would be "inconsistent with the policies . . . that favor recovering costs from the cost causer," "would distort the prices paid by . . . customers," and would create a "subsidy of short-term users by longer term customers"[65]

AT&T/WorldCom's claim that their approach is consistent with Commission policy and "the Commission's definition of a recurring cost as a cost 'incurred periodically over time,'" AT&T/WCom Opp. at 81-82, is clearly wrong. Both the *Order* and AT&T/WorldCom acknowledge that the costs of "*one-time* activities . . . [are] recovered through recurring charges" in the AT&T/WorldCom model. *Order* ¶ 582; *see also* AT&T/WCom Opp. at 81 (AT&T/WorldCom model does "*not* treat all one-time costs as NRCs") (emphasis in original). Thus, AT&T/WorldCom violate the Commission's established definitions of recurring and non-recurring costs by classifying costs as recurring even though they are *not* incurred "over time" but are rather one-time costs necessary to provision individual orders.[66]

AT&T/WorldCom's argument is based on a mischaracterization of "one-time" cost. According to AT&T/WorldCom, a cost is non-recurring "*only* if it is incurred for a one-time

[65] *Non-Recurring Charges Order* at 3499 ¶ 12, 3501-02 ¶¶ 32-33, 35; Order, *MCI Telecommunications Corp Application for Review of the Ameritech Operating Companies, Bell Atlantic Telephone Companies, BellSouth Telecommunications Inc , Cincinnati Bell Telephone Company, GTE Service Corporation, the NYNEX Telephone Companies, Pacific Bell, Rochester Telephone Corp., Southern New England Telephone Company, Southwestern Bell Telephone Company, United Telephone and Central Telephone Companies, and U S WEST Communications*, 12 FCC Rcd 16565, 16571 ¶ 12 (1997); *see also Local Competition Order* at 15874 ¶ 743.

[66] AT&T/WorldCom's claim that Verizon VA has included costs incurred over time, such as construction and maintenance, in non-recurring rates is contrary to fact. AT&T/WCom Opp. at 81. Verizon VA's cost studies recover construction and maintenance costs, as well as other costs "incurred over time," through recurring charges. Verizon Virginia Non-Recurring Cost Panel Surrebuttal Testimony at 93, 99-100 (Sept. 21, 2001) ("VZ-VA Ex. 124"). As the *Order* itself notes, "Verizon defines non-recurring costs as costs associated with the *one-time activities* necessary to process and provision competitive LECs' requests for the initiation, change, or disconnection or service, or for other one-time activities." *Order* ¶ 581 (emphasis added).

benefit (i.e., is exclusive to a particular order) and cannot be used for subsequent orders." AT&T/WCom Opp. at 81. But this confuses a one-time cost with a so-called "one-time benefit." Even if a subsequent carrier might benefit from the work done in connection with a non-recurring activity, that does not change the non-recurring character of the cost. The costs that AT&T/WorldCom shift from non-recurring to recurring rates are costs that Verizon VA incurs on a one-time basis in order to process and provision a particular order for a particular CLEC, not costs incurred over the life of the relevant facility or over the period in which the CLEC takes the UNE. Under Commission precedent, such one-time costs should be recovered through a non-recurring charge, and the CLEC, not Verizon VA, should bear the risk that there might *not* be future benefits from that service, since it is the CLEC that enjoys the *current* benefit and imposes the upfront cost.[67]

In any event, AT&T/WorldCom's argument fails to explain the shifting of numerous non-recurring costs into recurring rates in AT&T/WorldCom's model. The only example AT&T/WorldCom provide of a non-recurring activity that might benefit subsequent carriers is the placement of a cross-connect at the feeder-distribution interface. AT&T/WCom Opp. at 81 n.79; *see also Order* ¶¶ 569, 584. But Verizon's model includes *83* other additional non-recurring costs not identified in AT&T/WorldCom's model. *Id.* ¶¶ 581-82. These other missing 83 costs do not all relate to benefits that subsequent carriers might reuse, and thus, even under AT&T/WorldCom's approach, should be recovered through non-recurring rates. Indeed, AT&T/WorldCom fail to include *any* non-recurring costs at all for a large number of UNEs,

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[67] Although AT&T/WorldCom point to language in prior rulemaking orders where the Commission has permitted shifting of non-recurring costs to recurring rates in *limited* circumstances, AT&T/WCom Opp. at 84-85, their model would make recovery of non-recurring costs through non-recurring rates the *exception* rather than the rule — the exact opposite of what Commission precedent and economic principles require.

including subloops, many types of ports, multiplexing, and others. AT&T/WorldCom did not even try to show that all these other costs are for activities that will benefit subsequent carriers, nor could they

AT&T/WorldCom also incorrectly assert that Verizon VA "effectively acknowledged" that many of the non-recurring costs in its model are currently recovered through recurring charges. AT&T/WCom Opp at 82. The *Order* and AT&T/WorldCom cite to the fact that Verizon VA backs out non-recurring revenues from the accounts used to calculate its annual cost factors as evidence that non-recurring costs are included in both Verizon's non-recurring and recurring cost studies But Verizon VA makes this adjustment because it records both recurring and non-recurring revenues associated with particular UNEs to the same accounts. Thus, this adjustment is needed to ensure that those costs it treats as recurring when it develops its annual cost factors do not inadvertently include (and hence double recover) costs that are properly treated as non-recurring. How Verizon VA books revenues is simply irrelevant to whether those revenues recover recurring or non-recurring costs.

