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Via Electronic Filing

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

Re: Notice of Ex Parte Presentation: *In the Matter of Stale or Moot Docketed Proceedings, CC Docket Nos. 93-193, 94-65 and 94-157.*

Dear Ms. Dortch;

Yesterday, June 16, 2004 David Lawson of Sidley Austin Brown and Wood, Robert Quinn Jr. and I met with Daniel Gonzalez, Senior Legal Advisor to Commissioner Kevin J. Martin regarding the above mentioned proceeding. We reiterated the statements and positions taken in our previous filings and used the attached documents, including AT&T's June 4th ex parte filing, as an outline for our discussion.

Consistent with the Commission rules, I am filing one electronic copy of this notice and request that you place it in the record of the proceedings.

Sincerely,

A handwritten signature in black ink that reads "Patrick H. Merrick".

Attachment

CC: Daniel Gonzalez

RAO 20
1996 EXOGENOUS COST INCREASES

BASIC FACTS

- Other Postretirement Benefits or “OPEB” obligations are amounts that the Bells expect to pay in *future* years to retirees (in the form of medical, dental and other benefits), and are thus effectively a zero interest loan from employees.
- Prior to 1993, the Bells’ reflected in their books, only OPEB amounts that they were actually paying, rather than amounts that they owed to employees in the future.
- In 1991, the Commission required the Bells to also reflect future OPEB obligations as liabilities on their regulatory accounting books as of January 1, 1993.
- Long-standing Commission policy (and basic economic principles) hold that rates should not provide a return on such zero-cost sources of funds. Investors are only entitled to earn returns on funds they supply. Correlatively, to obtain an accurate measure of returns an ILEC is actually earning, the rate base must be reduced to reflect the fact that some assets are funded not only by investors, but by OPEB and other zero cost sources of funds.
- The OPEB liabilities are zero-cost sources of funds. The Bells have the free use of the money they show as OPEB “liabilities” on their books for years before they actually have to pay anything out to the retirees. *1995 Price Cap Order*, ¶¶ 292, 307 (10 FCC Rcd. 8961 (1995)).
- Accordingly, in 1992, the Common Carrier Bureau required the Bells to deduct OPEB amounts from their rate bases (as they had long been required to do for indistinguishable postretirement pension benefits). *RAO 20 Letter* (7 FCC Rcd. 2872 (1992)).
- The Bells deducted OPEBs from their rate base in 1992, 1993, 1994 and 1995.
- In 1996, the Commission ruled that the Bureau had acted beyond the scope of its delegated authority in issuing the *RAO 20 Letter*. *1996 Suspension Order*, ¶ 19 (11 FCC Rcd. 2957 (1996)).
- The Commission did not question the substantive correctness of the Bureau’s decision. To the contrary, in the same order that rescinded the *RAO 20 Letter* on that purely procedural ground, the Commission initiated a proceeding to memorialize the substance of the *RAO 20 Letter* in a formal Commission rule; nine months later the Commission did just that. *OPEB Rate Base Order* (12 FCC Rcd. 2321 (1997)).
- The Bells seized upon the few month period between rescission of the *RAO 20 Letter* and the formal adoption of the new rule as an opportunity to appropriate windfalls from ratepayers.
- Specifically, the Bells did the following:
 - They retroactively reversed the rate base deductions for 1992-1995.
 - By reversing the rate base deductions for prior years, the Bells increased their rate base for those years; the higher rate base made their “returns” for those years appear smaller; the Bells then contended that with lower returns, their sharing obligations in those years would have been lower.
 - The Bells then recovered those purported “over-sharing” amounts by adding, as a lump sum, those amounts to their 1996 rates through “exogenous cost” increases to their 1996 price cap indices (“PCIs”).
- The Commission immediately suspended the Bells’ tariffs, ordered an accounting (to ensure refunds) and opened an investigation. (11 FCC Rcd. 7564, ¶ 4)
- This proceeding is part of that ongoing investigation.

THERE HAS NEVER BEEN ANY DOUBT THAT THE BELLS ACTIONS WERE UNJUST AND UNREASONABLE

- The Commission has already ruled that the Bells' rate base practice is unjust and unreasonable and would allow them to overrecover by forcing ratepayers to pay returns on assets funded with zero-cost funds.
 - *OPEB Rate Base Order*, ¶ 19 (12 FCC Rcd. 2321 (1997) (“because the amounts recorded in Account 4310 are zero--cost sources of funds, rates should not provide a return on those amounts)).
- The Bells' therefore claim that the Commission is powerless, as a legal matter, to stop them from exploiting rule gaps that they claim bar the Commission from reaching the undeniably correct result in this tariff investigation.
- The Bells obviously bear a heavy burden to demonstrate that the Commission is without authority to do what the public interest so clearly demands. They have not remotely met that burden.

