs for their application of TELRIC. Despite the Herculean effort the commissions have put forth in conducting multiple rate proceedings, the ILECs attack the state commissions for their “inconsistent” rate determinations. The ILECs contend that differences in rates from state to state are not fully explained by cost differences.⁸⁷ The ILECs also argue that recent “drastic” reductions in TELRIC rates are not explained by cost considerations.⁸⁸

Many of these purported “problems” are caused by the ILECs. For instance, SBC proposed some rates that vary from state-to-state for no apparent reason, such as a vertical feature charge in California that appears in no other state in the SBC region.⁸⁹ As for the recent reduction in UNE rates, many of these reductions are propelled by better, more complete information that has helped correct some of the inflated rates that resulted from the first round of UNE proceedings. It should also not be forgotten that many of the RBOCs agreed to rate reductions to make their rates TELRIC-compliant so that they could obtain Section 271 authority. Now having obtained the benefit of the bargain, the RBOCs want to renege on their

could enter some new markets, but the *quid pro quo* was that they open up their own local exchange markets to competition.” *Id.*; see also, *National Railroad Passenger Corp. v. Boston and Maine Corp.*, 503 U.S. 407, 418 (1992) (upholding broad construction by Interstate Commerce Commission of its condemnation authority that implemented and interpreted the statute in a manner that comports with its words and structure).

⁸⁷ Qwest Comments at 14; Verizon Comments at 7.

⁸⁸ Verizon Comments at 7.

⁸⁹ AT&T Comments at 40.

part of it. In fact, rates are starting to increase in some states.⁹⁰ It should also be noted that variation in TELRIC prices should not only be tolerated, but encouraged. As the D.C. Circuit noted, there can be variation in TELRIC prices, such as variations found in the concept of just and reasonable rates. The court noted that state commissions can set rates lower within a “zone of reasonableness” to further the public interest.⁹¹

State commissions have actually been quite solicitous of ILEC issues. For instance, the New York Public Service Commission in its last rate proceeding adopted Verizon’s cost model which relied on historical data (the Commission did modify it somewhat to reflect TELRIC assumptions). The model more closely accounted for actual network technology and practices Verizon engages in.⁹² The Illinois Commerce Commission notes that from the very onset TELRIC cost models presented to it begin with real-world network attributes that go beyond existing wire center locations.⁹³ Thus, state commissions are adequately addressing these issues, and, if anything, may be too solicitous of the ILECs’ arguments. The ILEC request for the Commission to propound rules on the need for focus on “real” networks would be superfluous and may tilt the scale too much towards embedded cost pricing as will be discussed more in the next section.

⁹⁰ State Telecom Activities, Communications Daily, Vol. 24, Issue 4 (Jan. 7, 2004)(IURC raises UNE rates in Indiana by 30%).

⁹¹ *Sprint Communications Company, L.P. v. FCC*, 274 F.3d 549, 555 (D.C. Cir. 2001)

⁹² NY DPS Comments at 6.

⁹³ ICC Comments at 41.

IV. SPECIFIC METHODOLOGY RECOMMENDATIONS

A. Imputation

In the *NPRM*, the Commission noted that the combination of retail rates that include implicit support flows, *i.e.* rates that are lower than cost, and the availability of cost-based, deaveraged UNE rates could affect entry incentives.⁹⁴ More specifically, the Commission recognized that ILECs could be engaging in a price squeeze if UNE prices are close to or above retail prices.⁹⁵ The Commission asks how it can achieve its goal of sending appropriate economic signals with respect to competitive entry and investment given its limited ability to influence or control retail local exchange rates.⁹⁶

As stated in initial comments, the Commission should require that BOCs impute UNE prices to their retail rates. ILECs should be required to impute the UNE price to the corresponding retail service. As the Section 271 process demonstrated, there are numerous states where high UNE rates coupled with low retail rates posed a significant threat of a price squeeze.⁹⁷ Certain states, such as Indiana, under pressure from the RBOCs have already

⁹⁴ *NPRM* para. 133.

⁹⁵ *NPRM* n. 173.

⁹⁶ *NPRM* para 135.

⁹⁷ See, e.g., *Application by Verizon New England Inc., et al., for Authorization to Provide In-Region, InterLATA Services in New Hampshire and Delaware*, WC Docket No. 02-157, Memorandum Opinion and Order (2002); *Application by Verizon New Jersey Inc., et al., for Authorization to Provide In-Region, InterLATA Services in New Jersey*, WC Docket No. 02-67, Memorandum Opinion and Order (2002).

significantly raised UNE rates.⁹⁸ This continued pressure coupled with the possibility that modifications implemented by this Commission will further increase UNE rates makes the need for an imputation requirement acute.

There should be little question of the Commission's authority to implement an imputation requirement. In fact, the D.C. Circuit's decision in *Sprint v. FCC* suggests that the Commission may be required to act affirmatively to preclude a price squeeze in the Section 271 context pursuant to that section's public interest requirement.⁹⁹ In regard to non-BOC ILECs, the Commission's authority is particularly strong. The Commission has authority to preempt any state pricing regulations that would interfere with the goals and purposes of the Telecommunications Act.¹⁰⁰ If a state does not have an imputation requirement, and its UNE rates effect a price squeeze, the goals of the Telecommunications Act would be impeded because the price squeeze would stifle competition. The Commission must act to ensure that higher UNE rates do not pose an insurmountable barrier to competition. A price squeeze would establish such a barrier, and the Commission must act vigilantly and affirmatively to prevent this from happening.

⁹⁸ State Telecom Activities, Communications Daily, Vol. 24, Issue 4 (Jan. 7, 2004)(IURC raises UNE rates in Indiana by 30%).

⁹⁹ *Sprint*, 274 F.3d at 555.

¹⁰⁰ See *Wisconsin Bell, Inc., d/b/a Ameritech Wisconsin v. Bie, et al.*, 340 F.3d 441, 444 (7th Cir. 2003)(Wisconsin Public Service Commission's requirement concerning tariffing of UNE rates is preempted because it is inconsistent with the provisions of the Federal Telecommunications Act.)