Furthermore, the *Order*'s adoption of AT&T/WorldCom's classification of recurring and non-recurring charges also fails to address the increased risks to Verizon VA because it must underwrite the risk of CLECs' entry to the market. *See* VZ-VA AFR at 64. The *Order* requires Verizon VA to act as the CLECs' banker, extending credit to CLECs for immediate cash outlays that Verizon VA will recover over time, if at all. The result is to create a substantial risk of underrecovery since, as the *Order* acknowledges, estimates about how long the average customer will take service are inevitably uncertain *See Order* ¶ 597. But, the Commission has clearly stated that "LECs should not be forced to underwrite the risk" of CLECs' entry.[68] Moreover, the effect of the *Order* is to create a subsidy flowing from Verizon and other long-term users of the network to the CLECs. Such a subsidy is contrary to Commission policy. *Non-Recurring Charges Order* at 3501-02 ¶¶ 32-33.

AT&T/WorldCom do not deny this effect. Instead, they argue that Verizon VA should not be concerned about this risk because "'the risk of non-collection only exists if the competitive LEC exits the market'" and the uncollectibles markup Verizon VA makes to its UNE prices addresses this loss. AT&T/WCom Opp. at 86 (quoting *Order* ¶ 598). But AT&T/WorldCom's argument misses the mark. First, as discussed above, the .56% uncollectible rate approved by the *Order* does not come close to covering even Verizon VA's *current* wholesale uncollectible expenses; it certainly does not and could not cover the new and additional risk created by shifting most non-recurring costs to recurring rates.

Second, Verizon's risk of non-collection, while substantial, represents only a portion of Verizon VA's risk of non-recovery. The purpose of the uncollectible portion of Verizon VA's gross revenue loading is to recover money that Verizon VA has billed but has been unable to collect; it does not, and is not designed to, account for the risk that Verizon will not recover its costs as a result of ordinary customer churn. Thus, for example, if Verizon is forced to incur the non-recurring costs of establishing service for a WorldCom customer, and then that customer terminates service after three months — as WorldCom has stated 50% of its customers do, *Triennial Review Order* ¶ 471 — WorldCom would have made only three months worth of installment payments for the non-recurring cost it caused. The remaining unrecovered costs for

[68] Second Report and Order, *Local Exchange Carriers' Rates, Terms, and Conditions for Expanded Interconnection through Physical Collocation for Special Access and Switched Transport*, 12 FCC Rcd 18730, 18750 ¶ 33 (1997).

the non-recurring activities Verizon VA undertook would not be "uncollectibles," because WorldCom would not *owe* Verizon anything under the system set up by the *Order*. Yet Verizon VA would have no way to recover those costs.

B. AT&T/WorldCom's Model Improperly Excludes Non-Recurring Costs and Is Based on an Erroneous Interpretation of TELRIC's Requirement that Costs Be Based on "Currently Available" Technology.

In addition to improperly shifting most non-recurring costs to recurring rates, the *Order*'s decision to adopt the AT&T/WorldCom non-recurring cost model violates Commission policy by failing to compensate Verizon VA for the out-of-pocket non-recurring costs it will incur to provision UNEs. The Commission has consistently recognized that "LECs should . . . recover through an NRC their full one-time costs of providing, terminating or modifying a[] . . . service. This is consistent with our policies encouraging the recovery of costs from cost causers and would reduce the subsidy of short-term users by longer term customers." *Non-Recurring Charges Order* at 3501-02 ¶¶ 32-33. Thus, the Commission has found that CLECs are "required to bear the cost" of "modifications to incumbent LEC facilities to the extent necessary to accommodate interconnection or access to network elements," *Local Competition Order* at 15602-03 ¶¶ 198-99, and has expressly rejected interpretations of TELRIC that assume away costs, such as loop conditioning, that would not be incurred in a hypothetical network, but unquestionably must be performed in the real world.[69]

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[69] *Local Competition Order* at 15692 ¶ 382; Third Report and Order and Fourth Further Notice of Proposed Rulemaking, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 15 FCC Rcd 3696, 3784 ¶ 193 (1999); FCC Reply Br. at 10 n.7 ("[The] [] suggestion . . . that TELRIC authorizes regulators to require incumbents to modify, 'for free,' loops to facilitate certain advanced services ignores express FCC directions to the contrary.") (citations omitted).

