

C. Loop Costs

While AT&T/WorldCom try to make much of the marginal \$0.67 increase in Verizon VA's basic, two-wire statewide average loop rate, the fact remains that the loop rates produced by the *Order* remain lower than the New York benchmark — and New York is a state that has itself applied TELRIC aggressively. And the *Order* slashes high capacity loop rates by approximately 50%. These dramatically below-cost rates result from the *Order*'s decision to rely on a fundamentally flawed model and to adopt flawed inputs, and to set high capacity loop rates on the basis of calculations having nothing to do with cost at all.

1. The *Order* Erred in Relying on AT&T's Modified Universal Service Model

The *Order*'s adoption of the CLECs' modified version of the Commission's universal service Synthesis Model is contrary to the Commission's repeated pronouncements that this model is inappropriate for use in setting UNE rates. Thus, AT&T/WorldCom are wrong that their model "was the clear choice on the record in this case for developing forward-looking TELRIC loop prices." AT&T/WCom Opp. at 40. The Commission has explicitly found that "the USF cost model should not be relied upon to set rates for UNEs."^{42/} As the Commission explained, it "has never used the [universal service] cost model to determine rates for a particular element, nor was it designed to perform such a task."^{43/} Indeed, just recently, in the *TELRIC*

^{42/} Memorandum Opinion and Order, *Joint Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma*, 16 FCC Rcd 6237, 6277 ¶ 84 (2001) ("Kansas/Oklahoma 271 Order").

^{43/} Memorandum Opinion and Order, *Application by Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and Verizon Select Services Inc., for Authorization to Provide In-Region, InterLATA Services in Maine*, 17 FCC Rcd 11659, 11679 ¶ 32 (2002) ("Maine 271 Order"). See also VZ-VA AFR at 36-37 (citing cases).

NPRM, the Commission reiterated that its universal service model does not “provide *any* systematic guidance to states in the area of TELRIC rate-setting.” *TELRIC NPRM* ¶ 46 (emphasis added)

AT&T/WorldCom argue that “various adjustments” they made to the Commission’s original universal service model somehow “address any concerns about the appropriateness of using the [model] to develop UNE costs.” AT&T/WorldCom Opp. at 41. Those “adjustments,” however, do not make AT&T/WorldCom’s model any more appropriate for modeling Virginia UNE costs. Instead, they are simply designed to reduce the costs produced by the Commission’s original model. *See e.g.*, VZ-VA Reply Br. at 133-35; VZ-VA Ex. 109 at 5-6; VZ-VA Initial Br. at 146-147 (demonstrating model’s failure to use data specific or relevant to Virginia, and delineating “adjustments” that AT&T/WorldCom allege “fix” their model but which both the Commission and numerous states have rejected, including coding changes affecting drop terminal orientation and lot size/configuration; structure sharing inputs; plant mix assumptions; and DLC input values).

Nor do AT&T/WorldCom even address the fact that their model is entirely incapable of measuring certain key costs. For example, AT&T/WorldCom ignore the fact that their model is insensitive to changes in the make-up of DLC technologies, even though the *Order* acknowledges that such technologies are a “key loop investment component.” *Order* ¶ 303. Similarly, AT&T/WorldCom simply gloss over the fact that their model cannot measure the costs of high capacity loops, leaving them to make up these rates based on fictional ratios.

The *Order* accordingly erred in relying on the CLECs’ model. It instead should have adopted Verizon VA’s loop cost models. Contrary to the CLECs’ claims, the *Order* does not find that Verizon VA’s model is inconsistent with TELRIC. In fact, the *Order* specifically notes

that it is *not* making any such determination when it chose AT&T/WorldCom's model. *See Order* ¶ 49. And at minimum, the *Order* was *required* to use Verizon VA's models in those instances where the CLECs' model is incapable of producing costs at all, such as for high capacity loops.

2. The *Order's* DS3 and DS1 Loop Rates Must Be Rejected.

AT&T/WorldCom offer no response to Verizon VA's showing that the high capacity loop rates set by the *Order* are not cost-based and are inappropriately derived from a model that is incapable of measuring high capacity loop costs. Rather than measure DS1 and DS3 loop costs at all, the *Order* simply adopts rates for such loops by applying ratios proposed by AT&T/WorldCom to the 2-wire loop rates produced by their modified version of the universal service model. Even the *Order* concedes, however, that these ratios are "lack[ing] [in] thoroughness and clarity," *Order* ¶ 341, and the Bureau was "unable . . . to identify the starting point for the AT&T/WorldCom calculations." *Id.* ¶ 341 & n.888.

These "ratios" do not account for any actual cost relationships between 2-wire and high capacity loop rates, and no such fixed cost relationship exists. *See VZ-VA AFR* at 39-41. In fact, as Verizon VA showed, the costs of DS1s vary depending on whether copper or fiber facilities are used to serve those loops, which in turn may reflect the geographic area in which specific high capacity loops are provided. *See id.* at 40. The costs of basic two-wire loops do *not* vary in the same way, and accordingly there is no generalized, predictable relationship between the two types of loops. *See id.* Similarly, DS3 loops are provided exclusively over fiber and use electronics that are never found in the two-wire loop, and are almost always provided to large business customers who typically are located only in select areas rather than throughout

Verizon's service territory. *See id.* at 40-41. The costs of a DS3 loop provided in Virginia thus would not vary in a manner that bears any relationship to average 2-wire loop costs. *See id.*

AT&T/WorldCom do not dispute these facts. Instead, they seek to rely on post-hoc attempts to justify their ratios. But these attempts fail. First, they argue that the ratios they propose are at least close to some of the relationships that are illustrated in the chart Verizon VA produced showing loop rates in other jurisdictions. *See VZ-VA AFR Ex. A.* The CLECs simply miss the point. The fact that the ratios of two-wire loop rates to DS1 rates in other jurisdictions range from 4.8 to 11.5, for example, demonstrates the absence of *any* fixed cost relationship between basic and high capacity loops.

Next, AT&T/WorldCom suggest that their ratios are defensible because they are “similar to the relationship between two-wire loop rates and DS1/DS3 rates proposed by Verizon in this case.” AT&T/WCom Opp. at 43. But as Verizon VA has shown, ratios are *not* a valid means of assessing the specific costs of any of the facilities involved. And in any event, the 6.1 ratio derived from a comparison of Verizon VA's proposed DS1 and two wire loop rates is hardly “similar” to the 4.3 ratio adopted in the *Order*. Indeed, applying the 6.1 ratio to the *Order*'s \$14.43 2-wire loop rate, *Order* App. E, would produce a statewide average DS1 loop rate of \$88.02 — *more than 41% higher* than the \$62.05 rate adopted by the *Order*. *See id.* And if Verizon VA's 10.0 ratio of DS3 to DS1 rates were then applied to that \$88.02 rate, this would produce a DS3 rate of \$880.20 — *more than 47% higher* than the \$595.96 DS3 rate adopted by the *Order*. *See id.* Thus, the supposed similarities the CLECs cite justify neither the ratios nor the rates adopted by the *Order*.

