LAWLER, METZGER & MILKMAN, LLC

2001 K STREET, NW
SUITE 802
WASHINGTON, D.C. 20006

GIL M. STROBEL
PHONE (202) 777-7728

PHONE (202) 777-7700
FACSIMILE (202) 777-7763

February 9, 2004

BY ELECTRONIC DELIVERY

Marlene Dortch, Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: *Written Ex Parte*
Sunset of the BOC Separate Affiliate and Related Requirements, WC Docket No. 02-112; *2000 Biennial Regulatory Review – Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules*, CC Docket No. 00-175

Dear Ms. Dortch:

Attached is a letter from Alan Buzacott, MCI, to Michelle Carey, Chief, Competition Policy Division, Wireline Competition Bureau, Federal Communications Commission. Pursuant to the Commission's rules, 47 C.F.R. § 1.1206(b), this letter is being provided to you for inclusion in the public record of the above-referenced proceeding. Please do not hesitate to contact me if you have any questions regarding this submission.

Sincerely,

Gil M. Strobel

Attachment

cc: Michelle Carey
Michael Carowitz
Ben Childers
Renee Crittendon
William Dever
William A. Kehoe III
Pamela Megna
Brent Olson

MCI®

February 9, 2004

By Electronic Delivery

Michelle Carey
Chief, Competition Policy Division
Wireline Competition Bureau
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: Treatment of Integrated InterLATA Services for Accounting Purposes after Sunset of Section 272 Separate Affiliate Requirements

Dear Ms. Carey:

In the *Accounting Safeguards Order*, the Commission required incumbent local exchange carriers ("LECs") to treat interLATA telecommunications services, including those provided on an integrated basis, as non-regulated activities for purposes of the Commission's Part 64 cost allocation rules, in order to prevent subsidization of interLATA services by subscribers to exchange access services.[1] In a recent *ex parte* filing, BellSouth argued that this requirement would no longer be "useful or necessary" after the sunset of the section 272 separate affiliate, because price cap carriers' recorded costs have "no bearing" on the rates they charge for services.[2] BellSouth's argument is incorrect. As explained below, the Part 64 cost allocation rules play an important role in preventing Bell Operating Companies ("BOCs") from improperly using their non-competitive services to subsidize the prices of their competitive services. In addition, the costs of price cap carriers continue to be relevant to the rates charged by those carriers and to the interstate earnings reported by those carriers to the FCC. The Commission therefore should reject BellSouth's proposal to treat all integrated interLATA services as regulated for accounting purposes.[3]

---

[1] *Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, Report and Order, 11 FCC Rcd 17539, ¶¶ 73-76, 257 (1996) ("*Accounting Safeguards Order*").

[2] "Post-Sunset Long Distance Accounting Issues" at 4, attached to *ex parte* letter from Mary Henze, BellSouth, to Marlene Dortch, FCC, WC Docket No. 02-112 (Nov. 12, 2003) ("*BellSouth ex parte*").

[3] *BellSouth ex parte* at 1. As part of its proposal, BellSouth suggests that when a BOC provides integrated interLATA service, the BOC will "impute to itself" an amount for

As an initial matter, BellSouth fails to explain how the FCC would enforce Section 254(k)'s prohibition against subsidies of competitive services by non-competitive services if it were to adopt BellSouth's proposal and treat interLATA services as regulated under Part 64. The Commission currently enforces Section 254(k) in part by requiring the BOCs to treat interLATA services as non-regulated for purposes of Part 64. The Part 64 cost allocation rules are perhaps the Commission's single most important regulatory safeguard to prevent the BOCs from using their non-competitive (*e.g.*, exchange and exchange access) services to subsidize their competitive (*e.g.*, interLATA) services.[4] The fact that the costs associated with interLATA services, if treated as regulated, would be subject to the cost allocation and assignment rules set forth in Part 36 (separations) and Part 69 (access charges) is not a substitute for the Part 64 safeguard. The Commission has previously made clear that Parts 36 and 69 were not designed to prevent impermissible cross-subsidization.[5] The Commission therefore cannot rely on Part 36 or Part 69 to prevent prohibited subsidies. Instead, it must continue to prevent the types of cost subsidies prohibited by Section 254(k) by maintaining the current requirement that interLATA telecommunications services be treated as non-regulated activities for purposes of Part 64.

Because Parts 36 and 69 were not designed to prevent anticompetitive cross-subsidies, permitting the BOCs to treat interLATA costs as regulated, as BellSouth proposes, would create a risk that rates for non-competitive services, such as exchange access, would be higher than they would be if interLATA costs continued to be treated as unregulated. BellSouth, however, claims that the Commission should ignore this risk on the grounds that price cap carriers' recorded costs have "no bearing" on the rates they charge for services.[6] This is simply wrong. As MCI has previously explained, even under price caps, the interstate access rates of the BOCs continue to be linked to costs.[7] For instance, all exogenous cost changes prescribed in section 61.45(d) of the

---

access to its telephone exchange service and exchange access. *BellSouth ex parte* at 7. BellSouth's imputation proposal raises a separate set of issues, which MCI will address in a subsequent letter.