AT&T/WorldCom's argument that their model "neither understates nor ignores non-recurring costs," AT&T/WCom Opp. at 86, is belied by their admission, in the following sentence, that "the *Order* found that [AT&T/WorldCom's model] should have included certain activities that the *Order* agreed should be recovered on a non-recurring basis," *id* at 87. Indeed, the *Order* explicitly found that the AT&T/WorldCom model failed to produce costs for activities that the Bureau found are legitimate non-recurring activities, including design time, loop conditioning, and line sharing. *Id.* ¶¶ 618, 639, 642, 648. The fact that AT&T/WorldCom's model does not include such costs demonstrates the inadequacy of its underlying assumptions and overall approach. The baseball arbitration rules required the *Order* to use Verizon VA's model not only for the missing elements, but for all non-recurring costs, because it was the only model in the record that modeled the non-recurring costs that even the *Order* agreed should be recovered through non-recurring rates. Moreover, the *Order*'s decision to permit AT&T/WorldCom to introduce new evidence to calculate the missing non-recurring costs was both unlawful and unfair. The *Order* instead should have used Verizon VA's studies. *See, e.g.*, *Order* ¶ 554.

AT&T/WorldCom's argument that it was proper for the *Order* to allow them to introduce entirely new evidence concerning the costs missing from its model is hypocritical. AT&T/WorldCom opposed Verizon VA's motion to reopen the record, and defend the *Order*'s denial of Verizon VA's motion, on the grounds that it would be unfair to allow Verizon VA to introduce new evidence without the benefit of cross examination or discovery. AT&T/WCom Opp. at 37 Yet that is precisely the effect of the *Order*'s decision to permit AT&T/WorldCom to introduce new evidence even after the decision was issued. While AT&T/WorldCom suggest that "the *Order*'s procedures provide Verizon with the information it will need to verify the accuracy of the calculations," AT&T/WCom Opp. at 89 n.103, that clearly is untrue. Verizon VA will not have the opportunity to obtain discovery or cross-examine AT&T/WorldCom on the numbers it produces, and thus will have no way of testing the assumptions that underlie AT&T's numbers. That is particularly egregious since AT&T/WorldCom's "model" is nothing more than the collected opinion of a few subject matter experts, and accordingly there is no way to "verify" *any* of its results or calculations.

The *Order* also denies Verizon VA recovery of its out-of-pocket costs because even those "rates that AT&T/WorldCom's model produces are based on extreme hypothetical assumptions that drive rates down well below cost." VZ-VA AFR at 69. AT&T/WorldCom's defense of the technologies they assume in their model rests on a fundamentally flawed interpretation of TELRIC that deems technology to be "currently available" as long as it is theoretically "technically feasible" to develop at some future point. AT&T/WCom Opp. at 90. But the Commission made clear in the *Triennial Review Order* that any technology assumed for TELRIC purposes must be actually deployed and capable of performing the relevant function in at least *some* carrier's network, and may not be technology that theoretically "may be available in the future." *Triennial Review Order* ¶ 670 n.2020. In other words, TELRIC requires that the ILEC must actually be able to purchase the particular technology assumed in the cost study, not merely that it might be feasible at some point in the future.

Notwithstanding the Commission's rules, AT&T/WorldCom's model assumes technology that even they admit *no* carrier has deployed. *See* VA-VZ Ex. 122, Attachment A (AT&T/WCom Response to VZ-VA VII-26); *see also* Tr. at 4619 (Riolo). It is undisputed that, for example, *no* carrier can or has deployed OSS that enable it to process orders automatically with only 2% fallout.[70] Verizon Virginia Non-Recurring Cost Panel Rebuttal Testimony at 13-22 (Aug 27, 2001) ("VZ-VA Ex. 116") These assumptions violate the Commission's TELRIC principles and result in unrealistic and understated non-recurring costs.

AT&T/WorldCom attempt to defend their assumption based on a misstatement of Verizon's position. AT&T/WorldCom assert that "Verizon's criticism is based on its view that only the technology that *it* intends to provide in the future is 'currently available.'" AT&T/WCom Opp. at 90 But Verizon VA imposed no such limitation in modeling non-recurring costs. Indeed, AT&T/WorldCom are unable to point to any "currently available" technology (as opposed to the hypothetical technologies they assume in their model) that Verizon VA's model excludes.

Finally, as Verizon VA explained, AT&T/WorldCom's model is also flawed because it is based "solely on the subjective opinion of [AT&T's] subject matter experts." *Order* ¶ 571. AT&T/WorldCom's rejoinder that Verizon VA also used subject matter experts, AT&T/WCom Opp at 90, misses the point. As discussed below, Verizon VA's model was also based on extensive survey and statistical analysis. AT&T/WorldCom's model, on the other hand, lacks any such empirical grounding. And, while AT&T/WorldCom assert that their so-called experts had "many years of experience working for ILECs," *id.* at 91, they admittedly had *no* experience in processing wholesale UNE orders or provisioning UNEs. Tr. at 4650-54. (Walsh) Verizon

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[70] AT&T/WorldCom claim that the 2% figure consists only of orders that fallout due to CLEC error. AT&T/WCom Opp. at 89. But AT&T/WorldCom provided no more support for a 2% CLEC-caused fallout rate than they did for a 2% overall fallout rate. In any event, TELRIC requires that ILECs be compensated for the costs they will actually incur to process CLEC orders given currently available technology, including any necessary manual handling, even if that fallout is not the result of CLEC "error."

VA's experts, on the other hand, have extensive experience in the relevant processes for providing UNEs to CLECs. VZ-VA Ex. 107 at 317.