Finally, AT&T/WorldCom fall back on the procedural argument that Verizon VA should have proposed adjustments to the CLECs' proposed ratios, rather than relying on Verizon VA's

own models. See AT&T/WCom Opp. at 42. But the ratio approach proposed by AT&T/WorldCom and adopted by the *Order* is fundamentally nonsensical: it cannot be fixed by a handful of “adjustments.” The Bureau was obligated to assess the *costs* of high capacity loops, and neither the CLECs’ model, nor their proposed “ratio” methodology, can do so. In contrast, Verizon VA submitted models that produced cost-based rates for all high capacity loops. Indeed, the DS3 rates proposed by Verizon VA are based on a model the *Order* specifically finds is compliant with TELRIC and that the *Order* adopts for purposes of setting transport rates. See *Order* ¶ 503. In these circumstances, the *Order* should have adopted Verizon VA’s models to set high capacity loop rates. See *Order* ¶ 554 (adopting Verizon VA’s models where AT&T/WorldCom’s could not calculate relevant costs).

The *Order*’s adoption of arbitrary ratios results in DS1 and DS3 loop rates that are as much as 54% lower than the rates that the Commission found to comply with TELRIC less than one year ago. These new rates, in combination with the new EEL conversion rules adopted by the Commission in the *Triennial Review Order*, will further encourage CLECs to convert special access services to EELs, thus threatening “severe consequences” for the special access market. See Supplemental Order Clarification, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 15 FCC Rcd 9587, 9597 ¶ 18 (2000). Although AT&T/WorldCom claim that the Commission need not be concerned about this consequence because DS1 and DS3 loops “constitute an insignificant fraction of the UNEs provided by Verizon” to CLECs in Virginia, AT&T/WCom Opp. at 9, the dramatic reductions in high capacity loop rates produced by the *Order* inevitably and quickly will lead to massive conversion of special access services to EELs using high capacity loops.

3. The *Order's* Adoption of AT&T/WorldCom's Distribution Fill Factor Has No Rational Basis.

The fill factors proposed by AT&T/WorldCom and adopted in the *Order* are inconsistent with the only evidence in the record concerning the utilization levels at which a functional network can operate efficiently. Specifically, Verizon VA's fills reflect its experience operating a real-world network under a price cap regime designed to maximize incentives for efficiency, and its engineers' informed judgments concerning optimal, efficient fill. See VZ-VA Ex. 122, Att K at 119. By contrast, AT&T/WorldCom did not base their proposed fills on any experience with an operational network, and did not bother to show how a network could operate at those levels. See VZ-VA Reply Br. at 80-81; VZ-VA Initial Br. at 159-60. As a result, the *Order* produces an entirely hypothetical and patently unrealistic loop distribution fill factor.

AT&T/WorldCom's attempts to defend the *Order* are without merit. First, AT&T/WorldCom argue that the distribution fill adopted by the *Order* was consistent with the Commission's universal service *Inputs Order*. AT&T/WCom Opp. at 45. But the Commission has repeatedly stressed that it "ha[s] not considered what type of input values, company-specific or nationwide, nor what specific input values, would be appropriate for any other purposes" and further noted that "it may not be appropriate to use nationwide values for other purposes, such as determining prices for unbundled network elements."⁴⁴ Thus, AT&T/WorldCom's claim that "strong state-specific justifications" would be necessary to support *departure* from the universal service model inputs, *id.*, turns on the Commission's clear direction on its head.

⁴⁴ *Inputs Order* at 20172 ¶ 32; Ninth Report and Order and Eighteenth Order on Reconsideration, *Federal-State Joint Board on Universal Service*, 14 FCC Rcd 20432, 20455-56 ¶ 41 (1999) ("[T]he federal cost model was developed for the purpose of determining federal universal service support, and [] it may not be appropriate to use nationwide values for other purposes, such as determining prices for unbundled network elements.").

In any event, Verizon VA submitted real-world data showing the efficient levels of average distribution fill necessary to operate the Virginia network. Those data provide compelling evidence that the non-specific, universal service cost inputs are *not* appropriate here. AT&T/WorldCom argue that the *Order* appropriately rejects Verizon VA's extensive testimony and evidence because "Verizon submitted no optimization analysis in support" of its fill factors. AT&T/WCom Opp. at 46. But Verizon VA's evidence is the result of a rigorous "optimization analysis" conducted in the real world: it reflects the efforts of Verizon VA's engineers to optimize the network to meet customer demand, performance objectives, and carrier of last resort obligations, under the efficiency-enhancing conditions created by price caps and increasing competition. *See e.g.*, VZ-VA Ex. 107 at 35-40, 100-116; VZ-VA Ex. 122 at 104-42.

In response, AT&T/WorldCom offered nothing but the unsubstantiated opinions of its "expert" about the fill levels that AT&T/WorldCom would like to see. AT&T/WorldCom provided no real world evidence whatsoever about *how* such fill levels could be attained in the network without jeopardizing performance or substantially increasing maintenance and other operating costs. For example, AT&T/WorldCom produced no evidence that their fill inputs produce cable sizes that correspond to cable sizing guidelines in use by *any* local exchange carrier, much less an incumbent local exchange carrier that must meet the service quality standards that are imposed on Verizon VA. Indeed, the only evidence they point to even now is their witness's claim to have "directed operations that had a distribution fill factor in excess of the effective fill in the [AT&T/WorldCom model]." AT&T/WCom Opp. at 46. But that witness acknowledged during the hearings that he was not aware of any network that has achieved the network-wide average that AT&T/WorldCom propose. Tr. at 4513-4515 (Riolo).

AT&T/WorldCom next try to defend the *Order* by arguing that Verizon VA's fill factor is inaccurate. But these efforts also fail. AT&T/WorldCom first point to 1997 GTE engineering guidelines that they contend show that fill should be higher. See AT&T/WCom Opp. at 48. But as Verizon VA has explained repeatedly, those guidelines specifically apply to a service area that is significantly more rural than Verizon VA's service area and would produce much *higher*, inefficient operating expenses in Verizon VA's service area. See VZ-VA AFR at 43 n.54; VZ-VA Reply Br. at 80 n.69. AT&T/WorldCom do not respond to this explanation.

AT&T/WorldCom also suggest that Verizon VA's fill is higher than Verizon VA reports, because they assert idle and defective lines should not be treated as spare. AT&T/WCom Opp. at 46. But as Verizon VA showed, because such lines are by definition *not* producing revenue, they properly are treated as spare. any other approach would understate costs. See VZ-VA Ex. 122 at 115-117; Tr. at 4511 (Gansert); VZ-VA Br. at 106 n.109. Finally, AT&T/WorldCom try to show that Verizon VA's fill factor assumes absurd results in which an additional line would be put in for *every* line to every household, contrary to engineering guidelines. AT&T/WCom Opp. at 47-48. But this argument misrepresents Verizon VA's model, pretending that Verizon VA allocates spare distribution capacity on a per line rather than a per household basis. The *Order* properly ignored this nonsensical argument.

AT&T/WorldCom's final argument is that Verizon VA's fill factor improperly includes spare that will be used to accommodate *future* demand and, therefore, some of the costs ought to be borne by future ratepayers. AT&T/WCom Opp. at 49-50. But as Verizon VA showed in its application for review and before the Bureau, this criticism is fundamentally flawed. The spare distribution capacity included in Verizon VA's model is *not* designed primarily to serve future demand. Instead, spare is needed for *current* demand spikes and fluctuations, churn,

administrative and operational purposes, and other critical current needs. See VZ-VA Reply Br. at 82; see also VZ-VA Ex. 107 at 108-15; VZ-VA Ex. 122 at 118-24, 130-34. For this reason, spare in the network is a *current* network cost that *today's* customers should properly absorb.