THE BELLS FOCUS ON THE WRONG ISSUES AND THE WRONG RULES

- The Bells focus on whether the Commission’s 1996 rate base rules allowed them to restate 1992-95 rate bases (in direct contravention of the Commission’s policy with regard to zero-cost sources of funds).
 - The Part 65 rate base rules at the time of these tariff filings stated that “[t]he rate base shall consist of the interstate portion of the accounts listed in Sec. 65.820 that has been invested in plant used and useful in the efficient provision of interstate telecommunications services regulated by this Commission, minus any deducted items computed in accordance with Sec. 65.830.” 47 C.F.R. § 65.800.
 - Because 47 C.F.R. § 65.830 did not, at that time, specifically address OPEBs – which is not surprising, given that the OPEB liabilities *did not even exist* when the rate base rules were promulgated – the Bells claim that once *RAO 20* had been rescinded, the Commission has no choice but to allow them to restate their rate bases for each year from 1992-95.
- There are at least three fundamental flaws in the Bells’ argument.
 - *First*, the Bells’ focus on the Part 65 Rules is misplaced. Assuming, *arguendo*, that the Bells could lawfully have restated their rate base back to 1992, it does not at all follow that it was lawful for them to use those changes to implement massive exogenous cost increases to their PCIs and rates, as they did in the 1996 tariff filings at issue here. Their ability to do the latter is governed by the *Part 61 price cap rules*, not the Part 65 rate base rules. And the Part 61 price cap rules expressly and absolutely foreclose the challenged exogenous cost increases at issue here.
 - ✓ The price cap rules allow for periodic adjustments to price caps, but *only* as expressly authorized by the formula contained in those rules.
 - ✓ Rate changes based upon “exogenous” cost changes are strictly limited.
 - ✓ Under the rules in effect in 1996 (and today), “[e]xogenous changes represented by the term ‘delta Z’ in the [current period PCI] formula . . . shall be limited to those cost changes that the Commission shall permit or require by rule, rule waiver or declaratory ruling.” 47 C.F.R. § 61.45(d).
 - ✓ The Bells do not dispute that they never sought (much less obtained) a rule waiver or declaratory ruling permitting them to implement the disputed rate base-restatement generated exogenous cost increases to their 1996 PCIs.
 - ✓ The Bells have not identified a pre-existing Commission rule that expressly authorized those exogenous cost increases.
 - The Bells point to 47 C.F.R. § 61.45(d), which, as one component to the “delta Z” exogenous cost factor in the PCI formula, requires the Bells to “make such temporary exogenous cost changes as may be necessary to *reduce* PCIs to give full effect to any sharing of *base period* earnings required by the sharing mechanism.” See 47 C.F.R. § 61.45(d) (emphasis added).
 - The “base period” is the “12 month period ending six months prior to the effective date of annual price cap tariffs.” 47 C.F.R. § 61.3(e). The effective date of the Bell’s 1996 tariffs was July 1996, which means that the relevant “base period” was 1995.
 - Thus, under the Bells’ “sharing theory,” they could, *at most*, invoke § 61.45(d) as a justification for reflecting reversal of the OPEB deduction for the 1995 base period rate base that is used in the exogenous cost sharing adjustment authorized by that rule.
 - With respect to earlier years, the Bells quite plainly are seeking an extraordinary exogenous cost increase to their 1996 PCIs and rates that is neither permitted, nor required, by any Commission rule.

- And, in any event there is a second independent commission rule that categorically prohibits the Bells from increasing their 1996 PCIs to account for OPEBs in any year, *even for 1995*.
 - In 1995, the Commission expressly “limit[ed] exogenous cost treatment of cost changes resulting from changes in the USOA requirements to *economic cost changes*.” *1995 Price Cap Order*, ¶ 292.
 - The Commission unambiguously ruled that “when an accounting change *that otherwise meets the existing standards for exogenous treatment* also affects cash flow, carriers will be able to raise PCIs to recognize this effect,” but “[w]ithout a cash flow impact, carriers will *not* be able to raise PCIs to recognize an accounting change.” *Id.* ¶¶ 292, 294 (emphasis added). Thus, at the time of the tariff filings at issue here, an ILEC was required to make two independent showings to justify any exogenous cost increase to PCIs: (1) that the increase was authorized by rule, rule waiver or declaratory order, and (2) that even if the increase “otherwise meets” that standard, that it also has a cash flow impact.
 - But at the time the Bells filed their 1996 tariffs, the Commission had already determined in the same 1995 order that unfunded OPEB amounts are exactly the type of accounting changes that have *no* economic cost or cash flow impact. *Id.* ¶ 307. The “cash flow impact” rule is thus categorical and fatal to the Bells’ 1996 tariff filings.
- *Second*, even ignoring the Part 61 exogenous cost rules, and assuming that the Part 65 rules are controlling here (as the Bells do), it does not follow that the Commission must allow the Bells’ to make the retroactive rate base adjustments.
- ✓ The Part 65 Rules only address how to compute the rate base for the current tariff year.
 - ✓ Nothing in the Part 65 Rules authorizes LECs retroactively to change their rate bases for prior years; nor does it authorize LECs to compute any under-recovery from such changes in the current year’s rates through an exogenous cost increase.
 - ✓ The Commission has ample authority in this proceeding to determine whether its rules permit such retroactive changes.
 - ✓ The Bells contend that Part 65 of the Commission’ rules (47 C.F.R. §§ 65.800-830) contain the exclusive list of items that must be included and excluded from rate base calculations and that the Commission has *no authority* in subsequent tariff investigations to address the proper rate base treatment of new assets or liabilities or other new circumstances that are not expressly addressed by the rules.
 - The Bells read far too much into the rate base rules. 47 C.F.R. § 65.830 simply lists items that “shall be deducted from the interstate rate base.” There is no indication in the rules or any Commission order that the items that appear in § 65.830 at any given time are meant to be the *exclusive* list for all time, never to be expanded or contracted except through prospective rulemakings outside of tariff investigations.
 - Rule 65.830 reflects the need to reduce the rate base on which investor returns are determined to reflect the fact that some portion of the firm’s assets has been funded with capital supplied from sources *other* than investors – investors earn returns on the capital *they* supply. *All* “zero cost” sources of capital must be deducted if returns are to be properly calculated and, of course, not even the most prescient regulator could hope to anticipate all of the myriad forms that such zero cost capital might take. The categories expressly listed in section 65.830 at any given time thus merely reflect the ones that have come to the Commission’s attention to that point.