C. Verizon VA's Non-Recurring Cost Model Appropriately Models Costs for the One-Time Activities Verizon VA Will Perform to Provision CLECs' Orders.

The *Order*'s decision to reject Verizon VA's model also should be reversed. *First,* as the *Order* finds, Verizon provides "*more* support" for its time and frequency estimates than does AT&T/WorldCom, whose model is based "solely" on subjective opinion. *Order* ¶¶ 571-72 (emphasis added). Indeed, after extensive review, the New York Commission determined that Verizon's work times were well supported and statistically valid. *See New York Recommended Decision* at *188. Verizon VA's studies begin with an extensive survey of its workers with real-world experience to determine how long a particular task currently takes and the frequency with which it is performed. After the survey results were validated by a statistician, subject matter experts made forward-looking adjustments to the resulting time and frequencies where currently available technologies would enable those tasks to be performed more efficiently.[71] VZ-VA Ex. 107 at 311, 316-17. An outside consultant then reviewed the statistical precision of Verizon VA's non-recurring cost estimates and calculated that, for all but a few UNEs, there was a 95% probability that Verizon's non-recurring cost estimates were within 15% of the actual cost Verizon VA will incur to perform the relevant task. *Id.* at 325.

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[71] As Verizon VA explained in its application for review, Andersen Consulting validated the order processing times. AT&T/WorldCom note that Andersen Consulting subsequently performed its own study of work times for order processing. AT&T/WCom Opp. at 93 n.110. Verizon VA submitted that study, and the *Order* admits it into the record. *Order* ¶ 14. That study — performed by an objective third-party — clearly is a more appropriate basis for determining non-recurring costs for order processing than AT&T/WorldCom's wholly subjective model.

Second, Verizon has already demonstrated that the "methodological errors" AT&T/WorldCom cite, AT&T/WCom Opp. at 92, are unfounded. For example, concerns that employees might have overstated the times for completing activities are incorrect. As Verizon explained, the instructions to the survey respondents explicitly stressed that the results of the process needed to be "accurate and credible." Tr. at 4694. Indeed, as Verizon VA's statistical expert, Mr. Gene Goldrick, observed, workers may have had an incentive to *understate* the time it takes them to perform tasks out of "fear that [high work time estimates] might come back . . . and identify or tag [the worker] as an unproductive individual." Tr. at 4715-16. Similarly, there is no reason to believe that weighting the responses to account for the number of times the respondent performed the tasks, even if possible, would have reduced work times. To the contrary, if longer work times were more frequent, weighting may well have increased work times Tr at 4706 (Goldrick). Nor do variations in the survey data do not undermine the results. Many tasks included in Verizon VA's model are open-ended activities for which one would expect to observe even significant variation in respondents' estimates. Workers' average experiences and average work times will differ due to the types of orders they process, the environments in which they work (*e g.*, rural versus urban), and their differing skills or experiences. *See* VZ-VA Ex. 124 at 32-35.

AT&T/WorldCom are also incorrect that Verizon VA determined NRCs "based on its own embedded network." AT&T/WCom Opp. at 91. Verizon uses the existing network to determine current work times. Those current times, in turn, serve as a starting point for determining *forward-looking* costs. Verizon makes a variety of forward-looking adjustments that reduce work times and the frequency with which tasks must be done, adjustments that reduce costs and reflect a forward-looking environment. *See, e.g.*, VZ-VA Ex. 107 at 303-05;

VZ-VA Ex. 124 at 11-24, 26 Thus, Verizon VA's non-recurring cost model produces costs below its current real-world experience.

Third, AT&T/WorldCom acknowledge that a number of state commission decisions have relied on Verizon's non-recurring cost model but attempt to minimize that fact by asserting that the state commissions made adjustments to that model. AT&T/WCom Opp. at 94-95. As an initial matter, none of those adjustments resulted in non-recurring rates nearly as far below costs as those that result from AT&T/WorldCom's model. Moreover, those adjustments do not undermine the fact that these state commissions have determined that Verizon's model is an appropriate starting point for determining non-recurring costs.[72] The Bureau here could have made similar adjustments to the extent it properly determined that they were warranted. That approach certainly would have been far more consistent with TELRIC than the adoption of

[72] *See New York Recommended Decision* at *186-88; *see also* Order No. 78552, *In the Matter of the Investigation Into Rates for Unbundled Network Elements Pursuant to the Telecommunications Act of 1996*, Case No. 8879, Public Service Commission of Maryland, 87-88 (June 20, 2003) ("*Maryland UNE Order*"); Decision and Order, *In the Matter of the Board's Review of Unbundled Network Element Rates, Terms and Conditions of Bell Atlantic-New Jersey, Inc.*, Docket No. TO-00060356, at 157-67 (N.J. Bd. Pub. Util. Mar. 6, 2002) ("*New Jersey UNE Order*"), Order, *Investigation by the Department of Telecommunications and Energy on Its Own Motion into the Appropriate Pricing, Based Upon Total Element Long-Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the Appropriate Avoided-Cost Discount for Verizon New England, Inc. d/b/a Verizon Massachusetts Resale Services in the Commonwealth of Massachusetts*, Docket No. D.T.E. 01-20. MA Dep't of Telecommunications and Energy, 432-500 (July 11, 2002) ("*Massachusetts UNE Order*"); Findings, Opinion and Order No. 5967, *Application of Verizon Delaware, Inc (F/K/A Bell Atlantic-Delaware, Inc.), for Approval of Its Statement of Terms and Conditions Under § 252(f) of the Telecommunications Act of 1996*, Docket No. 96-324 Phase II, at 31-35 (Del. Pub. Serv. Comm'n June 4, 2002) ("*Delaware UNE Order*"); Report and Order, *Review of Bell Atlantic-Rhode Island TELRIC Study*, Docket No. 2681, at 62-69 (R.I. Pub. Util. Comm'n Nov. 18, 2001) ("*Rhode Island UNE Order*").