AT&T/WorldCom's effort to undermine this point by pointing to the fact that Verizon VA builds distribution cable to serve "ultimate demand," AT&T/WCom Opp. at 51, is based on a misunderstanding of what that term means. As Verizon VA explained, "ultimate demand" "merely refers to allocating two or more distribution pairs per living unit in order to handle however many lines" the residents will require at any given time. VZ-VA Reply Br. at 84. The "demand" at issue is not *future* demand, but the uncertain demand of *current* customers, who may demand a second line for Internet access or a line for a teenager in the home, for example, at any given moment in time, suddenly requiring the availability of additional capacity.^{45/} *Id.*; see also VZ-VA Ex. 107 at 114-15; VZ-VA Ex. 122 at 119-20; Tr. at 4116-17 (Gansert)

Spare capacity remains stable over time so that such *current* demand and operational needs may continue to be met across the network as a whole. See VZ-VA Ex. 122 at 106, 117. While *individual* facilities (or neighborhoods) may fill up at a given point in time, fill factors in the network as a whole remain relatively constant over time due to churn and other factors. *Id.* Spare capacity in the network is thus not reserved for the future, but critical for the network *today*. Thus, the revenues from future customers should *not* properly be credited toward the spare capacity that exists *today*, as AT&T/WorldCom and the *Order* suggest. See AT&T/WCom

^{45/} This uncertain demand also illustrates why AT&T/WorldCom's suggestion that a forward-looking network could contain less spare because it could account for — and build — less spare in areas where demand has historically been low is wrong. See AT&T/WCom Opp. at 48. Demand can change in an instant: a new family might move into the neighborhood and order additional lines, for example. Verizon VA is *required* to have spare available to serve that order.

Opp at 50, 52; *Order* ¶ 254. Rather, future customers will properly be charged for the average amount of spare capacity that will exist in the network at that future date, to serve *those* customers' needs.

In sum, the fill factors Verizon VA proposed were realistic, efficient, and forward-looking, and there was no basis for the *Order* to reject them. Thus, the Commission should reject the *Order*'s reliance on the distribution fill used in AT&T/WorldCom's model. The *Order* could and should have adopted the alternative distribution fill factor that Verizon VA submitted in its restated version of AT&T/WorldCom's model. See Verizon VA Modified Synthesis Model Runs (Dec. 12, 2001) ("VZ-VA Ex. 204"). That "restated distribution factor" shows how the *Order* could have relied on Verizon VA's fill evidence even while using AT&T/WorldCom's model. The *Order*'s suggestion that Verizon VA did not specifically propose an adjustment to distribution for the modified universal service model, *Order* ¶ 256, is therefore wrong.

D. DCS and Multiplexing Should Not Be Excluded from Certain Dedicated Transport Services Rates.

The *Order* requires Verizon VA to establish four rate options for each capacity level of dedicated interoffice transport (*e.g.*, DS1, DS3, and OC3): with digital cross-connects ("DCS") and multiplexing, with only DCS, with only multiplexing, and with neither DCS nor multiplexing. *Order* ¶ 511. But, as AT&T/WorldCom acknowledge, transport rates should include the costs of DCS and multiplexing that is "necessary to originate or terminate the interoffice transport." AT&T/WCom Opp. at 78. Since the *only* DCS and multiplexing costs that Verizon VA included in its studies are "necessary" rather than optional costs, the various rate options the *Order* requires that exclude DCS, multiplexing, or both should be stricken. Verizon Virginia Recurring Cost Panel Direct Testimony at 215 (July 31, 2001) ("VZ-VA Ex. 107").

AT&T/WorldCom concede in their opposition that the costs for DCS and multiplexing that are required for the transport service must in fact be included in the transport rates. In particular, AT&T/WorldCom now acknowledge that interoffice transport rates *should* include the costs of multiplexing that is performed by the SONET terminal equipment on each end of the interoffice transport circuit. *See* AT&T/WCom Opp. at 78. This should end any debate about whether Verizon VA should be required to offer transport-only rates for transport at the DS3 level or above. The *only* DCS or multiplexing functions that are included in Verizon VA's costs for DS3 and higher-capacity level interoffice transport are functions that are either integrated within the SONET terminal equipment or provide direct connection of the dedicated transport circuit to the SONET equipment at the requested dedicated transport capacity level. In both cases, the functions are critical to the provision of the requested service, not optional, and thus, under even AT&T/WorldCom's standard, are properly included in the transport rate. Indeed, the sole category that AT&T/WorldCom target for exclusion from the interoffice transport rate — multiplexing functions between the SONET terminal equipment and the handoff to the CLEC customer — are not included in Verizon VA's dedicated transport cost model.

Accordingly, the Commission should rule that Verizon VA is *not* required to offer DS3 (or higher levels) interoffice transport rates that exclude DCS or multiplexing functions. Eliminating all multiplexing from such services, as the *Order* seems to suggest, could be accomplished only by eliminating the SONET terminal equipment altogether, which would leave bare interoffice fiber cable. As AT&T/WorldCom now concede, AT&T/WCom Opp. at 78, and as Verizon VA pointed out in its application for review, VA-VZ AFR at 48, that is not functional transport. Eliminating all DCS investments is likewise impossible because the only means of providing DS3 and higher transport *without* such DCS would be exceedingly expensive, manual

cross-connection activities that are not even always achievable in highly complicated central offices, and that in any event are not accounted for in the rates proposed by the parties or ordered by the Bureau. Thus, removing the DCS either means that Verizon VA cannot provision the transport at all, because it would have no way to provide the necessary cross connect and related functions, or that CLECs will claim (erroneously) that they may obtain transport that includes the benefits of this DCS equipment without paying for it.

For similar reasons, the Commission should also reverse the *Order's* requirement with respect to *DS1* transport rates. AT&T/WorldCom argue that the CLECs should be free to purchase multiplexing or DCS that is *not* housed within the SONET terminal equipment, which is the case with *DS1* interoffice transport, "at their option." AT&T/WCom Opp. at 78. But that makes no sense. Notably, even AT&T/WorldCom contend that the only costs that should *not* be included in the price of transport are the costs of "multiplexing or DCS equipment [that] is not *necessary* to originate or terminate the interoffice transport at the speed (e.g. *DS1*, *DS3*, etc.) requested by the CLEC." *Id.* at 78 (emphasis added). But Verizon VA's model assumes no multiplexing functions for *DS1* transport that are *not* necessary, and thus the requirement in the *Order* is incongruous.

Multiplexing is necessary for *DS1* transport because the optical lines of interoffice SONET systems operate at capacities of OC-3 or higher. See VZ-VA Ex. 107 at 216. Thus, in order to provide *DS1* transport, multiple *DS1* channels must be multiplexed, or combined, into a single higher rate channel at some point between the CLEC service interface in the terminal wire centers and the optical line of the interoffice SONET systems. Verizon VA's studies make the forward-looking design assumption that part of this multiplexing of *DS1* services (specifically, *DS1* to *DS3* multiplexing) occurs before the lines are connected to the SONET terminal

equipment. This combination is accomplished in either a traditional, stand-alone multiplexing device or as an integrated function in a DCS system. AT&T/WorldCom never suggested that a different approach to the one in Verizon VA's forward-looking design was preferable, and the Bureau agreed that Verizon VA's transport model "assumes the deployment of the most efficient technology currently available for interoffice transport." *Order* ¶ 503.