[4] Because interLATA services are treated as non-regulated activities for purposes of Part 64, the costs associated with these services are not subject to the Commission's Part 36 separations rules, or its Part 69 interstate access charge rules. 47 U.S.C. § 254(k); *Implementation of Section 254(k) of the Communications Act of 1934, as Amended*, Order, 12 FCC Rcd 6415 (1997).

[5] *Accounting Safeguard Order,* ¶76.

[6] *BellSouth ex parte* at 4.

[7] Letter from Richard Whitt, MCI, to William Maher, FCC (Sept. 15, 2003), attached to *ex parte* letter from A. Renée Callahan to Marlene Dortch, CC Docket No. 02-33 (Sept. 15, 2003) (attached as Exhibit A); Letter from Richard Whitt, MCI, to William Maher, FCC, at 5-7 (July 29, 2003), attached to *ex parte* letter from A. Renée Callahan to Marlene Dortch (July 29, 2003) (attached as Exhibit B).

Commission's rules involve changes in the underlying regulated interstate costs of the price cap carrier, and require the carrier to adjust its price cap indices to reflect such cost changes.[8] These adjustments include routine exogenous cost changes that the BOCs file each year to account, for example, for changes in regulatory fees, excess deferred taxes, amortization of investment tax credit, Telecommunications Relay Service contributions and North American Numbering Plan Administration expenses.[9] Other exogenous cost changes are permitted on an occasional basis (*e.g.*, when exchanges are purchased or sold), or to take account of a one-time development (*e.g.*, to reflect thousands-block number pooling costs;[10] reallocation of General Support Facilities investment expenses;[11] reallocation of various costs related to access reform, including line-side port costs and marketing expenses;[12] and removal of Universal Service Fund contributions from access charges[13]). Other examples of significant exogenous cost adjustments include the completion of amortization of depreciation reserve deficiencies and equal access expenses, as well as inside wire amortizations.[14]

The effect of these changes over time has been substantial. Since the initiation of price cap regulation for incumbent LECs in 1991, the BOCs have been required to make exogenous rate adjustments to their price indices every single year, totaling hundreds of millions, if not billions, of dollars. These repeated adjustments to carriers' price cap indices directly refute BellSouth's claim that price cap regulation severs any links between changes in a carrier's cost of providing interstate regulated services and the prices it may charge for those services. The Commission therefore should reject BellSouth's proposal to treat all integrated interLATA services as regulated for accounting purposes.

BellSouth's proposal should be rejected for the additional reason that it would render meaningless the annual earnings reports that price-cap carriers are required to file.[15] BellSouth and other BOCs currently are required to file Form 492A "to enable the Commission to monitor access tariffs and price-cap earnings."[16] The inclusion of earnings from interLATA services in such reports, however, clearly would present a

---

[8] 47 C.F.R. § 61.45(d).

[9] *See* 47 C.F.R. § 61.45(d).

[10] *Numbering Resource Optimization*, Third Report and Order and Second Order on Reconsideration, 17 FCC Rcd 252, ¶¶ 39-40 (2001).

[11] *Access Charge Reform*, Third Report and Order, 12 FCC Rcd 22430, ¶ 43 (1997).

[12] *Access Charge Reform*, First Report and Order, 12 FCC Rcd 15982, ¶¶ 129, 323 (1997).

[13] *Access Charge Reform*, Sixth Report and Order, 15 FCC Rcd 12962, ¶ 218 (2000).

[14] 47 C.F.R. § 61.45(d)(1)(i), (viii)-(ix).

[15] *See* FCC Form 492A, "Price-Cap Regulation Rate-of-Return Monitoring Report."

[16] FCC Form 492A, "General Instructions."

distorted view of a BOC's interstate access service performance. For example, earnings for interLATA services, for which there is substantial competition, are likely to be lower than earnings for regulated interstate access services, for which there is very little competition. Thus, if the BOCs were to include their earnings for interLATA services in their reports to the FCC, the likely effect would be to depress the reported interstate returns. As long as the Commission requires price-cap carriers to file Form 492A, the Commission should ensure that the reported data is reliable and enables the Commission to have a clear understanding of the interstate earnings of price cap carriers for regulated, interstate services. In addition, to the extent that a BOC might rely on its reported regulated interstate earnings to justify a rate increase in the future, the annual earnings reports would be misleading if they included costs and revenues associated with interLATA services.

BellSouth claims that its proposal would eliminate "unnecessary burden[s]" arising from compliance with the existing Part 64 cost allocation rules.[17] As MCI has explained, however, the existing rules serve an important purpose and are far from "unnecessary." Moreover, any such alleged burdens could be avoided by retaining the existing section 272 separate affiliates, as MCI has previously recommended.[18]

In sum, BellSouth's proposal for changing the accounting treatment of interLATA service costs would be contrary to the Commission's goals of promoting efficient competition and protecting consumers. Adoption of BellSouth's proposal would eliminate the most effective accounting safeguards that the Commission has in place to prevent cross-subsidies between exchange access and interLATA services. Contrary to BellSouth's claims, an incumbent LEC's recorded regulated costs and revenues continue to have an effect on the prices it may charge for interstate access service because of ongoing exogenous adjustments. Finally, adoption of BellSouth's proposal would render meaningless the annual earnings reports that the BOCs file with the FCC. The Commission therefore should reject BellSouth's proposal and continue to treat integrated interLATA telecommunications services as non-regulated activities for purposes of its Part 64 cost allocation rules.