- The Commission has, in fact, *never* read the Part 65 list of inclusions and deductions to be so rigidly exclusive as to preclude case-by-case consideration of the appropriateness of particular costs that have not yet been specifically addressed at the time a tariff dispute arises. For example, in 1995 the Commission found that Ameritech had been improperly including an equity component in its cash working capital allowance, which is included in the rate base. Ameritech contended that “because the equity component was not specifically listed among the exclusions [in the Part 65 rules], it can be included in cash working capital calculations pending further, more specific pronouncements by the Commission.” (10 FCC Rcd. 5606, Appendix A ¶ 6 (1995)). Ameritech argued that “the applicable rule, Section 65.820(d), continues to be worded in a way that permits the inclusion of an equity component in the development of the cash working capital allowance.” (*Id.* ¶ 5). The Commission rejected that argument, and stated that “even if the Commission did not specifically exclude equity from cash working capital in the [original rules], the omission in the order cannot logically or legally be relied upon to justify including equity in earlier calculations [*i.e.*, calculations prior to the Commission’s later order clarifying that equity was to be excluded].” (*Id.* ¶ 6).¹
- If the Commission were constrained to deal with each new gray or unanticipated area only in a rulemaking initiated after a tariff dispute arose and with rules that could apply only to subsequent disputes, as the Bells’ contend, the Bells could with impunity use all new unjust and unreasonable practices that the Commission rules have failed to prophesy to raise rates in at least one annual tariff filing. That has never been – and could not rationally be – the law.
- It is thus well settled that in tariff investigations, the Commission can add to its rules to account for new circumstances in a manner that is consistent with the public interest and Commission policy. “[A] tariff investigation is a rulemaking of particular applicability under the APA,” *Access Reform Tariff Order* ¶ 81 (13 FCC Rcd. 14683, ¶ 81 (1998)), in which “[t]he Commission routinely makes significant policy and methodological decisions based on the records developed in tariff investigations and such decisions do not violate the notice and comment requirements of the [APA].” (Memorandum Opinion and Order, *Implementation of Special Access Tariffs of Local Exchange Carriers*, 5 FCC Rcd. 4861 (1990); 5 U.S.C. § 551(4))
- The Commission thus can in *this* tariff investigation reject the Bells’ proposed rate base restatements to reflect the reality that the Bells’ practice with regard to OPEBs was simply not contemplated or addressed by rate base rules.

¹ In a footnote to its *May 13, 2004 Letter*, Verizon tries to distinguish this case by noting that the Commission in that order relied on the fact that cash working capital had “always” been limited to “cash expenses” and excluded “equity.” *Verizon March 13, 2004 Letter*, at n.4. But that only proves AT&T’s point. Here, the Commission has always held that zero-cost sources of funds should be deducted from the rate-base, and that unfunded OPEB amounts are zero-cost sources of funds. In the Ameritech case, the Commission determined that equity amounts should not be included in cash expenses. In both cases, Commission recognized that those long-standing principles were not necessarily “explicitly” stated in the Commission’s rules or orders. In the Ameritech case (¶ 6), the Commission stated that “even if the Commission did not explicitly exclude equity from cash working capital . . . the omission . . . cannot logically or legally be relied upon to justify including equity in earlier calculations.” Likewise, here, the fact that the Commission’s rules during a short 9-month window in 1996 did not explicitly require the Bells to deduct OPEB amounts from their rate bases does not mean that they can logically or legally include OPEB amounts in their rate bases in violation of long-standing Commission policy.

- That is not, as the Bells wrongly suggest, tantamount to an unjustifiable about-face on the proper rate base treatment of OPEBs, but the filling of a clear gap in those rules, which is standard agency fare.
 - The Commission would not be interpreting its rules in a way that “arbitrarily and capriciously disregarded” the text of those rules as the Court found in *Southwestern Bell*, but forthrightly, reasonably and with fair notice construing and supplementing those rules to address a new practice.
 - The road to reversal here is the one urged by SBC and Verizon of mechanically applying the rate base rules without regard to their core purposes. See, e.g., *C.F. Communications v. FCC*, 128 F.3d 735, 740-41 (D.C.Cir. 1997) (rejecting Commission’s interpretation of rules because “[t]he Commission . . . unreasonably . . . ignored the context” of the rules); *Corporate Telecom Services v. FCC*, 55 F.3d 672, 675 (D.C. Cir. 1995) (rejecting Commission’s rule interpretation as inconsistent with the “values the provision is supposed to embody”); *WAIT Radio v. FCC*, 418 F.2d 1153, 1157 (D.C. Cir. 1969) (“That an agency may discharge its responsibilities by promulgating rules of general application which, in the overall perspective, established the ‘public interest’ for a broad range of situations, does not relieve it of an obligation to seek out the public interest in particular, individualized cases”).
- *Third*, even if the Part 65 rules authorized the LECs to make retroactive rate base adjustments, those rules would conflict with the Part 61 rules and the *1995 Price Cap Order*, which preclude the LECs from making exogenous cost adjustments to account for the OPEB costs at issue here.
- ✓ This conflict creates an ambiguity in the Commission’s rules, which even the Bells concede the Commission can resolve in this tariff investigation. *VZ May 24 2004 Ex Parte* at 4 (the Commission has authority to interpret the price cap rules in tariff investigations where “the price cap rules, by their terms, are ambiguous”).
 - ✓ And the Commission already has determined that allowing such exogenous cost treatment would violate the just and reasonable standards of the Act. *1995 Price Cap Order*.

EVEN ASIDE FROM THE PRICE CAP RULES, THE COMMISSION HAS AN INDEPENDENT OBLIGATION TO REJECT “UNJUST AND UNREASONABLE” RATES