B. Cost of Capital

With respect to each component of the cost of capital, *i.e.*, capital structure, cost of debt, and cost of equity,¹⁰¹ ILECs generally submit that offering UNEs is an extremely risky proposition and that the cost of capital should reflect this perceived increased risk. Verizon even recommends that an additional risk premium be added on top of the cost of capital because CLECs are not required to have a long-term UNE contract with Verizon and can cancel their UNE contracts on a monthly basis.

The FCC should reject the ILECs' fanciful view of the risks they face. Their recommendations do not have any basis in reality and adoption of any portion of them would permit ILECs to over earn significantly and increase UNE rates in a manner that thwarts CLEC competition in the local services market. For the reasons explained below, the Commission should: (1) establish a methodology for determining a separate and lower cost of capital for basic legacy loops and transport UNEs that inherently have a lower risk; (2) require that the cost of capital be based on (a) a book value capital structure that recognizes short term debt financing, and (b) a cost of equity that is indicative of a comparable group of RBOCs; and (3) reject Verizon's risk premium.

The Commission should also reject Qwest's suggestion that the Commission prescribe a cost of capital for all states because there is allegedly no legitimate reason for the use of different

¹⁰¹ An incumbent ILEC's cost of capital is determined by adding: (1) the cost to the ILEC (return it must pay) of equity, multiplied by the percentage of equity in its capital structure, and (2) the cost to the ILEC of debt, multiplied by the percentage of debt in its capital structure.

costs of capital in different states.¹⁰² However, state commissions are very experienced in determining cost of capital and each state has a different level of competition and set of issues and risks that need to be considered when the cost of capital is determined. Significantly, even SBC believes that state commissions should make such decisions pursuant to FCC guidelines.¹⁰³ Accordingly, the Commission should permit states to set the cost of capital subject to the guidelines described in these comments.

At several points in this section we refer to the very recent decision of the New Hampshire Public Service Commission (“NHPUC”) that determined Verizon’s cost of capital for purposes of setting UNE prices.¹⁰⁴ In addition to being the most recent state decision concerning cost of capital, this decision is particularly pertinent because the NHPUC carefully considered and rejected the identical arguments that Verizon and other ILECs are now parading before the Commission in this proceeding. We attach this recent decision of the NHPUC as well the testimony of Mr. James A Rothschild in that proceeding which is responsive to many of the ILECs’ arguments concerning cost of capital raised in this proceeding.¹⁰⁵

1. The Commission Should Require a Separate, Lower Cost Of Capital For Loops And Transport UNEs That Inherently Have Lower Risk

In its comments, AT&T states that it supports the Commission’s proposal to allow states to retain the “option of establishing UNE-specific costs of capital.”¹⁰⁶ Commenters agree that

¹⁰² Qwest Comments at 46.

¹⁰³ SBC Comments at 43-44.

¹⁰⁴ See Attachment B, *Investigation into the Cost of Capital, DT 02-110, Order Establishing Cost of Capital*, Order No. 24,265, at 52 (NH P.U.C. Jan. 16, 2004) (“*NHPUC 1/16/04 Cost of Capital Order*”).

¹⁰⁵ See Attachments B through F.

¹⁰⁶ AT&T Comments at 91 (citing Notice ¶ 90).

there is no basis for assuming that a carrier will face the identical risk for each type of service it provides. In this regard, ILEC legacy loops and transport facilities should have a separate cost of capital that reflects the limited risks, if any, associated with offering them as UNEs. At a minimum, the cost of capital for basic legacy loops and transport facilities should be derived consistent with the recommendations discussed below.

Indeed, as the Commission and federal courts have recognized, UNE prices should reflect only those costs (and risks) associated with the ILECs' provision of those UNEs.¹⁰⁷ Currently, the traditional methods for computing the cost of capital are based on all of the incumbents' lines of business, including new cutting edge lines of business, such as broadband that is considered by some to be extremely risky business proposition. However, the costs associated with offering services that may be considered riskier ventures are not necessarily associated with UNE offerings that are far less risky, such as basic legacy loops and transport. Therefore, the cost of capital for these UNEs should be lower than the cost of capital that is associated with riskier lines of business.

More specifically, the cost of capital associated with legacy loops and transport should be lower than the cost of capital associated with "other" network elements, such as switching, vertical services and data base services because sunk and fixed costs associated with these latter network elements do not impede competitive entry.¹⁰⁸ In fact, it is quite possible that CLEC facilities-based entry could, in some cases, reduce the demand for those latter elements because they are easier to duplicate and are subject to more rapid technological improvement.¹⁰⁹ Thus, if

¹⁰⁷ *Local Competition Order*, ¶ 691.

¹⁰⁸ CLEC Comments, B. Mitchell Report at 14-15.

¹⁰⁹ CLEC Comments, B. Mitchell Report at 14-15.

anything, it is more risky for an ILEC to offer these other network elements than it is to offer basic legacy loop and transport facilities on an unbundled basis.

Given the above and to properly reflect the dissimilar investment risks for different UNEs faced by the ILEC, the Commission should require that the cost of capital associated with basic legacy loops and transport that are available as UNEs be lower than the ILEC's overall average cost of capital in a TELRIC analysis and lower than the average cost of capital for other UNEs.

2. Capital Structure: The Commission Should Require that Capital Structure Reflect Book Value Rather Than Market Value

a. ILEC Proposed Market Value Capital Structure Should be Rejected

The Commission should reject ILECs' recommendation that the overall cost of capital be based on a "market value" capital structure, *i.e.*, that it be based on the relative proportion of the market value of the firm's equity and debt.¹¹⁰ This proposal improperly loses sight of how capital structure is determined in the first place. In particular, a market-based capitalization does not address the optimal cost of capital decisions either through direct computation or indirectly thorough decisions made by management.¹¹¹ Nor does it address the analyses made by rating agencies such as Standard & Poor's.¹¹² Further, it fails to recognize short-term debt. Short-term debt is a very low cost of capital that is currently used extensively by incumbents, especially Verizon.¹¹³

In addition, the ILECs' recommendation violates the Supreme Court's holding in *Hope*

¹¹⁰ Verizon Comments, Vander Weide Decl. ¶ 71; SBC Comments at 48; BellSouth at 30.