Respectfully submitted,

/s/ Alan Buzacott

Alan Buzacott
Senior Manager, Regulatory Affairs
(202) 887-3204

Attachments

---

[17] *BellSouth ex parte* at 4.

[18] MCI Comments at 16-25, WC Docket No. 02-112 (June 30, 2003).

Exhibit A

LAWLER, METZGER & MILKMAN, LLC

2001 K STREET, NW
SUITE 802
WASHINGTON, D.C. 20006

A. RENEE CALLAHAN
PHONE (202) 777-7723

PHONE (202) 777-7700
FACSIMILE (202) 777-7763

September 15, 2003

By Electronic Filing

Ms. Marlene H. Dortch, Secretary
Federal Communications Commission
445 Twelfth Street, SW
Washington, DC 20554

Re: *Ex Parte* Presentation, Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, CC Docket No. 02-33

Dear Ms. Dortch:

Attached for inclusion in the record of the above-referenced proceeding, pursuant to the Commission's rules, is a letter from Richard S. Whitt, Director, Federal Advocacy, MCI, to William F. Maher, Chief, Wireline Competition Bureau, FCC.

Sincerely,

/s/ A. Renée Callahan

A. Renée Callahan

Attachment

cc: Scott Bergmann
Matthew Brill
Michelle M. Carey
Daniel Gonzalez
Jane E. Jackson
Christopher Libertelli
William F. Maher, Jr.
Carol Mattey
Terri Natoli
John Rogovin
Jessica Rosenworcel
John P. Stanley
Lisa Zaina

Richard S. Whitt
Director, Federal Advocacy

1133 Nineteenth Street, NW
Washington, D.C. 20036
202 887-3845 (Tel.)
202 736-3304

MCI.

September 15, 2003

William F. Maher
Chief, Wireline Competition Bureau
Federal Communications Commission
Washington, DC 20554

Re: Cross-Subsidy Issues in the *Broadband Framework* Proceeding

Dear Mr. Maher:

The Communications Act of 1934, as amended (Act), and the Commission's rules prohibit improper cross-subsidization.[1] In the *Broadband Framework* proceeding, the BOCs have sought to evade Section 254(k) and the operation of the Commission's cost allocation rules with respect to DSL services.[2] MCI has previously explained that, as a matter of law as well as sound public policy, the Commission must have effective cost allocation rules in place before making a determination regarding the reclassification of DSL services.[3]

BellSouth recently submitted a letter arguing that the Commission should create an exception to the FCC's rules designed to prevent cross-subsidy for DSL services. For the most part, BellSouth does not raise any arguments that have not been addressed by MCI's previous submissions. However, BellSouth does claim that, under price caps, "there is now truly no link between an increase in costs directly causing an increase in

---

1 *See* 47 U.S.C. § 254(k); 47 C.F.R. § 64.901(c).

2 *See* Letter from W. Scott Randolph, Verizon, to Carol Mattey, Deputy Chief, Wireline Competition Bureau, FCC, attached to Letter from Ann D. Berkowitz, Verizon, to Marlene H. Dortch, Secretary, FCC (June 26, 2003); Letter from Cronan O'Connell, Qwest, to Marlene Dortch, Secretary, FCC (June 4, 2003); Letter from Mary Henze, BellSouth Corporation, to Marlene Dortch, Secretary, FCC (June 19, 2003). (All *ex parte* filings referenced herein were filed in CC Docket No. 02-33.)

3 Letter from Richard S. Whitt, Director, Federal Advocacy, MCI, to William F. Maher, Chief, Wireline Competition Bureau, FCC, attached to Letter from A. Renée Callahan to Marlene H. Dortch, Secretary, FCC (July 29, 2003).

prices."[4] To the extent that BellSouth is claiming that price cap regulation completely severs the link between costs and rates, BellSouth is just plain wrong. In fact, since the initiation of price caps, the Bell Operating Companies (BOCs) have been required to adjust their price indices every single year to reflect changes in their underlying costs of providing interstate regulated service. These exogenous rate adjustments have, over the past decade, totaled hundreds of millions, if not billions, of dollars.