- The Commission has an independent obligation to reject rates that are unjust and unreasonable. *E.g.*, 47 U.S.C. §§ 201 & 202.
- As noted, the Commission already has determined that permitting LECs to recover the OPEB costs at issue here through exogenous cost increases is unjust and unreasonable. *OPEB Rate Base Order*, ¶ 19 (12 FCC Rcd. 2321, ¶ 19 (1997)).
- Only Verizon attempts to address the Commission’s obligations under the Act to reject unjust and unreasonable rates. But Verizon’s arguments do not withstand scrutiny.
 - Verizon asserts that the 1996 tariffs are *per se* lawful because they complied with the Commission’s 1996 price cap rules at that time.
 - ✓ *First*, as noted, Verizon’s tariffs did not comply with the Commission’s 1996 price cap rules. Verizon’s tariff violated the Part 61 exogenous cost rules and the *1995 Price Cap Order*.
 - ✓ *Second*, at best, the Commission’s rules in 1996 were ambiguous with respect to how LECs should address the Commission’s 9-month rescission of the RAO 20 Order. The rules did not expressly permit retroactive rate base adjustments. And the Commission’s exogenous cost rules precluded exogenous cost increases associated with those rate base adjustments. As noted, Verizon admits that the Commission is authorized to resolve such ambiguities in tariff investigations such as this one.
 - ✓ *Third*, it is not true that the a tariff that complies with the Commission’s price cap rules is *per se* lawful, and cannot be reviewed to ensure that it is just and reasonable as required by the Act.
 - The Commission expressly rejected that precise argument in 1991, immediately after adopting the price cap rules. *Dominant Carriers Order*, ¶¶ 203-206 (6 FCC Rcd 2637, ¶¶ 203-206 (1991)).
 - “U S West contend[ed] that ‘there is no such thing as an unlawful rate based on overearnings in a price cap environment when . . . all price cap rules are adhered to.’” *Id.* ¶ 203 (quoting a U S West Petition). The Commission found “no adequate support for th[at] absolutist view.” *Id.* ¶ 206. “The possibility remains . . . that rates for specific services may be set at unreasonable levels, or be unlawful in other ways” and “compliance with the price cap rules does not necessarily make this impossible.” *Id.*; *see also* 13 FCC Rcd. 10597, ¶ 7 (1998) (“Even under price cap regulation, carriers bear an obligation under the Communications Act to tariff just and reasonable rates”); 6 FCC Rcd. 4891, ¶¶ 9-10 (1991) (noting that compliance with the price cap rules is “not the sole criteria on which the lawfulness of a rate in a tariff investigation or complaint proceeding is resolved”).
 - Verizon ignores these consistent holdings and instead relies on out-of-context snippets from ¶ 202 and footnote 211 of the *Dominant Carrier Order*. Those portions of the *Dominant Carrier Order* merely suggest that a complaint challenging a carriers’ tariff *solely* on the grounds that the carriers’ revenues are too high would be foreclosed if the carrier complied with the Commission’s price cap rules. *Id.* ¶ 202 (“[a] complaint against a price cap carrier that is based solely upon the theory that rates are unjust and unreasonable because the rates produced [high] . . . earnings would be dismissed”); *id.* n.211 (“Only filings that make price changes within cap and band limits are presumed lawful and streamlined, and even filings that are subject to streamlining may be investigated. The only complaints foreclosed by price cap regulation are those based upon total interstate earnings”).

- These provisions clearly have no application here because Verizon's tariffs are being investigated not "solely" because Verizon's total earnings were too high, but because Verizon's rate base-generated exogenous cost increase to its PCIs was unjust and unreasonable.
 - The other orders cited by Verizon (*Verizon May 24 Ex Parte* at 2-3) merely state that the Commission's price cap rules were designed to produce just and reasonable rates, and thus compliance with those rules is necessary to produce just and reasonable rates. But those orders do not even remotely suggest that mere compliance with the price cap rules is *sufficient* to produce just and reasonable rates.
- Verizon also purports to advance a "new" argument that unfunded OPEBs are not really zero-cost sources of funds. But this "new" argument was first advanced by Verizon's predecessor, Bell Atlantic, and others in the proceeding that resulted in the *OPEB Rate Base Order* and, based on the full record addressing that issue, the Commission properly rejected the that argument. *OPEB Rate Base Order* ¶¶ 16-17.

**THERE ARE NO LEGITIMATE POLICY ARGUMENTS FOR ALLOWING
THE BELLS TO KEEP THE OVERCHARGES**

- The Bells arguments that the Commission should allow them to keep tens of millions of dollars in overcharges on public policy grounds are baseless.
- The Commission has repeatedly recognized, “[e]very customer has the right to be charged lawful rates.” Memorandum Opinion and Order, 17 FCC Rcd 24201, *Communications Vending Corporation of Arizona, Inc., et al. v. Citizens Communications Company*, 17 FCC Rcd 24201, ¶ 47 (2002). The Bells, “having initially filed the rates and . . . collected an illegal return . . . must . . . shoulder the hazards incident to [their] . . . actions including . . . refund[ing] of any illegal gain.” *Id.*
- There is no legitimate basis for allowing the Bells, who were fully on notice that refunds would be required if their 1996 exogenous cost increases were found to be unlawful, to keep those amounts.
- Verizon nonetheless argues that the Commission should exercise “discretion” to put the Bells in the same position they would have occupied but for the Bureau’s procedural error in issuing the *RAO 20 Letter*.
 - But requiring refunds *would* put the Bells in the same position they would have occupied but for issuance of the *RAO 20 Letter*.
 - ✓ The Commission has consistently stated that it “agreed with the Bureau” on the substance of the *RAO 20 Letter*. *OPEB Rate Base Order* ¶¶ 17-19; *1996 Suspension Order* ¶ 25.
 - ✓ Thus, if the legal error complained of had not been made – *i.e.*, issuance of the *RAO 20 Letter* by the Bureau, rather than the full Commission – there would have been a binding *Commission* order in place during the 1992-1995 period requiring deduction of OPEB liabilities from rate bases.
 - ✓ Indeed, even in the best case scenario for the Bells – no *RAO 20* ruling by the Bureau *or* the Commission in 1992 – this issue would have been resolved in the first year that the Bells attempted to base sharing on rate bases without OPEB deductions. Because the Bells have never had any serious argument as to why OPEBs should not, like other zero-cost funds, be deducted from the rate base, the Commission would have suspended the Bells’ tariffs (as it did the first time they tried to implement their scheme in 1996) and expeditiously issued an order that precludes LECs from including such zero-cost OPEB amounts in the rate-base. Even under the Bells’ erroneous view that such a rule could operate only prospectively, that means that in the “but for” world that the Bells posit, they could, at most, have gotten away with their scheme for the first year (1992).
 - Verizon refers the Commission to cases where rates adopted by regulatory agencies were found to be unlawful by reviewing courts, and where the agencies were permitted to exercise discretion to correct the legal error by permitting the utility retroactively to recover the difference between the unlawful rates and newly-determined lawful rates. *See, e.g.*, Verizon Direct Case Reply at 15.
 - ✓ But, as the cited decisions make clear, the agency’s discretion to permit retroactive rate changes is grounded in a court ruling that prior rates adopted by the agency were, in fact, held to unlawfully low levels – the error correction doctrine is designed to serve equitable interests when substantive legal errors have been made.
 - ✓ The Bells plainly have no such equitable interest here. They seek pure windfalls. And the “error” that they rely upon here is not a substantive legal error at all, but simply a procedural error – the wrong Commission entity issued the plainly lawful ruling that OPEBs, like other zero cost funds, must be deducted from the rate base. There is no basis to conclude that the Bells’ rates in 1992-1994 were unlawfully low – and certainly no court decision so finding.