¹¹¹ See Attachment D at 16 (NHPUC DT 02-110: Exhibit 38, at 16 (JAR 1/27/03 Rebuttal)).

¹¹² See Attachment D at 16 (NHPUC DT 02-110: Exhibit 38, at 16 (JAR 1/27/03 Rebuttal)).

¹¹³ See Attachment D at 13 (NHPUC DT 02-110: Exhibit 38, at 13 (JAR 1/27/03 Rebuttal)).

Natural Gas. It is common knowledge that stock prices are substantially impacted by future expectations of earnings. Therefore, if a market value capital structure is used, the higher the stock price, the higher the percentage of common equity in the capital structure. This in turn results in a higher revenue requirement. In other words, using a market-based capital structure to establish the revenue requirements of a company results in an upward spiral where higher stock prices produce a need for higher income requirements, and the higher income requirements produce a need for higher revenue requirements. This approach is patently unreasonable. As the *Hope* decision states:

“fair value” is the end product of the process of rate-making not the starting point as the Circuit Court of Appeals held. The heart of the matter is that rates cannot be made to depend upon “fair value” when the value of the going enterprise depends on earnings under whatever rates may be anticipated.¹¹⁴

b. Book Value Should Be Used in Establishing an ILEC’s Capital Structure

As AT&T and MCI recommend, the overall cost of capital should be based on the company’s current (or “book”) capital structure. Because management is continually managing its capital structure, the most recent capital structure portrays the most economical and forward looking capital structure for the company.

Verizon’s Dr. Vander Weide has claimed in state UNE cost proceedings that financial and economic theory and economists do not support the use of the book value capital structure. However, although market value structure may be used by economists and investors when evaluating a company, it is not what management uses to determine the best and least-cost

¹¹⁴ *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 601 (1943).

capital structure that the company can use on a going forward basis to raise capital and fund its operations and thereby increase shareholder value.¹¹⁵

In the aforementioned and attached NHPUC decision, the NHPUC determined that the book value capital structure is appropriate because that is what “reasonable and prudent management would choose.”¹¹⁶ The attached testimony of Mr. Rothschild in that proceeding provides numerous reasons why book value should be used to determine ILECs’ capital structure.¹¹⁷

c. Capital Structure Should Reflect Any Short-Term Debt An ILEC Utilizes.

Verizon contends in its comments that short-term debt should not be reflected in the capital structure because it primarily uses short-term debt to finance its investment in working capital, and because its investment in working capital is not included in the investment component of UNE cost studies.¹¹⁸ The Commission should reject this transparent effort to inflate UNE prices by ignoring low cost short-term debt financing and take note of the recent NHPUC decision that did just that.¹¹⁹ The Commission should require that ILECs’ use of short-term cost of debt be recognized and be used in the capital structure.

¹¹⁵ See Attachment C at 17 (NHPUC DT 02-110: Exhibit 37, at 17 (JAR 1/27/03 Direct)).

¹¹⁶ Attachment B, *NHPUC 1/16/04 Cost of Capital Order*, at 50.

¹¹⁷ See Attachment C at 14 (NHPUC DT 02-110: Exhibit 37, at 14 (JAR 1/27/03 Direct)).

¹¹⁸ Verizon Comments, Vander Weide Decl. ¶¶ 49-50.

¹¹⁹ See Attachment B, *NHPUC 1/16/04 Cost of Capital Order*, at 54-55.

3. Cost of Equity: The Proxy Group Used To Establish the Cost of Equity Should Be Based On A Comparable Group Of RBOCs.

In its comments, Qwest submits that the most appropriate “proxy companies or industries for use” in determining the cost of capital are telecommunications carriers that face substantial competition, such as CLECs and interexchange carriers.¹²⁰ Verizon recommends that the proxy group be based on the S&P Industrials rather than a small group of telecommunications holding companies that own ILEC subsidiaries¹²¹ and BellSouth supports the use of the S&P 500.¹²² The Commission should reject these recommendations because a valid equity analysis requires the use of a comparison group consisting of other companies that are comparable in business risk to the company that is being analyzed.¹²³ Because there are no wholesale suppliers of UNEs that have similar characteristics to that of an ILEC, a proxy group of the RBOCs is appropriate.¹²⁴ Even SBC submits that ILEC companies “are fair – indeed, conservative - proxy group to use in estimating the cost of equity.”¹²⁵

S&P 500 or S&P Industrials’ firms unquestionably have different business risks than a local telecommunications provider. This is a group of companies with a higher risk profile than an RBOCs regulated retail regulations, and considerably more risky than the RBOCs UNE

¹²⁰ Qwest Comments at 45.

¹²¹ Verizon Comments, Vander Weide Decl. ¶ 42.

¹²² BellSouth Comments at 32.

¹²³ See Attachment B, *NHPUC 1/16/04 Cost of Capital Order*, at 61.

¹²⁴ See Attachment B, *NHPUC 1/16/04 Cost of Capital Order*, at 61.

¹²⁵ SBC Comments at 45.

operations.¹²⁶ According to Verizon, the S&P Industrials are a well known sample of publicly traded competitive companies whose apparent risk, on average, approximate the risk the incumbent LECs actually face in providing telecommunications services in a competitive market.¹²⁷ This conclusion, however, is at odds with the Supreme Court in *Verizon* which stated that the incumbent local exchange carriers have an “insurmountable competitive advantage.”¹²⁸ If anything, the combination of the “insurmountable” difficulty of competitors building facilities to compete with the regulated retail business of the incumbents and the basic important nature of telecommunications service makes the retail regulated portion of an ILEC’s business in the low-end of the spectrum of risk.