Thus, the multiplexing and DCS functions that Verizon VA included in its transport model for DS1 transport are "necessary to originate or terminate the interoffice transport at the speed [DS1] . . . requested by the CLEC." AT&T/WCom Opp. at 78. Indeed, there is no such thing as DS1 interoffice transport *without* multiplexing.^{46/} As the *Non-Cost Order* concludes, "in order to provide the channelizing functionality of dedicated transport, Verizon *must provide multiplexing.*" *Non-Cost Order* ¶ 499 (emphasis added). A fictional DS1 transport rate that excludes traditional or DCS multiplexing would either compel Verizon VA to provide DS1 transport without being permitted to recover its costs, which would create a subsidy for the CLECs, or would make it impossible for Verizon VA to provide DS1 transport at all. Since multiplexing must be provided as a necessary part of DS1 transport, Verizon VA must have the right to recover for such multiplexing in its transport rates.^{47/}

^{46/} Of course, a CLEC can purchase multiple DS1 loops, and provide its own multiplexing to aggregate those individual DS1s onto a single DS3 circuit. But this does not involve the purchase of DS1 *transport*. To the contrary, in that scenario, the interoffice *transport* link the CLEC would purchase from Verizon VA would be a DS3 interoffice transport circuit. *Non-Cost Hearing Tr.* at 408-411 (Gansert).

^{47/} As Verizon VA showed in its application for review, it also makes no sense for CLECs to be able to elect whether to purchase DS1 transport with DCS versus DS1 transport with multiplexing: Verizon VA could not practically comply with that requirement, and its effect would simply be to subsidize CLECs who will always choose the option that is less expensive to them, regardless of overall operational efficiency. *VZ-VA AFR* at 49.

The Commission accordingly should reverse the *Order's* requirement that Verizon VA create separate rates for *any* level of dedicated transport that exclude multiplexing and DCS, and should clarify that, in any event, CLECs must pay for the functionalities that they receive when they order dedicated transport from Verizon VA.

II. GLOBAL INPUTS

A. The Cost of Capital Adopted in the *Order* Improperly Fails to Compensate for the Regulatory Risks of Providing UNEs.

The 12.95% cost of capital adopted by the *Order* understates costs. Indeed, that figure is *lower* than AT&T's and WorldCom's own cost of capital figures for evaluating investments. As the Bureau recognized, AT&T has used a cost of capital of 15.31% for general investment purposes. *See Order* ¶ 92 n.268. Further, the cost of capital AT&T uses for evaluating local exchange investments also is [BEGIN AT&T PROPRIETARY] XXXXXXXXXXXXXXXXXXXX [END AT&T PROPRIETARY], as is the corresponding figure for WorldCom, at [BEGIN WORLDCOM PROPRIETARY] XX [END WORLDCOM PROPRIETARY]. *See* AT&T Response to Staff Record Request No. 10 (Oct. 24, 2001); WorldCom Response to Staff Record Request No. 10 (Oct. 24, 2001). Moreover, while the CLECs' own costs of capital are *higher* than the figure adopted in the *Order*, their costs of capital obviously do not reflect the additional risks inherent in the unbundling regime.

Even the *Order* finds that the cost of capital that properly accounts for basic competitive risks should be 13.068%. It adopts Verizon VA's lower number solely under the guise of the "baseball arbitration" rules. *Order* ¶ 104. Given the *Order's* routine disregard for those same rules elsewhere in the *Order*, *see, e.g., Order* ¶¶ 140, 387, 432, 457, its adoption of a 12.95% cost of capital in the face of its own conclusion that the actual cost of capital should have been 13.068% is unsupportable.

More fundamentally, the *Order* errs because the 12.95% cost of capital it adopts fails to account for the regulatory risks that arise from providing UNEs. AT&T/WorldCom do not dispute this omission. Instead, they claim that the *Triennial Review Order* only required the cost of capital to take into account the regulatory risk associated with the provision of new services. AT&T/WCom Opp. at 24-25. While the *Triennial Review Order* specifically acknowledges that a TELRIC cost of capital must take into account “any unique risks (above and beyond . . . competitive risks . . .) associated with new services that might be provided over certain types of facilities,” *Triennial Review Order* ¶ 683, there is no basis to conclude that all *other* regulatory risks can be ignored. It would make no sense to consider the risks associated with new services provided over UNEs, while disregarding the risks inherent in the provision of UNEs themselves. Indeed, the Commission itself has explained to the Supreme Court that the cost of capital must reflect all the “risks associated with the regulatory regime to which a firm [providing UNEs] is subject”^{48/}

Accounting for the regulatory risks inherent in providing UNEs also accords with well-established economic principles. As Verizon VA witnesses Dr. Shelanski, Dr. Vander Weide, and Professor Hausman all explained in their testimony, a proper cost of capital must take into account the regulatory risks of the UNE regime and of TELRIC pricing.^{49/} Failure to do so will “reduce artificially the value of the [use of the] incumbent LEC network and send improper

^{48/} Reply Brief for Petitioners United States and the FCC at 12 n.8, *Verizon Communications, Inc v FCC*, 535 U.S. 467 (Nos. 00-511 *et al.*) (2001) (“FCC Reply Br.”).

^{49/} *Verizon Virginia Inc. Direct Testimony of Dr. Howard Shelanski* at 12-14, 30-31 (July 31, 2001) (“VZ-VA Ex. 101”), *Verizon Virginia Inc. Direct Testimony of Dr. James Vander Weide* at 5, 10, 39-43 (July 31, 2001) (“VZ-VA Ex. 104”); *Verizon Virginia Inc. Rebuttal Testimony of Dr. James Vander Weide* at 3-4, 30-31 (Aug. 27, 2001) (“VZ-VA Ex. 112”); *Verizon Virginia Inc. Surrebuttal Testimony of Dr. James Vander Weide* at 11-12, 20-22, 29-30 (Sept. 21, 2001) (“VZ-VA Ex. 118”).

pricing signals to competitors” and thereby “discourage competitive LECs from investing in their own facilities.” *Triennial Review Order* ¶ 682.

Significantly, neither the *Order* nor AT&T/WorldCom deny that the UNE regime presents significant regulatory risks, such as the risk that CLECs can cancel UNE leases at any time and move to alternative facilities or technologies. Instead, they claim that Verizon VA “waive[d]” the issue AT&T/WCom Opp. at 22-23. They are wrong. Verizon VA presented testimony specifically noting that a provider of UNEs faces unique regulatory risks that must be compensated by UNE prices. In fact, this point was made at length by Dr. Shelanski, Dr. Vander Weide, and Dr. Hausman.⁵⁰ And, while Verizon VA did not include a specific risk premium in its initial cost of capital to account for these added risks at the time the initial cost studies were completed, these witnesses explained that the initial cost of capital proposal would have to be adjusted to reflect these risks. Professor Hausman also offered a calculation of one way to account for these risks in his testimony. *See* VZ-VA Ex. 111 at 18-19 (proposing markup factors). In addition, Verizon VA submitted supplemental evidence that showed that the risks of providing UNEs are similar to the risks inherent in cancelable operating leases because CLECs are generally free to terminate their use of a particular element or of UNEs at any time and instead move to alternative facilities or technologies, leaving the incumbent’s asset to sit idle. Moreover, even if CLECs continue to use the incumbent’s UNEs, they are able to “cancel” their existing UNE leases and renew them at the lower rates that are set every few years based on new hypothetical network assumptions. Verizon VA’s supplemental evidence showed that, applying a well-accepted methodology commonly used to value similar options in financial markets, the