In its July 29 letter, MCI described how, even under price cap regulation, the interstate access rates charged by the BOCs and other price cap carriers continue to be linked to cost. In its letter of August 26, BellSouth notes that the low-end adjustment is no longer available for price cap carriers with pricing flexibility, but fails to address the numerous other exogenous cost adjustments required by section 61.45(d) of the Commission's rules.[5] These adjustments include routine exogenous cost changes that the BOCs file each year, to account, for example, for changes in regulatory fees, excess deferred taxes, amortization of investment tax credit, Telecommunications Relay Services contributions and North American Numbering Plan Administration expenses.[6] In addition, BellSouth's letter makes no mention of other exogenous adjustments, which are permitted from time to time, for example, when exchanges are purchased or sold. Finally, BellSouth ignores one-time exogenous changes that the Commission occasionally may permit to take account of an extraordinary development. In recent years, these extraordinary cost changes have included an increase to reflect thousands-block number pooling costs;[7] reallocation of General Support Facilities investment expenses (some of which were reallocated to the billing and collection category, thus reducing access charges);[8] reallocation of various costs related to access reform, including line-side port costs and marketing expenses;[9] and removal of Universal Service

---

4 Letter from Stephen L. Earnest, Regulatory Counsel, BellSouth, to Marlene H. Dortch, Secretary, FCC, at 4 (Aug. 26, 2003).

5 BellSouth also ignores the ability of the BOCs to file rates that exceed the applicable price indices, based on their costs. 47 C.F.R. § 61.49(d); *see also Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, ¶¶ 300-304 (1990).

6 *See* 47 C.F.R. § 61.45(d).

7 *Numbering Resource Optimization*, Third Report and Order and Second Order on Reconsideration, 17 FCC Rcd 252, ¶ 39-40 (2001). Qwest alone estimated that its total cost recovery for thousands-block number pooling would exceed $100 million. *See* Qwest Tariff Transmittal No. 120, Chart 1 (March 18, 2002), *available at*: <http://tabb.qwest.com/PPNB.NSF/0/962dcb223650b43e87256b800073f4a6/$FILE/Charts+&+Workpapers.PDF>.

8 *Access Charge Reform*, Third Report and Order, 12 FCC Rcd 22430, ¶ 43 (1997).

9 *Access Charge Reform*, First Report and Order, 12 FCC Rcd 15982, ¶¶ 129, 323 (1997).

Fund contributions from access charges.[10] Other examples of significant exogenous cost adjustments include the completion of amortization of depreciation reserve deficiencies and equal access expenses, as well as inside wire amortizations.[11]

The effect of these changes has been substantial. Indeed, since initiation of price cap regulation in 1991, the FCC has made multiple rate adjustments totaling hundreds of millions, if not billions, of dollars based on routine, occasional, and one-time exogenous cost changes. These repeated exogenous adjustments to the indices of price cap carriers directly refute the notion that price cap regulation today completely severs any links between changes in a carrier's cost of providing interstate regulated services and the prices it may charge for those services. Clearly, even under price caps, rates continue to be adjusted for changes in the regulatory assignment of costs between the jurisdictions.

As MCI explained in its July 29 letter, Section 254(k) of the Act plainly states that the Commission is obligated to ensure that non-competitive services do not subsidize competitive services, and to establish any necessary cost allocation rules to ensure that services included in the definition of universal service bear no more than a reasonable share of joint and common costs.[12] Consequently, as long as costs are tied to rates, which is the case for both price cap carriers as well as rate-of-return carriers, Section 254(k) requires that the Commission have in place effective cost allocation rules before making a determination regarding the reclassification of DSL services.

Sincerely yours,

/s/ Richard S. Whitt

Richard S. Whitt

---

10 *Access Charge Reform*, Sixth Report and Order, 15 FCC Rcd 12962, ¶ 218 (2000).

11 47 C.F.R. § 61.45(d)(1)(i), (viii)-(ix).

12 47 U.S.C. § 254(k).

Exhibit B

LAWLER, METZGER & MILKMAN, LLC

2001 K STREET, NW
SUITE 802
WASHINGTON, D.C. 20006

A. RENEE CALLAHAN
PHONE (202) 777-7723

PHONE (202) 777-7700
FACSIMILE (202) 777-7763

July 29, 2003

By Electronic Filing

Ms. Marlene H. Dortch, Secretary
Federal Communications Commission
445 Twelfth Street, SW
Washington, DC 20554

Re: *Ex Parte* Presentation, Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, CC Docket No. 02-33

Dear Ms. Dortch:

Attached for inclusion in the record of the above-referenced proceeding, pursuant to the Commission's rules, is a letter from Richard S. Whitt, Director, Federal Advocacy, MCI, to William F. Maher, Chief, Wireline Competition Bureau, FCC.

Sincerely,

/s/ A. Renée Callahan

A. Renée Callahan

Attachment

cc: Scott Bergmann
Matthew Brill
Michelle M. Carey
Daniel Gonzalez
Jane E. Jackson
Christopher Libertelli
William F. Maher, Jr.
Carol Mattey
Terri Natoli
John Rogovin
Jessica Rosenworcel
John P. Stanley
Lisa Zaina

Richard S. Whitt
Director, Federal Advocacy

1133 Nineteenth Street, NW
Washington, D.C. 20036
202 887-3845 (Tel.)
202 736-3304

MCI

July 29, 2003

William F. Maher
Chief, Wireline Competition Bureau
Federal Communications Commission
Washington, DC 20554

Re: Cross-Subsidy Issues in the *Broadband Framework* Proceeding

Dear Mr. Maher:

In recent weeks, the Bell Operating Companies ("BOCs") have finally acknowledged that the relief they request in the *Broadband Framework* proceeding is so inconsistent with the provisions of the Communications Act of 1934, as amended ("Act"), and the longstanding regulatory treatment of BOC facilities, that they would need additional changes to the so-called "Part 64" rules so that the end result would not have unwelcome collateral consequences for the BOCs. In fact, what the BOCs demand is to have their cake and eat it too – they want services offered over their loop plant to be *unregulated* such that they are permitted to deny competitors access to their loop plant. But they want these very same services to be classified as *regulated* for accounting purposes, in order to forestall the application of the FCC's Part 64 rules that would require the BOCs to remove costs incurred in providing DSL from their regulated operations. This request for inconsistent (and unlawful) special treatment provides yet another reason to deny the BOCs the relief they request in the *Broadband Framework* proceeding, as we describe in what follows.

As explained below, the reclassification of DSL as a non-regulated service would create substantial risk of both discrimination, which has been thoroughly discussed in the record, and cross-subsidization, a topic that the BOCs have, until recently, avoided. Section 254(k) of the Act, however, clearly states that the Commission is obligated to ensure that non-competitive services do not subsidize competitive services, and to establish any necessary cost allocation rules to ensure that services included in the definition of universal service bear no more than a reasonable share of joint and common costs. It is fundamentally unfair, as well as unlawful, to compel customers purchasing other BOC services, such as traditional local voice services, to subsidize DSL, particularly in light of the fact that these voice customers, by and large, have no choice of service providers. Hence, if the FCC (without justification) were to classify DSL as a non-regulated information service, the only way in which the Commission could comply with that statutory requirement would be to adopt a set of safeguards, based on a complete record, that required the BOCs to remove the costs of their newly non-regulated services from their regulated services. The result of such a proceeding would be that prices for access and other services offered over the regulated portion of the loop would drop. Since the record in this proceeding is inadequate with respect to appropriate allocators, however, the development of such a record requires a further notice of proposed rulemaking. Pending development of that record and adoption of appropriate rules, the Commission must defer any action in the *Broadband Framework* proceeding that would involve reclassifying Title II services as information services. Failure to do so would be a violation of Section 254(k), and provide yet another ground for finding the Commission's action an unlawful hand-out to the BOCs.

Statutory Framework

The FCC seeks to promote broadband deployment and widespread competition, and also seeks to regulate only where necessary.[1] The best way for the FCC to achieve these goals is to continue to classify DSL as a Title II service, to streamline the *Computer II/III* rules as proposed by MCI, AOL, and EarthLink,[2] and to begin to apply those rules more rigorously to protect the interests of broadband ISPs. Under this approach, Internet access and other information services provided over DSL would continue to be deregulated, and underlying DSL telecommunications services would continue to be regulated. The FCC would retain the ability to police the boundaries between competitive information services and non-competitive telecommunications services to prevent discrimination and cross-subsidization. The FCC would also be able to address the Section 202 prohibition of unreasonable discrimination by enforcing the streamlined *Computer II/III* rules.[3] The operation of the Commission's cost allocation rules, including Part 64, would prevent improper cross-subsidization, and ensure compliance with the requirements of Section 201 (that rates be just and reasonable) and Section 254(k) (that non-competitive services not subsidize competitive services).[4]

In contrast, although the BOCs urge the FCC to treat their provision of DSL services as non-regulated (in order to avoid the operation of the *Computer II/III* rules), at

---

[1] *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities,* Notice of Proposed Rulemaking, 17 FCC Rcd 3019, ¶¶ 1-5 (2002) (*Broadband Framework Notice*).

[2] *Proposal to Streamline Title II Regulation of BOC Advanced Services to Promote Diverse Information Services,* attached to Letter from Donna N. Lampert, Counsel for EarthLink, Inc. to Marlene Dortch, Secretary, FCC (May 1, 2003). (Unless otherwise indicated, all *ex parte* filings cited herein can be found in CC Docket No. 02-33.)

[3] *See* 47 U.S.C. § 202.

[4] *See* 47 U.S.C. §§ 201, 254.

the same time, they contend that the Commission should treat DSL as a regulated Title II service (in order to avoid the operation of the Part 64 rules).

The Act bars this inequitable outcome by requiring the FCC to ensure that non-competitive services do not subsidize competitive services. Section 201(b) requires that all charges for telecommunications services be just and reasonable. In the *Joint Cost Order*, in which it adopted the cost allocation rules codified in Part 64 of the Commission's rules, the Commission explained that it had "proposed to develop a system of accounting separation that would inhibit carriers from imposing on ratepayers for regulated interstate services the costs and risks of nonregulated ventures."[5] The Commission further explained that its "ultimate, statutory goal was to promote just and reasonable rates for services in the interstate jurisdiction."[6]

The Telecommunications Act of 1996 furthered and strengthened the prohibition against cross-subsidies. Section 254(k) expressly prohibits the subsidy of competitive services, and requires the Commission to adopt cost allocation rules necessary "to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."[7] The Commission implemented Section 254(k) by codifying its prohibitions in Part 64.[8]