The basic fact is that the UNE business for an ILEC is even lower in risk than the risk borne by the relatively low risk regulated retail telephone business. This is because ILECs only provide UNEs if the facilities to provide such network elements are currently available. ILECs have no obligation, outside of routine upgrades, to construct new facilities for CLECs.¹²⁹ Accordingly, ILECs have not put any investment capital at risk in providing UNEs. Moreover, the UNE business actually reduces the risk an ILEC confronts in being in the regulated retail telephone business. Thus, if CLECs bypassed an ILEC’s UNE facilities and installed their own, then the ILEC would lose the UNE revenues and be subject to potentially more losses in revenues. Given the foregoing, the Commission should limit the proxy group used to establish the cost of equity to RBOCs.

¹²⁶ See Attachment D at 6-7 (NHPUC DT 02-110: Exhibit 38 at 6-7 (JAR 1/27/03 Rebuttal)).

¹²⁷ Verizon Comments at 71-72, Vander Weide Decl ¶ 43.

¹²⁸ *Verizon v. FCC*, 122 S. Ct. 1646, 1662 (May 13, 2002).

¹²⁹ *Triennial Review Order*, ¶¶ 632 & 636.

4. There Is No Justification for a Risk Premium

Verizon urges the Commission to add a risk premium to the cost of capital because CLECs may not continue to use UNEs.¹³⁰ This proposal should be rejected because ILECs are already being paid an allowance for any risk that some its equipment will be unused. For instance, the loop facilities that Verizon makes available to its competitors in New Hampshire have been priced under the expectation that they only will be utilized at 37.2% of capacity, leaving 62.8% of its lines as paid-for over-capacity to account for unused/stranded loops, which includes any loops that might be lost to competitive bypass.¹³¹ Because the cost of the over-capacity is already built into the charges to its customers, this not only protects Verizon with protection from an over-capacity risk, but should the over-capacity factor increase in the future, Verizon could petition the Commission to adjust its rates to account for its revised over-capacity condition.

Verizon's claim that a risk premium should be added because UNEs are not offered pursuant to long term contracts is particularly specious because this is solely because Verizon has not chosen not to offer any such long term contracts. In addition, Verizon does not make any incremental investment in UNE facilities, so it is not exposing itself to any lost incremental investment.¹³² Indeed, the *Triennial Review Order* made it absolutely clear that ILECs are not required to construct new facilities (other than routine modifications).¹³³ It is worth noting that Verizon's proposed risk premium was squarely rejected by the NHPUC in its aforementioned

¹³⁰ Verizon Comments at 73-76.

¹³¹ See Attachment F (NHPUC DT 02-110: Exhibit 13).

¹³² See Attachment D at 32 and Attachment G (NHPUC DT 02-110: Exhibit 38 at 32, 33 (JAR 1/27/03 Rebuttal) and Exhibit 11).

¹³³ *Triennial Review Order*, ¶ 636

recent decision.¹³⁴

In light of the above, the FCC should reject Verizon's proposed risk premium.

C. Depreciation: UNE Rates Should Be Based on Commission Prescribed Straight Line Rather Than GAAP Depreciation Lives.

The Commission should continue to rely on Commission-prescribed asset lives (rather than GAAP lives), and it should not deviate from straight line depreciation.¹³⁵ This is fully consistent with TELRIC and the goals of the Act, and is far more reliable and accurate than GAAP lives.¹³⁶ The Commission's prescribed lives are unbiased estimates of forward-looking lives and empirical evidence demonstrates that the Commission's prescribed lives, if anything, are too short.¹³⁷ Significantly, the Commission has even held that its prescribed lives represent "the best forward-looking estimates of depreciation lives."¹³⁸ For these reasons, the Commission has used prescribed asset lives for some time in its regulation of ILEC depreciation practices and has applied them in TELRIC proceedings.¹³⁹

¹³⁴ See *NHPUC 1/16/04 Cost of Capital Order*, at 45-47.

¹³⁵ See AT&T Comments, at 92-93; MCI Comments, at 33 & 37.

¹³⁶ See AT&T Comments at 92-100; MCI 33-38.

¹³⁷ See MCI Comments at 33.

¹³⁸ *United State Telephone Association's Petition for Forbearance from Depreciation Regulation of Price Cap Local Exchange Carriers*, ASD 98-91, Memorandum Opinion and Order, FCC 99-398, ¶ 61 (rel. Dec. 30, 1999).

¹³⁹ See, e.g., *In the Matter of Worldcom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration; In the Matter 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 Nos. 00-218 & 00-251, Memorandum Opinion and Order 18 FCC Rcd 17722, DA 03-2738 ¶ 112 (2003) ("Virginia Arbitration Award").

Moreover, GAAP lives are “nothing more than management’s estimates that are blessed by auditors.”¹⁴⁰ Verizon and SBC submit that management has no incentive to have short depreciation lives because having shorter lives (or accelerated depreciation lives for that matter) in financial reporting would increase reported costs and result in lower reported profits for their companies.¹⁴¹ This argument is blatantly specious because it fails to recognize that corporate managers are by nature willing to forgo short-run profits if they can reduce competition over the long run, and thereby be more profitable in the long run by charging higher UNE prices.

Fundamentally, GAAP standards are designed to achieve full and accurate disclosure of the financial condition of a company for use by lenders and the investment community. GAAP standards can accommodate a wide range of useful lives and permit the company to manipulate UNE prices by arbitrarily determining useful lives. For this reason, the Commission has consistently rejected GAAP as irrelevant in ratemaking and inadequate for assuring reasonable rates. The Commission should continue to do so in this proceeding.

D. Fill Factors

The ILECs contend that actual fill factors are the only reliable evidence of the fill factors that are achievable in their network.¹⁴² SBC contends that without sufficient spare capacity, it would not be able to meet service quality standards.¹⁴³ SBC argues that some states have applied fill factors which no carrier has remotely approached.¹⁴⁴ Qwest argues that aggressive fill factors

¹⁴⁰ MCI Comments at 35.