⁵⁰ *See* Verizon Virginia Inc. Rebuttal Testimony of Dr. Jerry Hausman at 3-4 (Aug. 27, 2001) (“VZ-VA Ex. 111”), VZ-VA Ex. 101 at 30-31; VZ-VA Ex. 104 at 40-43; VZ-VA Ex. 112 at 3-4, 30-31; VA-VZ Ex. 118 at 20-22

cost of capital used to set UNE prices in this case should include a 5.41% risk premium. VZ-VA Proffer at 14-17. The Bureau's failure to consider this directly relevant evidence was plain error, and its decision led to a cost of capital that does not, as the Commission's precedent requires, account for all relevant risks.^{51/}

Finally, as Verizon VA explained in its application for review, the *Order* also errs in relying on the Capital Asset Pricing Model ("CAPM") instead of Verizon VA's single-stage Discounted Cash Flow ("DCF") model. VZ-VA AFR at 49-50. Although AT&T/WorldCom suggest that Verizon VA somehow was "not aggrieved" by that choice, Verizon VA clearly is aggrieved by the rejection of its single-stage DCF model in favor of a cost of equity estimate generated by the CAPM: the CAPM is uniquely sensitive to changes in interest rates, and therefore use of this model will create substantial fluctuations in the cost of capital, and the particular cost of capital set at any time will be an accident of timing. Indeed, AT&T/WorldCom now agree that the CAPM should not have been used because it "has not been, and cannot be, fully tested to determine 'whether it fits the facts.'" AT&T AFR at 8 n.4.

As Verizon VA demonstrated in its opposition to AT&T's and WorldCom's applications for review, it would have been far more appropriate to select Verizon VA's proposed single-stage DCF model instead of AT&T/WorldCom's three-stage model. VZ-VA Opp. at 12-15. Simply put, AT&T/WorldCom's model produces illogical results: it generates a *lower* cost of equity for *higher* risk companies, and its "pick and choose" patchwork of growth rates is demonstrably unrelated to the growth assumptions investors use to value companies. *See id.* at

⁵¹ See, e.g., *United Mine Workers of Am. v. Dole*, 870 F.2d 662, 673 (D.C. Cir. 1989) (failure to supplement the record may raise serious doubts "about whether the agency chose properly from the various alternatives open to it"); see also *Radio-Television News Dirs. Ass'n v. FCC*, 184 F.3d 872, 888 (D.C. Cir. 1999) ("The FCC retains discretion to . . . reopen the record, to ensure that it fully accounts for relevant factual and legal developments . . .").

13-14. By contrast, Verizon VA's model results in a highly significant correlation between growth rates and stock prices, indicating that this approach accurately reflects the way investors value stocks. See VZ-VA Ex 192. Moreover, as the *Order* itself notes, the "constant growth DCF model has been widely accepted by regulators for many years," and the Commission itself used this model to derive the 11.25% cost of capital it has stated should be the starting point for determining a TELRIC cost of capital. *Order* ¶ 73 n.224. Thus, while the *Order* is right to reject AT&T/WorldCom's three-stage DCF model, it should have adopted Verizon VA's DCF model rather than the CAPM.

B. The *Order* Should Have Adopted Depreciation Lives Based on GAAP.

Verizon VA's proposed GAAP depreciation lives are accurate and forward-looking, and the *Order* should have adopted them rather than the outdated regulatory depreciation lives. That result was required by the Commission's fundamental requirement, reiterated in the *Triennial Review Order*, that TELRIC depreciation lives "should reflect any factors that would cause a decline in asset values, such as competition or advances in technology." *Triennial Review Order* ¶ 685. Verizon VA's GAAP lives, which are regularly reset and are specifically designed to account for such factors, comply with this principle. In contrast, the outdated lives adopted by the *Order* do not.

AT&T/WorldCom argue that the *Triennial Review Order* does not mandate the adoption of financial lives, but instead "leav[es] the choice of asset lives to the discretion of state commissions based on the best evidence of record." AT&T/WCom Opp. at 26. But in this case, Verizon VA's GAAP lives are the best, and indeed the only, "evidence of record" that "reflects the actual useful life of an asset that would be anticipated in a competitive market." *Triennial Review Order* ¶ 688. GAAP lives reflect the best available estimate of the effect of existing and

future competitive conditions on economic lives. Of course, even a GAAP analysis overstates the appropriate lives for use in the hypercompetitive TELRIC world because GAAP lives account only for actual anticipated competition, not the hypothetical perfect competition required in a TELRIC world. Nor can GAAP lives ensure recovery where rates are reset every few years. Indeed, the Commission's own staff recently concluded that, "if investment costs are falling over time, and the period between TELRIC price adjustments is shorter than asset lives, then traditional TELRIC pricing will not permit incumbents to recover the cost of their investment."^{52/} It therefore clearly made no sense for the *Order* to adopt lives *shorter* than Verizon VA's GAAP lives.

As Verizon VA demonstrated, its GAAP lives, which are the same lives it uses for financial accounting purposes, are intrinsically forward-looking as well as accurate. GAAP lives are designed to provide the most accurate estimate of an asset's economic life based on current information. Thus, GAAP lives specifically account for technological changes, competition, and other factors that may decrease the period during which an asset will produce economic value. *See, e.g.*, Verizon Virginia Direct Testimony of Allen E. Sovereign at 10-11 (July 31, 2001) ("VZ-VA Ex. 105"). Accordingly, GAAP lives are regularly revised — often on an annual or even more frequent basis — to ensure that they account for the most updated information. *See,*

^{52/} David M. Mandy & William W. Sharkey, "Dynamic Pricing and Investment from Static Proxy Models," FCC, Office of Strategic Planning and Policy, OSP Working Paper Series No. 40, at 1 (Sept. 2003). AT&T/WorldCom attempt to downplay the Working Paper's conclusions as unrelated to whether to adopt GAAP lives. AT&T/WCom Opp. at 30 n.28. But the recovery shortfall described in the Working Paper will be larger to the extent regulatory lives are prescribed. Because those regulatory lives are longer than GAAP lives, the gap between the asset lives and the time when TELRIC prices are adjusted would be longer and the shortfall therefore larger.

e.g., Verizon Virginia Direct Testimony of Dr. John Lacey at 4 (July 31, 2002) (“VZ-VA Ex. 105”).

Not surprisingly, then, Verizon VA’s GAAP lives are well within the range of other current estimates of telecommunications asset lives. In fact, Verizon VA’s GAAP lives are significantly *longer* than those used in AT&T’s financial reports: for example, AT&T’s 1999 annual report states that the useful life of network equipment (for both local and long distance service) ranges from 3 to 15 years, as compared to Verizon VA’s useful life of 9 to 50 years. *See* Sovereign Direct at 12; Tr. at 3263-64 (Lee). Verizon VA’s GAAP lives are comparable to those used by WorldCom as well. *See* VZ-VA Ex. 106 at 13 (noting that WorldCom’s stated depreciation life for network equipment is approximately ten years).

AT&T/WorldCom nonetheless contend that “Verizon failed to muster any ‘specific evidence’ to support its assertion that recent technological or competitive developments require even shorter lives.” AT&T/WCom Opp. at 28. But this argument makes no sense: it is a *requirement* of GAAP that factors such as technological and competitive developments be taken into consideration, and Verizon VA’s proposed lives “are in fact compliant with GAAP.” *Order* ¶ 116. As Verizon VA explained in its application for review, Verizon VA is required by *law* to comply with GAAP in its securities filings, which are certified by outside auditors. *See* VZ-VA AFR at 53. No additional evidence that Verizon VA’s lives are GAAP-compliant should be necessary.