- Verizon also claims that that it would be unfair to issue refunds because “Verizon was simply following the Commission’s clear, contemporaneous instructions.”
 - ✓ But, as demonstrated above, that is not true. Verizon’s exogenous cost increases violated multiple Commission rules.
- Verizon next claims that it should not be required to issue refunds because the carriers that paid the tens of millions of dollars in overcharges may have recovered those overcharges from their end user customers through increased rates in unregulated long-distance markets.
 - ✓ That precise argument has been rejected by the Commission. *See* Memorandum Opinion & Order, *Communications Vending Corporation of Arizona v. Citizens Communications Company*, 17 FCC Rcd. 24201 (2002). There, defendants argued, as Verizon does here, “that carriers should not receive a refund because they have already recovered from their customers the full [overcharge] . . . [and therefore] a refund would amount to double recovery.” *Id.* ¶ 47.
 - ✓ In rejecting that argument, the Commission explained that, in “a market with unregulated prices, the carriers were entitled to charge their customers a surcharge for per-call compensation or, indeed, to raise the retail rate to any level they think the market will bear. But the recovery of the surcharge does not undermine the legitimacy of the expectation that the carriers would eventually recover a refund because they paid an unlawful rate. . . . Carriers may have set their base rates or made other business plans in reliance on such an expectation, and we will not disturb those expectations because of the possibility of an appearance of double recovery. Indeed, the concept of double recovery is not particularly meaningful in a market where prices are not regulated.” *Id.*
 - ✓ In any event, Verizon has provided *no evidence* that AT&T or any other carrier fully recovered the tens of millions of dollars in overcharges from end user customers. In fact, it is not even clear that AT&T and other carriers could successfully have recovered the Bells overcharges through increased rates.
 - Basic economics teaches that increased rates result in decreased demand. Therefore, even if AT&T and other carriers tried to pass on the Bells unlawful overcharges to end-user customers, the demand for AT&T’s and other carriers’ services would have declined which, in turn, would have reduced revenues. And Verizon has provided no evidence that, even if AT&T and other carriers increased rates, the corresponding revenues were sufficiently compensatory. This is fatal to Verizon’s argument. *E.g.*, Memorandum Opinion and Order on Reconsideration, *1997 Annual Access Tariff Filings*, 13 FCC Rcd 10597, ¶ 9 (1998) (finding that “excessive . . . CCL charges . . . artificially depress[ed] demand . . . [and] also . . . transfer[red] . . . revenues to the LECs from their potential competitors, the IXC’s” and “refunds are necessary to protect end-users’ and IXC’s interests in the development of competition and in obtaining just and reasonable toll calling rates”).
- Verizon’s argument also fails on fundamental policy considerations. Permitting the Bells to keep tens of millions of dollars in overcharges would create additional incentives for Verizon and other carriers to implement unlawful tariffs that include substantial overcharges because they would know that even when the overcharges were ultimately deemed unlawful that they would be permitted to keep them.
- Finally, there is no merit to the Bells arguments that they should be immune from refunds just because the Commission failed to resolve these proceedings in a timely manner. The Bells’ earned a windfall of tens of millions of dollars financed by AT&T and other ratepayers. There is no legitimate basis for allowing the Bells to retain those windfall overcharges simply because the Commission, for whatever reason, failed to complete these investigations in a timely manner.

**BELL ATLANTIC UNLAWFUL BACKDATING
OF OPEB RULES**

BACKGROUND

- In 1990, the Federal Accounting Standards Board (“FASB”) adopted Statement of Financial Accounting Standards Number 106 (“SFAS-106”), effective December 15, 1992, which established new financial accounting and reporting requirements for other post-employment benefits (“OPEBs”).
- In December 1991, the Commission issued an order that required LECs, by January 1, 1993, to conform their regulatory books with the new SFAS-106 financial accounting rules. (6 FCC Rcd. 7560, ¶¶ 3, 5 (1991)).
- Verizon chose *voluntarily* to implement the accounting change in its regulatory books well before it was required to do so, in 1993. Verizon states that on December 31, 1991, it notified the Commission that it would implement the SFAS-106 rules immediately (and retroactively) as of January 1991.
- In its 1993/94 and 1994/95 interstate access tariffs Verizon sought to recover purported 1991 and 1992 costs associated with its voluntary early adoption of SFAS-106 by increasing its interstate access rates, claiming that its voluntary early adoption of SFAS-106 resulted in “exogenous cost” increases that justified increases to price cap indices (“PCIs”).
- The Commission immediately suspended Verizon’s tariffs, set an accounting order (to keep track of potential refunds) and opened an investigation of Verizon’s tariffs. (7 FCC Rcd. 2724, ¶ 8 (1992)).