AT&T/WorldCom's model, which is contrary to Commission policy and fails to capture many of Verizon VA's non-recurring costs *at all*.[73]

IV. THE COMMISSION MUST EVALUATE THE CONFISCATORY EFFECT OF THE ORDER BEFORE IT IS ALLOWED TO TAKE EFFECT.

In its application for review, Verizon VA demonstrated that the UNE rates adopted by the *Order* will be confiscatory because they will not permit Verizon VA to recover its unrecovered prudent investment in facilities used and useful in providing wholesale service, or to recover the actual operating costs and forward-looking investment costs that Verizon VA will necessarily incur to provide those facilities. The Commission is obligated to evaluate whether the UNE rates are confiscatory before they become effective and to provide a mechanism to compensate Verizon VA for any shortfall. *See* VZ-VA AFR at 72-77. None of AT&T/WorldCom's arguments undermines this showing.

A. The Constitutional Standard for Evaluating the Confiscatory Effect of Rates Is Recovery of Costs Necessarily Incurred by Verizon VA, Including Past Prudent Investment.

UNE rates are confiscatory if they fail to enable Verizon VA to recover the costs that it necessarily incurs to provide UNEs, including Verizon VA's past prudent investment. Even in the traditional regulatory takings context, where a utility has voluntarily committed its plant to serving the public, the courts have recognized that the utility is entitled to recover "the capital

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[73] AT&T/WorldCom's attempt to discount the Commission's approval of Verizon's 271 applications in many states where non-recurring rates were based on Verizon's model similarly fails While AT&T/WorldCom assert that the Commission seeks only to determine whether rates fall outside of a range that "a reasonable application of TELRIC principles would produce," *see* AT&T/WCom Opp. at 94, the fact is that the rates produced by AT&T/WorldCom's model are so low (or non-existent) that they cannot be in the same "reasonable range" as those produced by Verizon's model.

prudently devoted to the public utility enterprise by the utilities' owners." [74] In *Federal Power Comm'n v Hope Natural Gas Co.*, 320 U.S. 591 (1944), for example, the Court cited Justice Brandeis' opinion in *Southwestern Bell* to support the rule that "there be enough revenue not only for operating expenses *but also for the capital costs* of the business. These include service on the debt and dividends on the stock " *Id.* at 603 (emphasis added). As AT&T/WorldCom acknowledge, *Hope* states that a rate order is compensatory if it provides "the opportunity for a return on *investment*." AT&T/WCom Opp. 105 (emphasis added). There can be no return *on* investment until there has been a return *of* investment.

The necessity of using past prudent investment as the benchmark for evaluating whether a rate is confiscatory is even more pronounced here, where Verizon VA has not *voluntarily* dedicated its plant to providing UNEs to competitors. Instead, Verizon VA was compelled to enter that particular line of business, which is entirely unrelated to the retail telecommunications services it offers as a public utility. Moreover, to the extent Verizon VA made its investments pursuant to the regulatory regime that existed prior to the 1996 Act, the taking at issue occurred at the point of its forced dedication to the new regime, and thus prior to the imposition of TELRIC pricing, the government must preserve the opportunity to recover the capital invested before the shift in regulatory regimes In *Duquesne*, the Supreme Court determined that a new ratemaking methodology was not confiscatory because it produced recovery that was sufficient as measured *under the old methodology*. 488 U.S. at 312. The Commission has likewise

[74] *Duquesne Light Co v Barasch*, 488 U.S. 299, 309 (1989) (citing *Missouri ex rel. Southwestern Bell Telephone Co. v Public Service Comm'n*, 262 U.S. 276, 291 (1923) (Brandeis, J., dissenting)); *see also Democratic Central Committee v WMATA*, 485 F.2d 786, 808 (D.C. Cir. 1973) ("It is well settled that utility investors are entitled to recoup from consumers the full amount of their investment in depreciable assets devoted to public service.").

recognized the need to consider the impact of the transition to a forward-looking ratemaking methodology on the recovery of past prudent investment. VZ-VA AFR at 75 n.86.