Although the statutory requirements are unambiguous, and the Commission squarely presented the issues in the *Broadband Framework Notice*, the BOCs have done their best to ignore both. The *Notice* specifically asked for comment on this question: "if wireline broadband Internet access service is an information service, how should joint and common costs of facilities used to provide both those services and telecommunications services be allocated under Part 64.901 of our rules?"[9] In addition, the Commission noted that "deeming wireline broadband Internet access to be an information service would mean that the Commission would have to ensure that the costs of the network are properly allocated between regulated Title II services and Title I information services to comply with" Section 254(k), and sought comment on how to ensure that services supported by universal service "bear no more than a reasonable portion of the costs associated with facilities used to provide both supported services and unsupported Internet access."[10]

---

[5] *Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities*, Report and Order, 2 FCC Rcd 1298, ¶ 1 (1987) (*Joint Cost Order*).

[6] *Id.*

[7] 47 U.S.C. § 254(k).

[8] *Implementation of Section 254(k) of the Communications Act of 1934, as Amended*, Order, 12 FCC Rcd 6415 (1997).

[9] *Broadband Framework Notice*, ¶ 63.

[10] *Id.*, ¶ 83.

The BOCs chose not to respond in any meaningful way to either of these questions until specifically asked by FCC staff to answer them in March 2003.[11] Even then, the BOCs waited months to respond to the request to address these important issues, filing *ex partes* in June 2003.[12]

It is imperative that the FCC address the fundamental cross-subsidy and cost allocation issues before moving forward to consider reclassification of DSL. Given the limited nature of the BOCs' responses on this issue, the FCC lacks a sufficient record at this time to address the cost allocation requirements in the detailed manner that is required, particularly as a reclassification of this sort is unprecedented. To develop a record that would allow reasoned decisionmaking on these issues, the FCC has little choice but to adopt a further notice of proposed rulemaking specifically seeking comment on the cost allocation and cross-subsidy issues, and delay action on the reclassification until such time as it has in place effective rules to comply with the statutory prohibition against cross-subsidy. If the BOCs were permitted to reclassify DSL services as non-regulated, and also were allowed to treat those services as regulated for accounting purposes, that clearly would constitute a serious violation of Section 254(k). Having failed to answer the FCC's questions in a timely manner, the BOCs cannot now be heard to say that the Commission has run out of time to obtain answers that enable compliance with the Act.

Operation of the Commission's Rules

The FCC's Cost Rules

The FCC's cost rules, which are codified in Parts 32, 64, 36, and 69 of Title 47 of the Code of Federal Regulations, along with the price cap rules, which are codified in Part 61 of the CFR, were designed to ensure that interstate access rates charged by the incumbent LECs are just and reasonable, as required by Section 201(b) of the Act.

Part 32 (the Uniform System of Accounts) specifies how various costs should be assigned to prescribed accounts.

Part 64 divides costs recorded under Part 32 between regulated and non-regulated activities. Information services (along with customer premises equipment (CPE) and inside wire) are treated as non-regulated. Costs associated with those activities must be either directly assigned to the non-regulated category, or, for costs shared between

[11] Letter from W. Scott Randolph, Verizon, to Carol Mattey, Deputy Chief, Wireline Competition Bureau, attached to Letter from Ann D. Berkowitz, Verizon, to Marlene H. Dortch, Secretary, FCC (June 26, 2003) (*Verizon June 26 Ex Parte*).

[12] *See* Letter from Cronan O'Connell, Qwest, to Marlene Dortch, Secretary, FCC (June 4, 2003) (*Qwest June 4 Ex Parte)*; Letter from Mary Henze, BellSouth Corporation, to Marlene Dortch, Secretary, FCC (June 19, 2003) (*BellSouth June 19 Ex Parte)*; *Verizon June 26 Ex Parte.*

regulated and non-regulated services, allocated between regulated and non-regulated activities, using a fully-distributed costing methodology.[13]

Part 36 (Separations) divides regulated costs between the state and interstate jurisdictions.

Part 69 (Access Charges) establishes the rate elements for interstate access service, including transport, switching, common line and special access. For rate-of-return carriers, Part 69 also provides direction on how to apportion jurisdictionally interstate investment and expenses among the rate elements.[14]

Part 61 (Price Caps) establishes the rules that govern the rates assessed by price cap carriers. Section 61.45(d) describes exogenous cost changes that require adjustments to the price cap indices, including changes in the Uniform System of Accounts, changes in the Separations Manual, and the reallocation of investment from regulated to non-regulated activities pursuant to Section 64.901 of the Commission's rules.[15]

As the forgoing description makes clear, BOC interstate access rates, even under price caps, continue to be linked to cost.[16] For example, all exogenous cost changes prescribed in section 61.45(d) of the Commission's rules involve changes in the underlying regulated interstate costs of the price cap carrier, and require the carrier to adjust its price cap index to reflect such cost changes.[17] In addition, the low-end adjustment provides that a price cap carrier that has not sought and received pricing flexibility is entitled to adjust its price cap index upward if its earnings (calculated on the basis of regulated costs) during the prior calendar year were below the lower adjustment benchmark, currently 10.25%.[18] Moreover, BOCs that have received pricing flexibility still retain the right to file rates that exceed the applicable price indices, based on their costs.[19]

Allocation Between Regulated and Non-Regulated Activities

If the Commission were to reclassify DSL as a preemptively deregulated information service, Section 32.23 of the Commission's rules requires that DSL costs be

---

[13] 47 C.F.R. § 64.901; *Joint Cost Order*, ¶ 2.