VERIZON'S RATE INCREASES WERE UNLAWFUL

- There is no longer any dispute on the merits that allowing Verizon to keep the rate increases it collected in connection with the 1991/92 period of voluntary early adoption would be to grant Verizon a pure windfall at the expense of ratepayers.
 - The Commission ruled in 1995 that the proper SFAS-106 accounting change had absolutely no cash flow or other economic impact. *1995 Price Cap Order*, ¶ 309 (10 FCC Rcd. 8961, ¶ 309 (1995)).
- Verizon's argument therefore is that the Commission's rules in place at the time of the tariff filing did not allow the Commission to reach the correct outcome and require refunds.
- But there were in fact two separate Commission rules in place in 1993, each of which independently foreclose the Verizon rate increases.
 - *First*, the Commission's *1990 Price Cap Order* made clear that "no GAAP change can be given exogenous treatment until FASB has actually approved the change *and it has become effective.*" (5 FCC Rcd. 6786, ¶ 168 (1990)).
 - ✓ It is undisputed that the "effective" date of SFAS-106 was, as expressly stated in the order promulgating that rule, December 15, 1992.
 - ✓ The Commission's rules therefore prohibited Verizon from making any exogenous cost adjustment for any SFAS-106 costs incurred prior to December 15, 1992.
 - ✓ Verizon's response is that the relevant "effective date" should not be the date on which the FASB rule change itself became effective but instead the date on which Verizon chose to make the rule effective for its own internal accounting purposes.
 - That interpretation of the rule is foreclosed by both its plain language and clear Commission precedent: (1) it would render the effective date rule meaningless as it would permit carriers arbitrarily to choose "effective dates" and (2) the Commission has rejected that argument. In an earlier 1990 order the Commission rejected AT&T's attempt to obtain exogenous cost treatment in connection with AT&T's own voluntary early adoption of SFAS-106. (5 FCC Rcd. 3680 (1990)). Like Verizon here, AT&T had argued that FASB would soon adopt the SFAS-106 changes and would make those changes mandatory by 1992 and that AT&T had internally already made those changes effective. The Commission squarely rejected AT&T's claims for exogenous treatment, and it must do the same with respect to Verizon's claims for exogenous treatment for periods prior to the effectiveness of SFAS-106.
 - *Second*, any costs associated with the 1991/92 period of early voluntary adoption do not satisfy the definition of "exogenous cost" under the Commission's 1993 rules.
 - ✓ LECs are permitted to obtain exogenous cost treatment only for costs that are "beyond the[ir] control." *1990 Price Cap Order* ¶ 166; *Southwestern Bell*, 28 F.3d 165, 170 (D.C. Cir. 1994).
 - ✓ The Commission did not require Verizon to reflect SFAS-106 in its accounting books until January 1, 1993.

- ✓ Any implementation of SFAS-106 prior to January 1, 1993 was therefore entirely within Verizon's control.
- ✓ Accordingly, any costs related to such early implementation could not be treated as exogenous costs within the meaning of the Commission's rules, and thus could not be used to increase price caps.
- ✓ Contrary to Verizon's assertions, *Southwestern Bell*, 28 F.3d 165, supports this straightforward application of the 1993 rules. In *Southwestern Bell*, the Court did nothing more than reject a prior Commission finding that the "control" test could be interpreted to mean that a LEC maintains control, even after an accounting change has become "mandatory," simply because the LEC retains control of the underlying OPEB costs – e.g., the LEC retains the ability to control the types of post-retirement benefits it pays to its employees. The Court reasoned that such an "underlying control" criterion was not part of the Commission's "control" test under the existing rules. *Southwestern Bell*, 28 F.3d at 170, 173. Here, by contrast, Verizon had complete control over its decision to implement SFAS-106 early, which is fully consistent with the D.C. Circuit's holding. As the Court explained, the SFAS-106 accounting change was "outside the control" of carriers "once mandated by the Commission." *Southwestern Bell*, 28 F.3d at 170. Thus, under the classic control test applied in *Southwestern Bell*, Verizon maintained complete control over whether to adopt SFAS-106 prior to January 1, 1993, and such costs, therefore, are not "exogenous" costs that can be recovered through subsequent rate increases. 47 C.F.R. § 61.45(d).
- ✓ Verizon makes much of the fact that it was "permitted" and "encouraged" to make the accounting change prior to January 1, 1993, but that is irrelevant to the question whether such cost changes are *exogenous*. As explained above, a cost change is exogenous only if it is truly beyond the control of the carrier, and prior to January 1, 1993, cost changes related to SFAS-106 were not.

VERIZON MISCALCULATES ITS HEADROOM

- Verizon states that it should not be subject to refunds because it had sufficient “headroom” in the 1993/94 tariff period, even without additional exogenous cost increases to its price caps.
- Verizon has offered two headroom analyses, both of which are wrong.
 - First, Verizon argued that it could avoid refunds even in price cap baskets in which it concededly lacked headroom (the special access basket) by applying headroom that existed in other baskets (the common line and traffic sensitive baskets).
 - ✓ But the price cap rules operate on individual baskets, not collectively for all baskets, and the Commission has repeatedly rejected LEC attempts to “borrow” headroom from one basket to avoid refund obligations in another basket. *See, 800 Database Recon. Orde*, ¶ 17 (12 FCC Rcd. 5188, (1997)) (“We . . . find unpersuasive arguments by various incumbent LECs that we should not require refunds because they could have raised rates in other baskets”).
 - Second, Verizon offered an equally unlawful, basket-by-basket approach.
 - ✓ The 1993/94 tariff period ran from July 1, 1993 through June 30, 1994. During that time period, the Verizon rates at issue were governed by one basket and rate structure from July 1, 1993 through February 28, 1994 (the special access basket), and a second basket and rate structure from March 1, 1994 through June 30, 1994 (the new “trunking” basket). Under the first basket and rate structure, Verizon’s API exceeded its PCI for its special access baskets by \$5.4 million on an annualized basis, *i.e.*, the “headroom” was \$5.4 million. The second basket and rate structure, which started in March 1994, implemented new Commission rules that required Verizon to rearrange the costs allocated to different baskets and to create a new basket called “Trunking.” The new trunking basket includes all of the special access basket, which had virtually no headroom, and transport costs that were formerly in the traffic sensitive basket. And when the transport costs were transferred to the new trunking basket, a portion of the traffic sensitive basket headroom was also effectively transferred into that new basket as well.
 - ✓ Verizon’s new accounting gimmick is to compute headroom in the special access basket for the entire 1993/94 accounting period by averaging the headroom under the two basket and rate structures – *i.e.*, treating the combination of baskets as if it had occurred in 1993.
 - ✓ The Commission has rejected this approach. In the 800 database proceeding several LECs, including Verizon’s predecessors, tried to avoid refunds by averaging headroom available under different tariffs in effect during the same year. The Commission expressly rejected that “averaging” approach: “Regarding [the] . . . argument that [LECs] . . . should calculate their headroom amounts by not averaging the offset for the entire year, but rather by comparing rates to caps at distinct points in time, we agree that *such weighted averaging should not be allowed because it distorts the headroom calculation* for those LECs.” *800 Data Base Order* ¶ 13 (emphasis added). Accordingly, the Commission required the LECs to compute refunds by comparing the APIs to their PCIs in the tariffs that were in effect for each time period. *Id.*