The Constitution also protects a private party from being compelled to provide service without compensation for the *ongoing* costs that will necessarily be incurred by that party. VZ-VA AFR at 75-76. AT&T/WorldCom do not contest this rule. Indeed, *FERC v Pennzoil Producing Co.*, 439 U.S. 508, 517 (1979), which they cite, actually supports it by adverting to a procedure for a producer to obtain special relief when its "out of pocket" expenses exceed the revenues from area rates. Thus, UNE rates are confiscatory if they fail to compensate a utility for the actual forward-looking costs that the utility will necessarily incur to provide those elements

B. The "Market Value" Theory Does Not Shield The *Order's* UNE Rates From Constitutional Scrutiny.

AT&T/WorldCom imply that the *Order's* UNE rates are not confiscatory because they allegedly reflect the "market value" of those facilities. AT&T/WCom Opp. at 104. This is wrong. Market value cannot be used as the standard of compensation in the absence of an objective standard of comparable and reliable market transactions.[75] As the Supreme Court has said, in the absence of such transactions, market value is merely a "guess."[76] But there is no free

[75] *United States v Virginia Elec & Power Co.*, 365 U.S. 624, 633 (1961); *United States v. John J Felin & Co.*, 334 U.S 624, 630 (1948) (plurality opinion).

[76] *United States v Miller*, 317 U.S. 369, 374-75 (1943). *See also United States v. 564.54 Acres of Land*, 441 U.S 506, 513 (1979) (listing "public facilities such as roads or sewers" as within the category of property "so infrequently traded" as to render the concept of market value meaningless); *Duquesne*, 488 U.S. at 316 n.10 (noting the "practical problems" with fair value, which might be overcome by the emergence of a real "market for wholesale electric energy" that "could provide a readily available *objective* basis for determining the value of utility assets" (emphasis added)).

market for UNEs, and thus no direct way to determine the actual "market value" of UNE leases.[77]

One way to estimate "market value" in the case of a regulated utility would be to measure the opportunity cost, *i.e.*, the revenue that the utility would receive from its own use of the assets that are taken. "[W]hen the property is of a kind seldom exchanged, it has no 'market price,' and then recourse must be had to other means of ascertaining value." *Kimball Laundry Co. v. United States*, 338 U S. 1, 6 (1949) A traditional means of ascertaining the value of utility property is its earning capacity. For example, when the government condemns utility property for the purpose of continuing to operate it as such, the utility is entitled to be compensated for the value of its franchise — that is, its ability to obtain revenue from retail customers by charging rates allowed by law.[78] Accordingly, if "market value" were the relevant measure of compensation, Verizon VA would be entitled to recover the value of the income stream of retail revenues that

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[77] Indeed, the closest analogy to a "market transaction" in this context would be the sale of exchanges in the open market. Such sales have yielded a per-line price in the range of $3,200, which is substantially in excess of the UNE rates here. *See* Richard G. Klugman, CFA, Regina Bienstock, William J. Cook & Andrew R. Tuttle, *Telecommunications Services, Shelter from the Storm Initiation of Rural Telcos,* Jeffries & Company, Inc., May 2002, at 17; Michael J. Balhoff, CFA, Christopher C. King, & Bradley P. Williams, *Legg Mason, Equity Research*, The RLC Monitor, Winter 2003 Vol. 6 (2003) at 39; Michael I Rollins, CFA, Michael G. Chung, & John Santo Domingo, CFA, *ALLTEL Corp - A Different Kind of Telecom Company*, Salomon, Smith, Barney, Telecommunications Wireless Services, March 15, 2002, at 22; Andrew Hammerling, Richard Y. Choe, & Robert Dezego, *CenturyTel, Inc.: Increases Scale with 675,000 Access Lines in Alabama and Missouri for $2 159 Billion; Reiterates Guidance for 3Q01*, Banc of America Securities, Wireline Telecommunications Services, Oct. 23, 2001, at 1; Martin Dropkin, Daniel P. Reingold, *CenturyTel, Inc. Initiated Coverage with Buy; $37 Target Price*, Credit Suisse First Boston. Feb. 15, 2002, at 8.

[78] *See Monongahela Navigation Co. v United States*, 148 U.S. 312, 329 (1893); *Willcox v. Consolidated Gas Co.*, 212 U.S. 19, 44 (1909); *United States ex rel. TVA v. Powelson*, 319 U.S. 266, 282 & n.12 (1943); *Kimball Laundry*, 338 U.S. at 12-13; *see also Smyth v Ames*, 169 U.S. 466, 546-47 (1898) (fair value includes "the probable earning capacity of the property," along with its original and reproduction cost).

Verizon would have received but for the federal government's taking of the UNEs on behalf of CLECs.[79]

By contrast, the rates adopted in the *Order* are *not* a valid proxy for the fair market value of Verizon VA's property. As discussed above and in Verizon VA's application for review, the *Order* adopts extreme and hypothetical assumptions that bear no relation to the real-world costs that Verizon VA incurs to provide UNEs; in fact, in some cases, such as high capacity loops, the *Order* does not even purport to measure costs. And the *Order* repeatedly rejects Verizon VA's proposed rates and inputs on the erroneous ground that such proposals allegedly reflect Verizon VA's actual forward-looking costs. Accordingly, the resulting rates cannot even arguably be used as a realistic proxy of the fair market value of the real world network.