[14] 47 C.F.R. §§ 69.301, *et seq.* and 47 C.F.R. §§ 69.401, *et seq.*

[15] 47 C.F.R. § 61.45(d)(1)(ii-iii), (v).

[16] Qwest's claim that the price cap mechanism "severs the connection between embedded costs and retail rates" is simply incorrect. *See Qwest June 4 Ex Parte* at Slide 3.

[17] 47 C.F.R. § 61.45(d).

[18] 47 C.F.R. § 61.45(d)(1)(vii).

[19] 47 C.F.R. § 61.49(d); *see also Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, ¶¶ 300-304 (1990).

treated as non-regulated.[20] Section 64.901 of the Commission's rules then would govern the separation of Part 32 costs between regulated and non-regulated activities. That rule requires that costs be directly assigned to either the non-regulated or the regulated activity wherever possible.[21] Equipment that is used only for DSL service, such as the DSLAM, could likely be directly assigned to the non-regulated activity. Under the Commission's rules, common costs must be allocated between regulated and non-regulated activities. Outside plant investment costs (such as loop) must be allocated based on relative regulated and non-regulated usage.[22] Therefore, loop plant, which would be used for both regulated traditional voice service and non-regulated DSL, would need to be allocated between regulated and non-regulated activities, based on usage.

The allocation of common costs associated with the loop, as the BOCs note, is complex.[23] In the context of similar situations in the past, the FCC has provided guidance on the allocator that should be used. The Commission, however, currently has a record that is inadequate to determine the best allocator for assigning DSL loop costs; consequently, this issue must be the subject of a further notice. Thus, if the Commission wished to consider reclassifying DSL, it first must seek comment on several alternative allocators that could be used to apportion loop costs, including allocation based on bandwidth, or the 50/50 split proposed in the Commission's Notice of Proposed Rulemaking regarding open video systems.[24] In addition to loop costs, there may be other common costs that need to be allocated, such as the costs of transport, and perhaps the splitter. The FCC may also wish to provide guidance on allocation factors for those costs.

Exogenous Adjustments to Price Cap Indices

If DSL were treated as non-regulated, Part 61 of the Commission's rules would also require certain downward adjustments to the price cap indices (PCI), which likely would lead to downward adjustments to interstate access rates. As described above, Section 61.45(d)(1)(v) requires exogenous changes to the PCI caused by the "reallocation of investment from regulated to nonregulated activities pursuant to § 64.901 of this chapter."[25] The rules direct that exogenous cost changes be apportioned on a cost-

---

[20] 47 C.F.R. § 32.23. Information services have been preemptively deregulated. *Joint Cost Order*, ¶ 20. The BOCs have requested that the Commission reclassify DSL as an information service, and preempt the states from regulating DSL. *See, e.g., Verizon June 26 Ex Parte* at 1, 5.

[21] 47 C.F.R. § 64.901(b)(2).

[22] 47 C.F.R. § 64.901(b)(4).

[23] *See Qwest June 4 Ex Parte* at 4.

[24] *Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services*, Notice of Proposed Rulemaking, 11 FCC Rcd 17211, ¶ 39 (1996).

[25] 47 C.F.R. § 61.45(d)(1)(v).

causative basis between price cap services as a group, and excluded services as a group.[26] In addition, total exogenous cost changes thus attributed to price cap services must be "recovered from services other than those used to calculate the ATS charge."[27] As transport and local switching elements are excluded from such adjustments (because they are used to calculate the ATS charge), the required downward adjustments would apply principally to the indices for common line and special access.

Response to Specific Arguments Made by Verizon

Billing and Collection

Verizon erroneously concludes that the Commission's treatment of billing and collection service is relevant to the accounting treatment of DSL as an information service.[28] As described above, the Commission has treated all preemptively deregulated services, including information services, as non-regulated for accounting purposes.[29] Billing and collection service, however, was not preemptively deregulated, and in the *Joint Cost Order*, the FCC explained that billing and collection would be treated as regulated for accounting purposes.[30] The FCC determined that it was not necessary to treat billing and collection as a non-regulated activity in order to address its potential concerns regarding cost allocation and cross-subsidy issues.[31] Because Part 69 rules already had established a separate rate element for costs associated with billing and collection, costs were assigned to that rate element, and not recovered through charges for other services, such as local switching. Consequently, the FCC determined that there likely was no practical consequence to using Part 69 rules (rather than Part 64 rules) to remove costs attributable to interstate billing and collection service.[32]

By contrast, information services have been preemptively deregulated, and Verizon has sought the same treatment for DSL services.[33] Consequently, the relevant FCC precedents are the treatment of information services and other preemptively deregulated activities.