¹⁴¹ Verizon Comments at 65; SBC Comments at 54.

¹⁴² SBC Comments at 64; BellSouth Comments at 27; Qwest Comments at 39.

¹⁴³ SBC Comments at 68.

¹⁴⁴ SBC Comments at 16.

fail to account for the fact that much of telecommunications equipment increases in capacity only in large increments that do not correspond to the amount of demand at given locations and that in planning and constructing networks, carriers leave ample room for future growth.

The arguments that Qwest raises, however, are precisely the reasons for not relying on ILEC actual fill factors. The sizing of equipment is a significant source of spare capacity. This concept, known as “breakage,” is likely sufficient to account for all the spare capacity needed for ILECs to address customer churn, defective facilities, and network growth.¹⁴⁵ For instance, an ILEC may only need 60 cable pairs to serve a particular area, but cable sizes come in sizes of 50 pair or 100 pair. Thus, the ILEC will purchase the 100 pair cable which will leave 40 pair as spare capacity. This should be more than sufficient to cover customer churn or any defective pairs. The problem with ILEC cost models is that they factor in additional capacity needed to address customer churn and maintenance without factoring in that breakage already provides sufficient spare capacity.¹⁴⁶ Thus, ILECs are importing too much spare capacity into their cost models, and the CLECs are paying the price for this through higher UNE prices.

The need for spare capacity in ILEC networks should be significantly decreasing. If, as the ILECs contend, wireless and cable facilities are providing substitution for their facilities, then less spare capacity is needed. Despite this, fill factors still allow for this spare capacity. The Florida Public Service Commission based its assumption of two distribution pairs per household on the BellSouth cost assumptions, though the Commission has long (at least since 1999)

¹⁴⁵ AT&T Comments at 63.

¹⁴⁶ AT&T Comments at 63-64.

recognized that BellSouth does not actually deploy two pairs per household.¹⁴⁷ Moreover, BellSouth has recently acknowledged that the average end user is not wired with two pairs, and is unlikely to be so wired in the future, given the reduced demand for second lines caused by increased wireless usage, DSL, and cable modem service.¹⁴⁸ Thus, there is simply no basis to factor in so much spare capacity.

This cost of spare capacity for growth should not be passed on to current ratepayers. An efficient firm would not build spare capacity for future growth unless the present value of the future revenue from the growth capacity exceeded the present value of its cost; the conservative simplifying assumption is to assume away both the existence of future growth in demand and the existence of the capacity to meet that growth. Thus, the cost of plant capacity is properly attributed to current ratepayers (including CLECs, with respect to local loops) without considering any capacity needed for future growth.¹⁴⁹

Another reason that the Commission should refrain from attaching any weight to ILEC actual fill factors is the fact that, as discussed above, ILEC networks are not efficient.¹⁵⁰ Under rate-of-return regulation, ILECs had no incentive to deploy efficient networks, and price cap regulation has not been in place for a sufficient period of time to undo the effects of this inefficient deployment.

¹⁴⁷ *Determination of the cost of basic telecommunications service*, Docket No. 980696-TP, Order No. PSC-99-0068-FOF-TP, 1999 WL 112536, *78 (Jan. 7, 1999) (“*FL USF Order*”) (“BellSouth itself is not placing two pairs per housing unit, rather it is placing 1.4 to 1.5 pairs”).

¹⁴⁸ BellSouth has recently admitted that it only deploys one line for every household. Scott Woolley, *Bad Connection*, *Forbes Magazine* (August 12, 2002).

¹⁴⁹ AT&T Comments at 64.

¹⁵⁰ *See also* AT&T Comments at 66-68.

A strong testament to the need to adhere to forward-looking fill factors is found in the Comments of the Illinois Commerce Commission. The Illinois Commerce Commission still clings to the notion of the importance of target fill factors despite legislation virtually forcing them to use actual fill factors. The Illinois Commerce Commission demonstrated how employing actual fill factors, as ILECs propose, would significantly increase UNE prices. The TELRIC cost for most loops would be doubled by the use of actual fill factors.¹⁵¹ It is little wonder that the Illinois Commerce Commission is so concerned as such an increase in UNE prices will most certainly imperil competition in Illinois. The Commission should be wary of making the same error that the Illinois legislature did, particularly since there is no case for the use of actual fill factors.

E. Expense Factors

Another way in which ILECs have sought to recover their embedded costs have been via expense factors. The ILECs have used their control over the data necessary to calculate these expense factors to inflate the factors and substantially increase UNE rates.¹⁵² The ILECs propose more of the same by seeking to base expense factors on their actual current operating expenses.¹⁵³ These expenses, however, rarely reflect forward-looking costs. ILEC expenses generally overstate labor and maintenance costs, and include expenses unrelated to the provisioning of UNEs. For instance, ILEC expense factors suffer from a failure to account for declining network expense trends that result from changes in technology and improved equipment quality, inclusion of unwarranted network upgrade costs, wholesale and image

¹⁵¹ ICC Comments at 50-53.

¹⁵² AT&T Comments at 100.

¹⁵³ SBC Comments at 74; Qwest Comments at 47; Verizon Comments at 57.

advertising, and legal, regulatory and lobbying costs.¹⁵⁴ ILECs have used expense factors as yet another way to sneak their historical costs into their cost models. The Commission should ensure that expense factors are truly forward-looking.