C. The "Total Company" Theory Does Not Shield The *Order's* UNE Rates From Constitutional Scrutiny.

AT&T/WorldCom also err in arguing that the *Order's* UNE rates are not confiscatory because they have not jeopardized the financial integrity of Verizon Communications Inc. as a whole. AT&T/WCom Opp. at 106, 108, 111-113. The UNE rates must be compensatory in and of themselves for the capital dedicated to providing such UNEs. Verizon Communications Inc.'s revenues from other sources — including both retail revenues subject to the jurisdiction of other states and revenue from competitive lines of business — may not be considered in evaluating whether the *Order's* UNE rates are confiscatory.

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[79] AT&T/WorldCom's reliance on *Market Street Railway Co. v. Railroad Comm'n*, 324 U.S. 548 (1945), is therefore misplaced. In *Market Street*, the utility's financial distress resulted from changes in the market, not from regulatory action. Higher rates would not have helped the utility. 324 U.S. at 556, 566-67, 568. The Court expressly distinguished that situation from the one Verizon VA faces, in which "public regulation curtailed earnings otherwise possible." *Id.* at 554; *see also id.* at 566, 568.

As an initial matter, it is axiomatic that where the government forcibly occupies a portion of a firm's property, it must fully compensate the firm for the portion so taken. *See Loretto v Teleprompter Manhattan CATV Corp*, 458 U.S. 419, 435-36 (1982). It is no answer to say that the firm's other remaining operations may nonetheless allow it to continue to operate at a profit. That is why the government unquestionably could not occupy and convert a General Motors plant to the production of tanks without fully compensating General Motors for the property taken. The same principle applies here where a portion of Verizon VA's property has been forcibly dedicated to the use of its competitors — a business it did not choose to enter. Under those circumstances, the government must fully compensate Verizon VA for the property that is dedicated to that compulsory regime.

In fact, the law is clear that even where a firm *voluntarily* dedicates a portion of its property to a regulated business, a regulator may not force the portion of the business it is regulating to operate at a loss and claim that the deficiency can be covered by other parts of the firm's business. Thus, in *Brooks-Scanlon Co. v Railroad Comm'n*, 251 U.S. 396, 399 (1920), the seminal case applying this principle, the Supreme Court held that regulators could not justify below-cost railway rates by claiming that the railroad was still profitable due to healthy returns in its competitive lumber business. As Justice Holmes explained, earnings from competitive operations are the firm's private property, and a firm "no more can be compelled to spend that [money] than it can be compelled to spend any other money to maintain a railroad for the benefit of others who do not care to pay for it" *Id*

The same underlying principle is reflected in the rule that a regulator may not justify deficient rates by pointing to revenues from operations under a different sovereign's jurisdiction. As the Supreme Court has explained: "The state cannot justify unreasonably low rates for domestic transportation, considered alone, upon the ground that the carrier is earning large profits on its interstate business, over which, so far as rates are concerned, *the State has no control*." *Smyth v. Ames*, 169 U.S. at 541 (emphasis added); *see also Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930). Thus, as the Commission itself has acknowledged, in conducting a takings analysis, the agency "may not consider incumbent LECs' revenue derived from services not under our jurisdiction." *Local Competition Order* ¶ 737 n.1756.

The "total effect" test from *Duquesne* does not support AT&T/WorldCom's position. In *Duquesne* and *Hope*, the companies at issue were regulated monopolies in *all* their operations and had voluntarily dedicated their operations to the businesses that were being regulated. In those cases, therefore, it was proper to consider the company's overall revenue from all operations in determining the sufficiency of a rate order. But those cases clearly do not mean that, where a regulatory regime reaches only part of a business, that regulator can justify a non-compensatory rate on a regulated service by claiming that revenues from sources outside that regime make up the difference, especially where the relevant part of the business was *not* voluntarily dedicated.[80/] Further, today, *all* of Verizon VA's services are subject to competition from CLECs, wireless providers, cable operators, and others. Thus, any attempt to increase non-UNE rates to make up for shortfalls in the UNE rates could not work. There is a dynamic relationship between UNE rates and Verizon VA's retail revenues. as UNE rates drop, CLECs are able to undercut Verizon VA's retail rates and capture Verizon VA's customers. Raising Verizon VA's retail rates accordingly would only accelerate Verizon VA's loss of customers to

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80/ *See Brooks-Scanlon*, 251 U.S. at 399; *see also Calfarm Ins. Co. v. Deukmejian*, 48 Cal.3d 805, 819, 258 Cal. Rptr. 161, 168, 771 P.2d 1247, 1254 (Cal. 1989) (statute providing relief from insurance rates based on financial condition of company as a whole invalid because allowed consideration of income from "sources unregulated by" the state; inquiry should have been limited to financial results of regulated lines).

CLECs. Thus, far from making up for a shortfall in UNE rates, increasing retail rates would simply exacerbate Verizon VA's loss.