AT&T/WorldCom next argue that Verizon VA’s GAAP lives are too short. They insist that GAAP lives are “biased towards the low (shorter) side because they are driven by corporate objectives, including the objective of protecting shareholders, and by the GAAP principle of conservatism, which encourages the accountant to err on the side of overstating costs for

financial reporting when there is uncertainty about their precise level.” AT&T/WCom Opp. at 28-29. Notably, the *Order* does *not* base its decision on the CLECs’ arguments about GAAP’s alleged conservatism; in fact, other than merely acknowledging that the CLECs make this argument, *see Order* ¶ 111, the *Order* never mentions it at all. And in any event, the CLECs have it backwards. As Verizon VA witness Dr. Lacey explained, shorter lives produce higher expenses, lower net income, and lower asset values, all of which may serve to *lower* stock prices rather than raise them. Shorter lives could also be a concern to creditors, causing them to raise the interest rates they charge the company. *See* VZ-VA Ex. 105 at 12-13; Verizon Virginia Surrebuttal Testimony of Dr. John Lacey at 6-7 (Sept. 21, 2001) (“VZ-VA Ex. 119”). Thus, Verizon VA would not have any interest in *understating* depreciation lives. And since Verizon VA uses its GAAP depreciation lives for *all* its operations and in a variety of contexts outside of UNE pricing, the possibility that its lives *might* be adopted in a UNE rate case simply would not provide Verizon VA with an incentive to adopt shorter depreciation lives across the board.

Nor is there anything to AT&T/WorldCom’s assertion that GAAP lives are based on the “principle of conservatism.” As Verizon VA showed, the CLECs’ argument is outdated: Verizon VA’s witness Dr. Lacey, who served on the committee that established GAAP and is a co-author of some of the GAAP principles, explained that in 1993, the Accounting Standards Executive Committee specifically rescinded the standard that implied that a conservative bias might be acceptable. Tr. at 3308 (Lacey). As Dr. Lacey demonstrated, conservatism is no longer included in the “hierarchy of accounting qualities” on which accounting standards are based. Tr. at 3308 (Lacey); VZ-VA Ex. 119 at 3. Indeed, Dr. Lacey explained that this change was made in order to ensure that application of GAAP produced its ultimate goal: the “right answer . . . an unbiased answer, our best answer.” Tr. at 3311-12 (Lacey). AT&T/WorldCom’s

reliance on outdated cases that fail to acknowledge the revisions to GAAP, *see* AT&T/WCom Opp at 29-30, cannot change the fact that accountants responsible for applying GAAP must do so in keeping with current GAAP requirements, which compel accuracy.

There was accordingly no reason for the *Order* to reject Verizon VA's GAAP lives. By contrast, there was ample reason the *Order* should *not* have adopted outdated regulatory lives based on ranges the Commission prescribed in 1994 and updated in 1999. Those lives simply cannot qualify as "forward-looking." AT&T/WorldCom attempt to defend the regulatory lives as reflecting "a rigorous application of forward-looking principles by the Commission, including a 'detailed analysis of each carrier's most recent retirement patterns, the carriers' plans, and the current technological developments and trends.'" AT&T/WCom Opp. at 27 (citation omitted). But the Commission conducted that analysis *nine years ago*, before the passage of the Act and in the context of an entirely different regulatory regime, and the factors it considered have been long since superceded. And while AT&T/WorldCom claim that the Commission "reaffirmed" in 1999 that its lives were forward-looking, AT&T/WCom Opp. at 27, *that* determination is itself four years old. The telecommunications industry has undergone overwhelming competitive and technological developments over the past four years: the explosion of the Internet, the rise in local competition, the increasing substitution of wireless for wireline lines, and the growth in non-traditional sources of competition such as e-mail and instant messaging are all phenomena that developed over that time period. Verizon VA's GAAP lives can and do account for such developments, as well as those that are expected in the foreseeable future today. Regulatory lives that were set in the past cannot. The Commission should reverse the *Order* and adopt Verizon VA's GAAP lives.

C. The *Order* Should Have Adopted the Uncollectible Rate Proposed in Verizon VA's Supplemental Evidence.

The *Order*'s failure to consider the accurate and updated uncollectibles data submitted by Verizon VA results in a drastic understatement of costs. *See* VZ-VA AFR at 54-55. Both the Commission and AT&T have recognized that rates should be set at a level sufficient to compensate carriers for any charges that cannot be collected.^{53/} Because Verizon VA had limited experience with providing UNEs at the time its initial studies were performed, it used a proxy uncollectible figure based on its experience providing access and related services. But Verizon VA's supplemental evidence demonstrates that the uncollectible rate for the provision of UNEs is more than 45 times higher than the proxy figure used in its initial studies. *See id.* The Commission itself has recognized that the uncollectible rate going forward will be many times the historical access proxy rates (on the order of 4% to 5%) even for more stable lines of business.^{54/} The *Order* clearly errs by refusing to consider Verizon VA's updated uncollectibles evidence, and the Commission should reverse that determination.

AT&T/WorldCom fail to offer any reason that Verizon VA's evidence on uncollectibles was properly ignored. Contrary to AT&T/WorldCom's assertions, AT&T/WCom Opp. at 37,

^{53/} *See* Policy Statement, *In the Matter of Verizon Petition for Emergency Declaration and Other Relief*, 17 FCC Rcd 26884, 26889 ¶ 9 (2002) ("the Commission's ratemaking policies for incumbent LECs also account for interstate uncollectibles and provide for their recovery through interstate access charges"); *see also* Letter from James W. Cicconi, General Counsel and Executive Vice President, Law & Government Affairs, AT&T Corp., to Honorable Michael Powell, Chairman, Attachment at pp. 1-2 (July 26, 2002) ("If Verizon believes that the recent bankruptcies of WorldCom and other CLECs warrant a higher allowance than previously approved, Verizon is free to ask state regulators to reopen its UNE prices so that the allowance for uncollectibles may be increased going forward.").

^{54/} Wireline Competition Bureau Staff Study of Alternative Contribution Methodologies, attachment to "Commission Seeks Comment on Staff Study Regarding Alternative Contribution Methodologies," Public Notice, FCC 03-31, at 5-8 (rel. Feb. 26, 2003) ("Staff Study") (assuming uncollectible rates of 4-5%).

Verizon VA's evidence appropriately reflects the long run rate of uncollectibles. The local telecommunications market is only becoming more volatile, and, as new entrants to the local service market, CLECs — particularly those that rely on UNEs rather than making long term investments in their own facilities — inevitably will have a higher rate of default than established firms in a more stable market. As Verizon VA explained, in the last seven years, more than 140 CLECs in Verizon's service areas have filed for bankruptcy and, of those, more than 50 have gone out of business. See Garzillo Decl. ¶ 16 (attached as Ex. A to Verizon Virginia's Motion for Stay (Sept. 29, 2003)).^{55/} Indeed, the trend of increased uncollectibles is evident throughout the telecommunications industry. For example, the uncollectibles for carriers reporting on ARMIS 43-01 (mainly mid-and larger-size ILECs) rose to more than \$2.63 billion in 2001 — an increase of more than 51% over the prior year alone. See Verizon Virginia's Submission of Additional Record Evidence at 5 (Sept. 13, 2002).