- ✓ Correcting Verizon's error, and applying the proper computational methodology confirms that under Verizon's basket and rate structures from July 1993 to March 1, 1994, Verizon's API for the special access basket exceeded its PCI by \$5.4 million on an annualized basis. The rates using those basket and rate structures were effective for two thirds of the year, so Verizon is subject to refunds for *at least* two thirds of those annualized amounts, or \$3.6 million, even if Verizon could be given headroom credit for the latter third of the tariff year.
- ✓ Given the circumstances, Verizon should not be given headroom credit for even the last third of the tariff year. There is no established method for computing refunds for the unique situation that arose in the last third of the 1993/94 tariff period. Ratepayers still were paying the same excessive special access rates that they were paying for the first two-thirds of the year because Verizon never lowered its rates – it was charging the same excessive special access rates that it was charging the first two thirds of the year. However, the basket restructuring reflected in that new tariff created the illusion that Verizon's excessive special access rates were legitimate, because the newly computed APIs fell below the newly computed PCIs for the new basket as a whole. In this unique situation, the Commission's usual method for measuring overcharges – *i.e.*, comparing the APIs to the PCIs for each basket – does not work, because such a comparison no longer provides a valid proxy for overcharges. The most equitable outcome in this situation is to compute refunds using the special access headroom (or, more precisely, the lack of special access headroom) that was in effect for the first two-thirds of the year. Because the special access rates in effect for the first two-thirds of the year were set to over-recover \$5.4 million on an annualized basis, and those special access rates *were not changed* after the March 1 basket restructuring, the Commission should require Verizon to refund the full \$5.4 million that was actually collected.
- ✓ As for the refunds due in the 1994/95 tariff year, there was no basket restructuring, eliminating any opportunity for Verizon to apply "averaging." And Verizon and AT&T agree that during the 1994/95 tariff year, Verizon's APIs exceeded its PCIs for the common line, traffic sensitive, and trunking baskets, and the total amount of these overcharges is more than \$2 million. *See* Exhibit A (attached); Verizon March 1, 2004 *Ex Parte*, Attachment at 12.
- ✓ Verizon thus owes ratepayers at least \$7.4 million in refunds for the 1993/94 and 1994/95 tariff periods.

ADD-BACK ISSUES

BASIC FACTS

- The concept of add-back is fairly straightforward:
 - Prior to January 1, 1991, the LECs were subject to “rate-of-return” regulation, whereby the LECs’ interstate access rates were set to target a prescribed rate-of-return. If a LEC earned a return that exceeded the prescribed maximum, the LEC was generally required to refund those over-earnings to ratepayers. To the extent that refunds were paid in subsequent tariff periods, a question arose as to whether LECs could account for those refund amounts when computing returns in those subsequent tariff periods. The Commission correctly determined that refunds in subsequent periods for overearnings in prior periods should not be allowed to impact the return calculations for the subsequent periods. The Commission therefore adopted the “add-back” rules.
 - An example illustrates the add-back issue: If a LEC earned \$100 in excessive returns in period 1, the LEC might be required to refund that amount to ratepayers in period 2. This refund would have the effect of reducing the LEC’s period 2 earnings by \$100. The issue, then, is whether the LEC is permitted to reflect that \$100 in reduced period 2 earnings when computing period 2 returns. The Commission reasoned that because the \$100 was paid by the LECs for overearnings in period 1, the LEC should not be permitted to reduce its period 2 earnings by that amount. If the \$100 were not “added back” to period 2 earnings, the LEC would report that it earned \$100 less than it actually earned in period 2, resulting in understated rate-of-return estimates for period 2. And because period 3 return requirements are based, in part, on reported period 2 returns, the LEC’s period 3 return requirements would be inaccurately computed as well. Accordingly, the Commission’s rules have long required LECs to “add back” the \$100 to its period 2 earnings when computing the LEC’s period 2 returns.
- In the price cap orders, the Commission adopted a new regulatory approach – the “price cap” mechanism – whereby the Commission regulates the maximum prices that LECs can charge for baskets of interstate access services rather than the maximum rates-of-return they can earn. However, to protect ratepayers, the Commission still required LECs that earned returns that exceeded just and reasonable levels to “share” those returns with ratepayers. Therefore, even under the price cap mechanism, LECs are required to compute rates-of-return for the purpose of determining whether the LEC is subject to sharing adjustments.
- The Commission’s price cap orders, however, did not expressly mention whether the add-back component of the rate-of-return regulations should be applied when computing rates-of-return under the price cap mechanism.
- In their 1993 and 1994 interstate access tariffs, therefore, the price cap LECs attempted a “heads we win, tails you lose” approach to the Commission’s failure to *explicitly* require add-back.
- The LECs that benefited from applying the add-back rules applied the add-back rules. The LECs that benefited by not applying the add-back rules did not apply the rules.

- The Commission therefore suspended the LECs' 1993 and 1994 tariffs and set them for investigation to determine, *inter alia*, whether the LECs correctly had calculated returns.
- The LECs and the Commission agreed from the outset that the LECs should have applied add-back consistently, and that it would be unlawful for the Commission to permit each LEC to choose the approach that results in the highest rates.
- The D.C. Circuit recognized that add-back was always an implicit part of the price cap rules.
- Therefore, all carriers should have implemented add-back.
- The LECs that did not implement add-back thus owe refunds to ratepayers.
- If the Commission finds that add-back was not authorized by its price cap rules, then the LECs that did not apply add-back (NYNEX and SNET) are liable for refunds.
- But the one outcome that would plainly be unlawful – the outcome urged by the Bells – would be to rule that each LEC was free in 1993 and 1994 to adopt whichever approach harmed ratepayers the most.