D. Verizon VA's Evidence Demonstrated a Substantial Constitutional Problem that the Commission Must Consider.

Verizon VA has presented substantial evidence demonstrating that the *Order's* rates would be confiscatory under the applicable standards. The rates would not enable Verizon VA to recover either its past prudent investment or its actual forward-looking costs. *See* VZ-VA AFR at 72-77; Garzillo Decl ¶¶ 29-31; Verizon Virginia Supplemental Testimony of Pat Garzillo at 1-16 (April 15, 2003). The Commission thus is obligated to consider Verizon VA's evidence so that it may properly evaluate Verizon VA's constitutional claims before any rates go into effect. Indeed, when a party raises allegations that particular rates are confiscatory, or are not "just and reasonable," the agency entrusted with that decision *must* evaluate that claim.[81]

AT&T/WorldCom's assertions that Verizon VA's takings claim is untimely and improper, *see* AT&T/WCom Opp. at 113-15, are completely unfounded. The Supreme Court has expressly established that a challenge to the constitutional adequacy of UNE rates becomes ripe at the time that rates are set. *See Verizon Communications, Inc v. FCC*, 535 U.S. 467, 524-28 (2002). And AT&T/WorldCom's argument that the Commission should not consider Verizon VA's evidence at this point because the non-loop rates have not been definitively set, AT&T/WCom Opp. at 109-110, misses the point. The Supreme Court has observed that the Commission had committed to consider a claim of confiscation even "in advance of a rate

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

order." *Verizon*, 535 U.S. at 528 n.39.[82] That is particularly appropriate here, where all parties' preliminary calculations of the rates — which will be finalized in a matter of days in the parties' compliance filings — illustrate that the *Order*'s rates will not recoup Verizon VA's prudent historical investment and actual forward-looking costs. And whatever the precise rates, the Commission is obligated to consider whether they will cover such costs before allowing them to go into effect

AT&T/WorldCom are also wrong that Verizon VA's evidence fails to establish a *prima facie* takings claim. AT&T/WCom Opp. at 109. AT&T/WorldCom wrongly suggest that the Commission need not consider evidence of Verizon VA's historical costs that is derived from Verizon's ARMIS data AT&T/WCom Opp. at 110. But the *Order* itself repeatedly relies on ARMIS data. *See Order* ¶ 298. And the Commission itself has stated that ARMIS is a reliable source of data.[83] In addition, contrary to AT&T/WorldCom's claim, the Supreme Court did not hold that Verizon's ARMIS reports "have no credibility." AT&T/WCom Opp. at 110. Although the Court expressed concern that net book value would not necessarily reflect the *economic* value of the facilities, it did not suggest that accounting records were unreliable as evidence of the extent of the utility's actual investment. *Verizon Communications*, 535 U.S. at 517-18 ("the 'book' value or embedded costs of capital presented to traditional ratemaking bodies often bore

[82] The Due Process Clause of the Fifth Amendment also requires that a utility be afforded a meaningful opportunity to challenge rates as confiscatory. *See, e.g., Michigan Bell Tel. Co. v. Engler*, 257 F.3d 587, 593 (6th Cir. 2001); *Guaranty Nat'l Ins. Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990), *Calfarm Ins Co. v Deukmejian*, 771 P.2d 1247, 1254 (Cal. 1989).

[83] *See e g* Memorandum Opinion and Order, *Joint Application by SBC Communications Inc., Southwestern Bell Telephone Co., and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Arkansas and Missouri*, 16 FCC Rcd 20719, 20748 ¶ 60 n.161 (2001) (noting that "ARMIS data is [] reliable because it is based on publicly available reported data").

little resemblance to the economic value of the capital"). In any event, the net book value reflected in Verizon's ARMIS reports is the product of depreciation schedules *required* by the Commission; indeed, the Commission has rejected attempts by Verizon to depreciate assets more quickly.[84] Thus, Verizon VA has a constitutional right to recover its remaining unrecovered investment.

Likewise, the evidence Verizon VA submitted concerning its current retail revenues is relevant to show such a takings. AT&T/WorldCom's effort to prove otherwise, *see* AT&T/WCom Opp. at 109, fail. Those revenues — less the costs that Verizon VA would avoid when providing only wholesale services — provide a reasonable proxy for the level of revenues that Verizon VA would need to cover its wholesale costs of providing UNEs while earning a reasonable rate of return.

Finally, AT&T/WorldCom are wrong that Verizon VA's TELRIC studies do not provide a meaningful benchmark for its actual forward-looking costs of providing UNEs. *See* AT&T/WCom Opp. at 110. Their sole support for this argument is that the Bureau rejected Verizon VA's proposed rates. But in rejecting Verizon VA's proposed rates, the *Order* concludes — albeit erroneously — that those rates are too *close* to Verizon VA's actual costs. And TELRIC necessarily produces an *understatement* of actual forward-looking costs, as Verizon VA has explained. VZ-VA Ex. 101 at 4-7, 21-25. Thus, Verizon VA's proposed TELRIC rates are if anything an overly conservative proxy for (and therefore *understate*) Verizon VA's actual forward-looking costs.

84/ *See* Report and Order, *1998 Biennial Regulatory Review — Review of Depreciation Requirements for Incumbent Local Exchange Carriers*, 15 FCC Rcd (1999).

CONCLUSION

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

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<u>CERTIFICATE OF SERVICE</u>

I do hereby certify that true and accurate copies of the foregoing, Verizon's Reply to AT&T/WorldCom's Opposition to Verizon's Application for Review, were served by hand delivery via courier this 24th day of October, 2003, to:

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