AT&T/WorldCom's assertions that Verizon VA could decrease the uncollectible rate by "enforc[ing] the existing rules governing security deposits and advance payments from those CLECs that prove unable or unwilling to pay legitimate Verizon charges," AT&T/WCom Opp. at 38, miss the point. Verizon VA has every incentive to take advantage of these types of

^{55/} See also Varun Grover and Khawaja Saeed, *The Telecommunication Industry Revisited - the Changing Pattern of Partnerships*, Communications of the ACM, July 1, 2003 ("The [telecommunications industry] seems chaotic with valuations of telecom companies dropping . . . and no consistent view of the direction of the structural changes taking place. . . ."); Sandra Ward, *Stunted Growth: A Team of Tech-Telecom Specialists Sees More Static Ahead For Investors*, Barron's Online (Feb. 25, 2002) ("What concerns us is that this could be a dynamic where overcapacity continues to exist. It could be like the steel industry, where companies go into bankruptcy, restructure, come back and lower prices, and still find themselves not making it." (quoting industry analyst Scott Cleland)); Roger Crockett, *End of the Telecom Turmoil?*, Business Week Online, Aug. 22, 2002 ("Analyst Glenn A. Waldorf of UBS Warburg thinks that every telecom upstart [i.e., CLEC], except Time Warner Telecom, will have to restructure its debt, in most cases by going the Chapter 11 route.").

protections and already does so. Indeed, it has requested that the Commission impose even more rigorous protections to help incumbents guard against increased uncollectible charges from CLECs that declare bankruptcy.^{56/} But despite its vigorous attempts to collect what it is owed, Verizon VA's uncollectibles have increased. *See Verizon Virginia's Submission of Additional Record Evidence at 5.* The CLECs' suggestion that Verizon VA is somehow "inefficient" in its use of these security arrangements is both ironic and hypocritical: AT&T itself forcefully *resists* the inclusion of such protections when negotiating interconnection agreements with Verizon.^{57/}

Finally, the *Order* compounds the underrecovery caused by its refusal to consider Verizon VA's updated uncollectibles evidence by prohibiting Verizon VA from collecting disconnect charges at the time of connection. Although the *Order* claims that Verizon VA could account for any shortfall in recovery through its uncollectibles factor, it does not even propose its own upward adjustment to Verizon VA's uncollectibles figure. *See Order* ¶ 598.

Like AT&T/WorldCom's substantive objections to Verizon VA's uncollectibles evidence, their procedural criticisms of this evidence are meritless. AT&T/WorldCom claim that Verizon VA somehow "waived" its right to have this evidence considered because it was not presented until after the close of the record. AT&T/WCom Opp. at 35-37. But this ignores the fact that the Bureau had both the authority and the obligation to consider this critical and directly

^{56/} See Policy Statement, *Verizon Petition for Emergency Declaratory and Other Relief*, 17 FCC Rcd 26884 (2002).

^{57/} See, e.g., Panel Direct Testimony of AT&T Communications of New Jersey, L.P. *et al.*, *Application of AT&T Communications of NJ, L.P., TCG Delaware Valley, Inc. and Teleport Communications of New York Petition for Arbitration of Interconnection Rates, Terms and Conditions and Related Arrangements with Verizon New Jersey Inc. Pursuant to Section 252(b) of the Telecommunications Act of 1996*, BPU Docket No. TO00110893, at 198-201 (N.J. Bd. of Pub. Utils. Feb. 25, 2003) (arguing against inclusion of advance payment provision in interconnection agreement).

relevant evidence in light of marketplace and legal developments since the record in this case closed.^{58/} Indeed, the Commission's rules would have permitted the Bureau to consider this evidence on reconsideration: it makes no sense, therefore, to suggest that the Bureau was barred from doing so when Verizon VA presented this evidence almost one year before the decision was issued.^{59/} See 47 C.F.R. § 1.106(b)(2)(1).

AT&T/WorldCom's claims that Verizon VA is attempting to selectively reopen the record only with respect to issues that are favorable to Verizon VA, AT&T/WCom Opp. at 36, 38-39, are simply untrue. Verizon VA specifically and repeatedly requested that *all* parties be permitted to supplement the record with evidence of significant new developments.^{60/}

AT&T/WorldCom's objections to Verizon VA's supposed "piecemeal reopening of the record" are further undermined by AT&T/WorldCom's defense of the *Order's* decision to permit *the CLECs* to selectively supplement the record with respect to non-recurring costs. As discussed below, the *Order* permits AT&T/WorldCom to introduce new evidence concerning work times and occurrence factors for various non-recurring tasks that were not included in AT&T/WorldCom's non-recurring studies. AT&T/WorldCom defend this decision on the

^{58/} See, e.g., *United Mine Workers*, 870 F.2d at 673 (failure to supplement the record may raise serious doubts "about whether the agency chose properly from the various alternatives open to it"); see also *Radio-Television News Dir's Ass'n*, 184 F.3d at 888 ("The FCC retains discretion to . . . reopen the record, to ensure that it fully accounts for relevant factual and legal developments.").

^{59/} For the same reason, AT&T/WorldCom's suggestion that consideration of Verizon VA's evidence would have delayed the proceeding, AT&T/WCom Opp. at 36, is incorrect. Clearly, one year would have been more than enough time for the parties to supplement the record.

^{60/} See, e.g., Verizon Virginia Inc.'s Motion to Permit Parties to Supplement the Record at 1 (Nov. 22, 2002); Reply of Verizon Virginia Inc. to Opposition of WorldCom Inc. and AT&T Communications, Inc. to Verizon Virginia Inc.'s Motion to Permit Parties to Supplement the Record at 1 (Dec. 16, 2002).

ground that Verizon VA will have an opportunity to respond to the new evidence AT&T/WorldCom introduce. AT&T/WCom Opp. at 88-89 & n.103. But, of course, AT&T/WorldCom would have had a full opportunity to respond to Verizon VA's supplemental evidence had the Bureau accepted it — and to conduct discovery and cross-examination.

D. By Rejecting the FLC and Adopting a Current Cost to Book Cost Ratio, the Order Guarantees that Verizon VA Will Underrecover Proper Forward-Looking Expenses.

By rejecting Verizon VA's "forward-looking-to-current" conversion factor (the "FLC"), the *Order* "twice TELRIC[s]" the reductions that both Verizon VA and the *Order* itself make to the forward-looking expenses included in Verizon VA's models.^{61/} As a result, Verizon VA's expenses are slashed even below what the *Order* deemed forward-looking. This reduction is due to a mathematical function of Verizon VA's studies, which the FLC is designed to address. The *Order* compounds this error by adopting a current cost to book cost ("CC/BC") ratio that effectively "triple TELRICs" expenses without justification.

Verizon VA develops its cost factors using forward-looking expenses in the numerator. The factors are a ratio comparing these forward-looking expenses to *embedded* investment. But in the cost studies — and specifically, in the compliance runs of those studies Verizon VA must now produce as a result of the *Order* — the factors are applied to the forward-looking TELRIC investment adopted by the *Order*, which is much lower than the embedded investment. As a function of simple mathematics, therefore, when the cost factors are applied to this reduced

^{61/} Order on Unbundled Network Element Rates, *Proceeding on Motion of the Commission to Examine New York Telephone Company's Rates for Unbundled Network Elements*, Case No. 98-C-1357, at 57 (N.Y. Pub. Serv. Comm'n Jan. 28, 2002) ("*New York UNE Order*") (quoting Recommended Decision in Module 3, *Proceeding on Motion of the Commission to Examine New York Telephone Company's Rates for Unbundled Network Elements*, Case No. 98-C-1357, 2001 N.Y. PUC LEXIS 293, at *140 (N.Y. Pub. Serv. Comm'n May 16, 2001) ("*New York Recommended Decision*").

investment in Verizon VA's compliance runs, they will artificially understate expenses by calculating them as a percentage of this lower investment amount. Since the expenses were already adjusted to be forward-looking, this additional reduction makes no sense and has no basis in any assumed attribute of the forward-looking network; it is merely mathematical. As even AT&T/WorldCom acknowledge, the FLC corrects for this second level of reduction, ensuring that applying the annual cost factors within Verizon VA's studies produces the level of forward-looking expenses used to develop those factors. *See* AT&T/WCom Opp. at 31 (FLC produces "expenses that Verizon inputs into the numerator of the ACFs.") The FLC simply adjusts the factors to account for the new level of investment in order to preserve the identified forward-looking expenses. *See* VZ-VA Ex. 107 at 70-73.