Moreover, while the FCC's Part 69 rules assign interstate billing and collection costs to a rate element independent of interstate access elements, there is no separate DSL

---

[26] 47 C.F.R. § 61.45(d)(3).

[27] *Id.* ATS stands for Average Traffic Sensitive, and is the sum of the Local Switching and Transport components. 47 C.F.R. § 61.3(e).

[28] *Verizon June 26 Ex Parte* at 3.

[29] 47 C.F.R. § 32.23.

[30] Billing and collection for interstate services was detariffed, but the Commission did not preempt state regulation of billing and collection. *Joint Cost Order*, ¶ 80.

[31] *Id.*, ¶ 81.

[32] *Joint Cost Order*, ¶ 81.

[33] *Verizon June 26 Ex Parte* at 2, 5.

rate element. Some costs associated with the provision of DSL services, for example, the DSLAM, may be assigned entirely to special access.[34] Other costs, such as the cost of the loop, are clearly common to DSL and other services. Furthermore, while DSL is tariffed only in the interstate jurisdiction, certain costs associated with DSL, including loop costs, appear to be separated between the state and interstate jurisdictions.[35] Consequently, the FCC cannot conclude, as it did with respect to billing and collection, that declining to treat DSL as non-regulated (assuming DSL were reclassified as an information service) raises no significant risk of misallocation of costs between jurisdictions.[36]

Section 254(k) Arguments

The Commission also should reject summarily Verizon's specious claim that the FCC can ignore the cost allocation issues because "all services are now subject to competition and market forces protect against cross-subsidization."[37] As Verizon well knows, most local services offered by incumbent LECs are not yet competitive, particularly for traditional mass market voice services, which rely on exactly the same loop facilities that are used for mass market DSL. Given the state of local competition, it is absurd to suggest that there is no opportunity for an incumbent LEC to use its non-competitive monopoly services to subsidize services for which it faces competition.

Verizon also makes the odd claim that Section 254(k) of the Act "could not affect the allocation of loop costs."[38] Verizon asserts that all the costs of the loop are incurred simply to provide voice-grade access, and that there can therefore be no improper cross-subsidy, even if none of the costs of the loop are recovered from charges for DSL services. Section 254(k), however, expressly requires that "services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."[39] Verizon's argument appears

---

[34] Letter from Mary Henze, BellSouth, to Jane Jackson, FCC, attached to Letter from Mary Henze, BellSouth, to Marlene Dortch, Secretary, FCC, at 1 (July 8, 2003) (*BellSouth July 8 Ex Parte*).

[35] *See BellSouth July 8 Ex Parte.*

[36] *See Joint Cost Order*, ¶ 81. Verizon's argument with respect to the *Separations Freeze Order* and the need to minimize uncertainty is a red herring. *See Verizon June 26 Ex Parte* at 3. Verizon notes that if DSL is treated as a non-regulated activity, this could lead to "further corrective pricing action by either state or federal regulators." *Id.* That is because corrective pricing action would be necessary to ensure that competitive services were not being subsidized by non-competitive services. The best way to achieve certainty is to refrain from reclassifying DSL service. The invocation of the need for "certainty" in the separations process is an argument that should be accorded no weight.

[37] *Verizon June 26 Ex Parte* at 6.

[38] *Verizon June 26 Ex Parte* at 7.

[39] 47 U.S.C. § 254(k).

to assume that 100% of common costs is a reasonable share, and essentially renders Section 254(k) meaningless.

In an analogous situation, in *Smith v. Illinois Bell*, the Supreme Court held that when facilities are used for multiple different services (local exchange, intrastate toll and interstate toll) it is improper to allocate 0% of the costs to one of the services (interstate toll).[40] The Court found that Illinois Bell improperly had attributed 100% of the costs of its exchange property to the intrastate jurisdiction. "While the difficulty in making an exact apportionment of the property is apparent, and extreme nicety is not required, only reasonable measures being essential, it is quite another matter to ignore altogether the actual uses to which the property is put. It is obvious that, unless an apportionment is made, the intrastate service to which the exchange property is allocated will bear an undue burden – to what extent is a matter of controversy."[41] In this case, the failure to assign any of the common loop costs to DSL service similarly would impose an "undue burden" on subscribers to regulated voice service.

Conclusion

The Commission should continue to classify DSL as a Title II service. If it does not, however, it must act consistently, and it must act lawfully. The Act requires that the FCC have effective cost allocation rules in place before making a determination regarding the reclassification of DSL services. The development of the necessary record requires a further notice of proposed rulemaking. Pending development of that record and adoption of appropriate rules, the Commission must defer any action in the *Broadband Framework* proceeding that would involve reclassifying services.

Sincerely yours,

/s/ Richard S. Whitt

Richard S. Whitt

---

[40] *Smith v. Illinois Bell*, 282 U.S. 133 (1930).

[41] *Id.* at 150-51 (citation omitted).