V. NONRECURRING RATES

A. Nonrecurring Rates Should Reflect Forward-looking, Efficiently Incurred Costs

As AT&T recommends, nonrecurring rates should be based on forward-looking network assumptions and should only be assessed in accordance with the strict principle of cost causation.¹⁵⁵ Moreover, it is imperative that the same cost methodology used to establish recurring charges also be used to establish nonrecurring charges. That is, they both assume that the use of the least-cost, most efficient currently available technology. As the FCC recognizes, “Using one set of network assumptions for recurring charges and a different set of network assumptions for NRCs potentially results in some over-recovery or under-recovery.”¹⁵⁶ Indeed, if the basic assumptions used in determining recurring versus nonrecurring charges were not consistent, ILECs would be freely permitted to double recover costs.¹⁵⁷ This would not only deter efficient entry by CLECs but also give ILECs even less of an incentive to modernize their

¹⁵⁴ *Investigation by the Department of Telecommunications and Energy on its own Motion into the Appropriate Pricing, based upon Total Element Long-Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the Appropriate Avoided Cost Discount for Verizon New England, Inc. d/b/a Verizon Massachusetts’ Resale Services in the Commonwealth of Massachusetts*, Massachusetts D.T.E. Docket No. 01-20, Rebuttal Testimony of Warren R. Fischer at 3 (July 17, 2001).

¹⁵⁵ AT&T Comments at 104.

¹⁵⁶ Notice ¶ 117.

¹⁵⁷ AT&T Comments at 105 (citing Murray Decl. ¶¶ 142-48, 158).

networks.¹⁵⁸

In their comments, ILECs maintain that it is unsound for a cost model to assume that hypothetical technological developments could make ILECs more efficient in the future and contend that the non-recurring cost models should permit ILECs to recover actual costs associated with the real world attributes of the ILECs' network.¹⁵⁹ ILECs argue that the real world assumptions are already efficient for a number of unavailing reasons that can easily be brushed aside.

First, ILECs argue that price caps have created strong incentives for ILECs to design systems and perform tasks associated with nonrecurring activities efficiently.¹⁶⁰ As previously demonstrated, these arguments are invalid because price caps have not provided an incentive for ILECs to establish business processes that are forward-looking and efficient. Indeed, as a general matter, price caps are based on rate levels that were established during previous rate-of-return regulation. Thus, as noted above, ILECs could reduce their costs below the price cap rate level, but still remain inefficient.

Second, ILECs aver that non-recurring tasks associated with wholesale services have typically been developed in collaborative proceedings in which the tasks were subject to CLEC and state commission input.¹⁶¹ This ILEC characterization is entirely inaccurate because many of the basic nonrecurring tasks *have not been* investigated and critiqued through collaborative

¹⁵⁸ AT&T Comments at 105 (citing Murray Decl. ¶¶ 142-48, 158).

¹⁵⁹ See Verizon Comments at 79; SBC Comments at 80; BellSouth at 46; Qwest at 54.

¹⁶⁰ See Verizon Comments at 80.

¹⁶¹ See Verizon Comments at 80; BellSouth at 47.

proceedings. Moreover, even if they were, the processes established are already outdated. Indeed, the collaboratives do not generally refine and streamline nonrecurring business processes on a continual basis. Thus, there are no incentives for ILECs to operate more efficiently on a going-forward basis if the cost model does not inherently demand that the ILECs do so.

For similar reasons, ILEC arguments that 271 performance measures also ensure that their nonrecurring processes are efficient also fail.¹⁶² These performance measures serve only to ensure the *status quo* and, at most, prevent the ILEC from backsliding after it has received its 271 authority. Contrary to ILEC suggestions, they do not serve to spur ILECs to establish more efficient approaches to getting the nonrecurring tasks accomplished in a timelier, less costly, and more efficient manner. If anything, the performance measures allow ILECs to be complacent and not move to the next level of service and support. Indeed, ILECs have no incentive to provide service superior to what is required by the performance standards if doing so will give CLECs a more meaningful opportunity to compete with the ILEC. At bottom, the 271 performance measures are devices that serve to prevent ILECs from backsliding under 271 and do not compel the ILECs to be more efficient than they have to be.

Third, ILECs posit that they have every incentive to be more efficient because once the nonrecurring rates are set, they are motivated to be more efficient so that they can increase their profit margins.¹⁶³ This argument fails as well and such an incentive cannot be presumed for obvious reasons. One only has to ask why would an ILEC be motivated to handle nonrecurring activities in a better and more efficient manner if doing so would serve to benefit CLEC competition. The answer is – the ILEC wouldn't. ILECs have a natural and obvious incentive to

¹⁶² See Verizon Comments at 80-81; SBC Comments 82-83.

¹⁶³ Verizon Comments at 80; BellSouth at 47.

forgo these short-run benefits because they are inherently more interested in reducing competition over the long run by harming their smaller competitors with less efficient processes. Given this, ILECs will do nothing more than what current outdated processes require them to do.

Finally, ILECs assert that basing non-recurring rates on the ILEC's actual non-recurring costs would eliminate the speculation that often characterizes state proceedings.¹⁶⁴ This notion is incorrect as well. Even under a "real world" approach, state commissions would still need to resolve conflicting testimony by subject matter experts as to whether the ILEC's practices (including the times required to complete certain tasks) are reasonable and accurate and which party's time and motion study is more reliable.¹⁶⁵ Thus, if nonrecurring costs are not forward-looking, state commissions would still have to test the reasonability of the nonrecurring activities.

For the foregoing reasons, the Commission should reject the ILEC request that nonrecurring costs be based on actual costs they incur and require that nonrecurring rates be designed so that they reflect forward-looking, efficiently incurred costs.

B. TELRIC Nonrecurring Cost Models Should Assume A Fully Mechanized OSS

Implicit in the ILECs request that nonrecurring costs reflect real world assumptions is that the Commission accept ILEC actual OSS fallout percentages. If the Commission allowed this to happen, the OSS fallout percentage would increase and, in turn, nonrecurring charges would as well. The Commission should recognize that if ILECs had it their way and nonrecurring costs were not forward-looking, they would have no incentive to improve

¹⁶⁴ Verizon Comments at 81; SBC Comments at 80; Qwest at 54-55.