AT&T/WorldCom's only defense of the *Order's* rejection of the FLC is to assert that Verizon VA's expenses are not sufficiently forward-looking. AT&T/WCom Opp. at 31-32. But that is a non-sequitur. It is not appropriate for AT&T/WorldCom to try to reduce expenses through the back door by removing the FLC from Verizon VA's studies. And to the extent AT&T/WorldCom had substantive arguments concerning reductions in specific expenses that should be assumed in the forward-looking network, they had the opportunity to present those arguments in the case before the Bureau. They have not sought reconsideration or review of *any* of the *Order's* determinations concerning Verizon VA's expenses, and thus must be presumed to agree that there is no valid basis to reduce particular expenses beyond what the Bureau ordered. There accordingly is no basis to indirectly reduce expenses further by simply removing the FLC.

In any event, AT&T/WorldCom's efforts to show that the expenses Verizon VA's factors would produce *with* the FLC are too high simply fail. Verizon VA's *proposed* expenses were themselves forward-looking, and on top of that, the *Order* now requires additional reductions to

Verizon VA's expenses. Thus, the expenses Verizon VA's factors — as adjusted by the FLC — will produce in the compliance runs in this case are forward-looking and are well below the embedded expenses that Verizon VA experiences today. As the Pennsylvania Commission recently recognized, that alone is reason to reject AT&T/WorldCom's attack on the FLC: “[The CLECs’] argument is not with the FLC itself but with the issue of whether Verizon’s TELRIC expense levels are truly forward-looking. Our adjustments to expenses are designed to ensure that they are forward-looking and thus, would negate [the CLECs’] arguments.”^{62/}

As noted, Verizon VA itself makes significant forward-looking adjustments to embedded expenses, and only these adjusted expenses are used in the factors. Verizon VA adjusts maintenance expenses to reflect the use of new copper and assumes productivity improvements. *See* VZ-VA Ex. 107 at 62; VZ-VA Ex. 122 at 22. AT&T/WorldCom suggest that these changes are insufficient, arguing in particular that Verizon VA's productivity factor is too limited. AT&T/WCom Opp. at 31-32. But they have never offered any concrete proposals for a different productivity factor. Based on the Bureau's baseball arbitration rules, *Order* ¶ 24, that should end the matter. AT&T/WorldCom's more generalized insistence that Verizon VA's expenses “accounted for *none* of the expected savings in expenses in a forward-looking network” arising from technology or equipment changes, AT&T/WCom Opp. at 31, likewise fails. Verizon VA's studies reflect precisely such savings. By using cost factors related to specific classes of equipment, Verizon VA ensures that its studies include only the expenses associated with the forward-looking technology mix. *See* VZ-VA Ex. 107 at 17; VZ-VA Post-Hearing Reply Brief at 47. Thus, where the forward-looking network assumes technology or equipment that is less

⁶² *See* Tentative Order, *Generic Investigation Re Verizon Pennsylvania Inc 's Unbundled Network Element Rates*, Docket No. R-00016683, at 60 (Proprietary Version) (PA P.U.C. Oct. 24, 2002) (“*Tentative Pennsylvania Order*”).

expensive to maintain, such as fiber in place of copper plant, Verizon VA's models would produce more of the fiber and less of the copper maintenance expense — and thus lower *overall* maintenance expenses.

Moreover, the *Order* has required assumptions that reduce Verizon VA's expenses even further below the levels Verizon VA proposed. Specifically, the *Order* adjusted the plant mix and eliminated Verizon VA's expenses by eliminating advertising and marketing expenses. Order ¶ 145. Thus, the *Order* already determines those respects in which it found that Verizon VA's expenses were not sufficiently forward-looking, and it has made the adjustments it found to be appropriate. The resulting expenses must be treated as the level of forward-looking expense that Verizon VA has the right to recover.

As explained above, recovery of these expenses will occur *only* if the FLC is included in Verizon VA's factor development. Without the FLC, the expenses the adjusted factors will produce in Verizon VA's compliance runs will be even further reduced. The New York Commission found that this improperly “double count[s] the TELRIC” reduction.^{63/} *New York UNE Order* at 58. There is no defensible basis for that result. As the Pennsylvania Commission recognized, once expenses have been reviewed and adjusted, Verizon has a right to recover the approved amounts, and using the FLC produces that result. *See Tentative Pennsylvania Order* at 60.

^{63/} AT&T/WorldCom try to dismiss the New York Commission's adoption of the FLC on the ground that Verizon made a larger productivity adjustment in that case. AT&T/WCom Opp. at 33. But the CLECs miss the point: the New York Commission correctly recognized that the question of appropriate forward-looking adjustments is *distinct* from the question of whether the FLC is appropriate. If the CLECs believed Verizon VA should have adopted a higher productivity factor in this case, they could have proposed one. Their failure to do so is not ground to reject the FLC.

The *Order* erred further when, in addition to rejecting the FLC, it applied a current cost to book cost ratio. That results in yet a *third* reduction to Verizon VA's expenses.⁶⁴ The *Order* cannot lawfully preclude Verizon VA from recovering even those expenses that the *Order* approved as legitimately forward-looking. The sole effort AT&T/WorldCom make to actually defend the application of the CC/BC ratio makes no sense. They correctly note that the ratio converts *embedded* investment into *current* dollars, which would make such investment more consistent with *current* expenses. ATT/WCom Opp. at 34 (emphasis added). But TELRIC is designed to measure *forward-looking* costs, not *current* expense or investment. Because Verizon VA uses forward-looking expenses in its factors, application of the CC/BC ratio produces a ratio of *forward-looking* expenses to *current* investment. This does not eliminate the "timing mismatch" that the CLECs identify. AT&T/WCom Opp. at 34. An adjustment is still required to make the ratio forward-looking. This would just be a restated FLC, designed to account for the difference between CC/BC-adjusted investment, and forward-looking TELRIC investment. But when the CC/BC is instead applied in *lieu of* the FLC, the resulting expenses are below the levels that would result from the technology assumptions the *Order* adopts.

III. NON-RECURRING COSTS

A. The *Order's* Decision to Shift Most Non-Recurring Costs to Recurring Rates Is Erroneous and Creates New Subsidies for CLECs.

The *Order's* requirement that Verizon VA recover most of its non-recurring costs through recurring rates is inconsistent with established Commission policy. The Commission has specifically found that "[l]oad[ing] the unrecovered non-recurring costs into recurring rates"

⁶⁴ See VZ-VA AFR at 56. This is so because the average CC/BC ratio is greater than one, and it therefore increases the level of investment in the ACF denominator and decreases the value of the ACF. See *id.* at 61.