¹⁶⁵ See AT&T Comments at 105 (citing Murray Decl. ¶¶ 160-71, 178).

mechanized service order processing. However, by using a forward-looking cost construct, ILECs have such incentives. Indeed, assuming that the data entered into an ILEC's systems by a CLEC are accurate, the flow-through capabilities of a forward-looking OSS virtually eliminate all labor components of order processing. Otherwise said, a significant level of manual intervention would not be involved. If there were, it would be due to either (1) the ILEC's management decision not to provide flow-through capability for certain orders, or (2) to the ILEC's failure to maintain correct data in its OSS.¹⁶⁶

Given this, CLEC's should not be required to pay for manual processing in these circumstances because they are a product of processes that are incompatible with a forward-looking network. As AT&T explained in its comments,¹⁶⁷ the Commission and other state commissions have found that the 2 percent rate is consistent with forward-looking TELRIC requirements. The Commission should continue to recognize this and not give ILECs the permission and incentive to increase this percentage.

C. Nonrecurring Charges Should Be Limited to Those Activities that Benefit a CLEC Solely and No One Else

The Commission should limit nonrecurring charges to those costs that "exclusively benefit the competitive LEC ordering the UNE."¹⁶⁸ Stated differently, the costs incurred by an ILEC that are associated with a particular nonrecurring activity that the ILEC performs for a CLEC should be recoverable as a nonrecurring charge *only if the work performed benefits the particular CLEC order exclusively and not other orders*. As AT&T explained, treating the costs

¹⁶⁶ AT&T Comments at 110 (citing Murray Decl. ¶ 199.)

¹⁶⁷ AT&T Comments at 110.

¹⁶⁸ Notice ¶ 121.

of an activity that benefits later UNE customers as non-recurring would likely result in double recovery of costs by the ILEC.¹⁶⁹ Therefore, in determining whether a cost should be designated nonrecurring, the Commission should employ a “reusability” test.¹⁷⁰ Specifically, if a nonrecurring activity is reusable (that is other CLECs will potentially benefit from it), then the forward looking cost of that activity should be fully recovered through recurring charges.

ILECs oppose this proposal and contend that all costs that they incur that are associated with a CLEC’s order should be borne by that CLEC despite that fact that other CLECs or the ILEC may later benefit from the work performed. ILECs argue, the CLEC not the ILEC should bear the risk that there might not be future benefits from the service, since it is the CLEC that enjoys the current benefit and imposes upfront costs.¹⁷¹ Moreover, they maintain that it is equally possible that a CLEC will benefit from a nonrecurring task the ILEC performed for its customer. In theory, this may be true. However, what ILECs fail to reveal is that, apart from NRCs, ILECs recover “reusable” costs across all of their retail customers. Generally speaking, no one retail customer is burdened with costs that would benefit other retail customers and the same should hold true with respect to the ILECs’ wholesale side of the business because it is an equitable approach to cost recovery. For these reasons and as AT&T submits, the Commission should adopt this approach because it is consistent with TELRIC, promotes cost recovery on an equitable basis, and fosters ILEC efficiency.¹⁷²

¹⁶⁹ AT&T Comments at 111 (citing Murray Decl. ¶¶ 244-53).

¹⁷⁰ AT&T Comments at 111.

¹⁷¹ See Verizon Comments at 84-85.

¹⁷² See AT&T Comments at 112-13.

D. Disconnection Charges Should Be Assessed At Time of Disconnection

As to disconnection charges, the Commission should rule that they be assessed at the time of disconnection rather than at the time of installation. Basic cost causation and recovery principles require that costs be recovered when they are incurred, which in the case at hand is at the time of disconnection because an ILEC does not incur the costs of disconnection until the facility is actually disconnected.¹⁷³ Verizon opposes cost recovery in this fashion because its standard retail practice is to recover disconnection charges at the time of installation and that its wholesale practice should not be any different.¹⁷⁴ The nature of the wholesale and retail markets and pricing framework, however, is drastically different and simply because the practice is allowed in one market does not mean that it should be followed in another, especially under TELRIC cost recovery guidelines.¹⁷⁵ BellSouth agrees and even stated that “a rate structure for UNEs where the costs are recovered at the time of disconnect is acceptable.”¹⁷⁶ For these reasons, the Commission should require that disconnection charges be assessed when they are incurred.

VI. THE COMMISSION SHOULD RETAIN GEOGRAPHIC RATE DEAVERAGING

The Commission should continue to require states to implement geographic deaveraging of UNE rates. Because ILECs incur different costs depending on the population density served, averaged UNE rates across urban, metro, suburban, and rural density zones would discourage

¹⁷³ See AT&T Comments at 114-15.

¹⁷⁴ Verizon Comments at 86-87; BellSouth Comments at

¹⁷⁵ See ICC Comments at 82.

¹⁷⁶ See BellSouth Comments at 48.

efficient facility investment, encourage inefficient arbitrage, and deny many consumers any opportunity for competitive choice.¹⁷⁷ ILECs recognize this and generally support retaining deaveraging requirements.¹⁷⁸ Therefore, the Commission should not repeal these requirements at this time.

VII. IMPLEMENTATION ISSUES

A. The Commission Should Not Establish An Implementation Schedule or True-up Mechanism.

The Commission should not adopt a national “timetable” for implementing any changes to the TELRIC rules adopted in this proceeding. If the Commission did prescribe a specific timeframe, UNE cost proceedings would be initiated across the country by state commissions at roughly the same time. If that occurred, it would be very difficult for CLECs that are operating in numerous states to participate fully and actively in each of the respective state proceedings due to resource constraints. Instead, the Commission should permit each state commission to determine whether its UNE prices are consistent with the Commission’s new rules and whether a proceeding is warranted.¹⁷⁹ State commissions should have the leeway to establish a proceeding during a timeframe in which they can devote the appropriate commission resources needed to properly implement the FCC’s new costing rules.¹⁸⁰ Finally, as AT&T noted, an implementation

¹⁷⁷ See AT&T Comments at 102 (citing Willig Decl. ¶¶ 145-48).

¹⁷⁸ Verizon Comments at 97; Qwest Comments at 61; Sprint at 21.

¹⁷⁹ See New York State Department of Public Service at 14-15.

¹⁸⁰ See New York State Department of Public Service Comments at 14-15; Illinois Commerce Commission Comments at 94.

timeframe is unnecessary because as parties negotiate new interconnection agreements, they may seek state commission arbitration of rates based on the new standards.¹⁸¹

The Commission should also not establish a true-up mechanism. Verizon argues that a true-up should be imposed dating back to the date that any rules are issued in this proceeding.¹⁸² However, the Commission may not apply a true-up mechanism because current rates are lawful until superseded by new rates set by states pursuant to any new TELRIC rules. Moreover, a true-up would create harmful regulatory uncertainty. Verizon's proposal is gross overreaching and should be rejected as such.

B. The Commission Should Ensure Adequate Disclosure of ILEC Cost Data and Not Require CLECs to Reveal Their Costs When ILEC Costs Are Being Investigated.

As AT&T pointed out in its comments, Bells consistently fail to adequately disclose cost data.¹⁸³ As part of any new TELRIC rules, the Commission should establish a "rule of thumb" that the information upon which a ILEC bases its UNE cost study is fully discoverable, otherwise it should not be considered by the state commission. ILEC arguments that certain information cannot be revealed because it is protected by a third-party confidentiality agreement should not be an exception to this rule. Indeed, ILECs have been involved in UNE cost proceedings for over seven years and fully recognize what information is needed to support their cost studies and models. Thus, if an ILEC intends to rely on cost information that is protected by a third-party confidentiality agreement in a state UNE cost proceeding, the ILEC needs to do one of two things: (1) get approval from the third-party to disclose that information in the proceeding before

¹⁸¹ See AT&T Comments at 132.

¹⁸² See Verizon Comments at 105.

¹⁸³ See AT&T Comments at 127 (citing Klick Decl. ¶¶ 45-74).

the ILEC relies on such information in its cost studies; or (2) include a clause in all such third-party confidentiality agreements that permits the ILEC to reveal such information in such proceedings subject to the Protective Order established in those proceeding.

Contrary to Verizon's recommendation, CLECs seeking information through discovery, which was not provided with the ILEC's cost study, should not have an initial burden of demonstrating the relevancy of their request.¹⁸⁴ There are many instances where an ILEC's cost studies are not consistent with its own practices and these inconsistencies serve to reveal the significant flaws and shortcomings of the cost studies and the assumptions made in them. Given this, the burden should not be on a CLEC to justify, as an initial matter, why it seeks information that the ILEC did not provide with its cost studies. Rather, the basic discovery process should be followed in such cases. For instance, if an ILEC believes the CLEC's discovery is not relevant, the ILEC should simply object and not respond to the data request. If the CLEC wishes to pursue the matter, the CLEC can then file with the state commission a motion to compel the ILEC's response that explains the relevancy of the ILEC information the CLEC seeks. At that point, the ILEC will have an opportunity to respond to the motion and, after that, the state commission will either grant or deny it. The discovery process is generally that simple. Thus, rather than adopt Verizon's approach that places the burden on CLECs to justify their data requests as an initial matter, the Commission should allow basic state commission discovery procedures to apply instead. Verizon's proposal is also ridiculous on its face because cost data is highly relevant to setting UNE prices.

¹⁸⁴ See Verizon Comments at 108.

As a final matter regarding discovery, the Commission should reject ILEC requests that CLEC cost information be fully discoverable in UNE cost proceedings.¹⁸⁵ In particular, Verizon recommends that the Commission require CLECs to provide cost data to the extent they challenge the accuracy or validity of the ILEC data.¹⁸⁶ Qwest, on the other hand, proposes a broader rule and suggests that the Commission find that the cost information of all CLECs participating in a state UNE cost proceeding is discoverable.¹⁸⁷ These recommendations should be rejected because CLEC cost data is irrelevant to UNE prices. The proposals are made solely to chill CLEC involvement in cost proceedings and criticisms of ILEC cost studies. Moreover, if a CLEC's related recommendations (which serve to cure the problems with the ILEC's cost model) expose the CLEC to having its confidential costs subject to discovery, CLEC participation in UNE cost proceedings would be chilled and ILEC cost models would be subject to less scrutiny.

C. The Commission Should Not Adopt a UNE Adjustment Factor

As AT&T submits in its comments, the Commission should not establish a mechanism for making automatic adjustments to UNE rates over time, in lieu of comprehensive UNE rate proceedings.¹⁸⁸ If adjustment factors were applied, UNE rates would not be cost based as

¹⁸⁵ Qwest Comments at 62-64; Verizon Comments at 107.

¹⁸⁶ Verizon Comments at 107.

¹⁸⁷ Qwest Comments at 64. In particular, Qwest requests that the Commission, "modify its rules to provide that a party subject to the jurisdiction of the state commission may not: (1) withhold from parties to a proceeding to determine UNE rates documents or information it holds or controls relevant to the costs of building or operating a network, or (2) rely upon or seek to justify costs, models, or assumptions it has proposed in a proceeding to determine UNE rates that were provided by incorporate or are based upon documents or information that have no been disclosed to other parties in the proceeding." Qwest Comments at 64.

¹⁸⁸ See AT&T Comments at 128-29.

47 U.S.C § 252(d)(1) of the Act requires and the adjustment would systematically disfavor CLECs because conservative adjustments would be used which would tend to overstate costs.¹⁸⁹ Further, based on the complexities of establishing an adjustment factor on an ongoing basis and because cost adjustment factors would need to be made on a state specific basis, it would be no less burdensome than the current system of periodic direct review of costs.¹⁹⁰

VIII. CONCLUSION

Accordingly, if the Commission adopts any changes to UNE pricing rules it should do so consistent with the recommendations in these comments.

¹⁸⁹ See AT&T Comments at 128-29

¹⁹⁰ See AT&T Comments at 130-31.

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