LECS THAT FAILED TO APPLY ADD-BACK OWE REFUNDS TO RATEPAYERS

- Pursuant to § 204 of the Act, 47 U.S.C. § 204, the Commission suspended the LECs' 1993 and 1994 tariffs, ordered an accounting, and set them for investigation to determine whether those tariffs properly reflected add-back. (*1993 Suspension Order* ¶ 32 (8 FCC Rcd. 4960 (1993)); *1994 Suspension Order* ¶ 12 (9 FCC Rcd. 3705 (1994))).
- Add-Back Was Necessary To Carry Out the Sharing Requirements of The Price Cap Rules.
 - “[T]he add-back adjustment is essential if the sharing and low-end adjustments of the LEC price cap plan are to achieve their intended purpose.” *1995 Add-Back Order* ¶ 56 (10 FCC Rcd. 5656 (1995)).
 - “Without this adjustment . . . the sharing and low-end adjustments would not operate as [the price cap order] intended.” *1995 Add-Back Order* ¶ 50.
 - “[A]dd-back adjustments are *necessary* to achieve fully the purpose of the sharing and low-end adjustment mechanisms.” *1995 Add-Back Order* ¶ 50
- The add-back requirement was *always* implicit in the price cap rules and thus LECs were required in 1993 and 1994 to apply add-back.
 - The Commission never “intended to eliminate the [add-back rules from the price cap system] for the purpose of calculating current returns.” *1995 Add-Back Order* ¶¶ 32, 56.
 - The Commission only “*clarified*” the price cap rules by “adopt[ing] a rule *explicitly* incorporating the add-back process into the LEC price cap plan.” *Id.* ¶ 16 (emphasis added).
 - The D.C. Circuit noted that, according to the Commission’s own construction of its price cap orders, the “add-back rule had been implicit in the sharing rules from the beginning.” *Bell Atlantic*, 79 F.3d at 1202.
 - Also, sharing and low-end adjustments should “operate only as one-time adjustments to a single year’s rates, so a LEC does not risk affecting future rates.” *1990 Price Cap Order* ¶ 136 (5 FCC Rcd. 6786).
 - ✓ Add-back is necessary to ensure that sharing and low-end adjustments affect only a single year’s rates. *1995 Add-Back Order* ¶ 28.
 - ✓ “[W]ithout add-back, the sharing adjustment . . . would continue to affect a carrier’s price caps year after year because the carrier’s earnings, rather than reflecting the carrier’s true productivity, would simply reflect the previous year’s sharing obligation.” *Bell Atlantic*, at 1205 (79 F.3d 1195 (1996)).
 - ✓ The Commission demonstrated the *mathematical reality* that, absent add-back, the LECs’ rates over time would not reflect the full amount that the Commission intended the LECs to share with ratepayers under the *1990 Price Cap Order*.
- Even if Add-Back was not implicit, the Commission can in *this* proceeding find that the LECs’ 1993 and 1994 tariffs must reflect add-back.

- It is black letter law that “a tariff investigation is a rulemaking”¹ under the APA, that the Commission can and does “routinely make[] significant policy and methodological decisions based on the records developed in tariff investigations[,] and [that] such decisions do not violate the notice and comment requirements of the [APA].” *Access Reform Tariff Order* ¶ 80.
- In the Bells’ view, the Commission’s rules said nothing one way or the other about add-back prior to 1995. If so, this is thus the archetypal case in which the Commission has authority to address in a tariff investigation new circumstances not contemplated by its rules.
- The Act expressly permits the Commission to order refunds for rates that that fail to comply with rule clarifications or modifications that result from such tariff investigations. 47 U.S.C. § 204(a).

¹ See, e.g., Memorandum Opinion and Order, *Tariffs Implementing Access Charge Reform*, 13 FCC Rcd. 14683, ¶ 81 (1998) (“*Access Reform Tariff Order*”); Memorandum Opinion and Order, *Implementation of Special Access Tariffs of Local Exchange Carriers*, 5 FCC Rcd. 4861 (1990); 5 U.S.C. § 551(4).

RETROACTIVE RULEMAKING HAS NO APPLICATION HERE

- Congress has expressly authorized the Commission to order “retroactive” refunds pursuant to tariff investigations where, as here, the Commission has suspended the rates and put the carriers on express notice that their right to collect the rates prior to any determination of lawfulness is subject to refund obligations if the rates are ultimately determined to be unlawful. *See* 47 U.S.C. § 204.
- It is black letter law that Congress can, as it did here, authorize retroactive rulemaking. *See, e.g., Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (explaining that an agency may retroactively apply rules if “that power is conveyed by Congress”).
- As explained by the Commission (Memorandum Opinion and Order, *Implementation of Special Access Tariffs of Local Exchange Carriers*, 5 FCC Rcd. 4861, ¶ 7 (1990)),

[a]lthough Section 204(a) proceedings are rulemakings of particular applicability, . . . the Commission’s authority under the section is not limited to a prospective determination of the lawfulness of rates. Rather, as a tradeoff for permitting rates under investigation to go into effect, Section 204(a) specifically authorizes the Commission to order refunds at the conclusions of such a proceeding if such relieve is appropriate. Thus, it is obvious from the nature of the statutory scheme, and from the fact that this proceeding was commenced through a Designation Order rather than a Notice of Proposed Rulemaking, that any conclusions this Commission reached with respect to the lawfulness of strategic pricing would be applied to the rates that took effect subject to the investigation, and that the Commission would exercise its statutory authority to determine whether a refund was appropriate.

- It would indeed be absurd if the Commission lacked authority to order refunds based on clarifications of existing rules (or even new rules) developed in ongoing tariff investigations.
 - The opposite rule would establish an entirely one-sided system that would unfairly and systematically favor LECs. The LECs would be able immediately to construe all slightly ambiguous interstate access rules in a manner favorable to them, while ignoring all ambiguities that are unfavorable to them. And ratepayers would be forced to pay those rates. In effect, every time that an ambiguity arose in the Commission rules – and no set of rules, no matter how comprehensive, can anticipate everything – the LECs would be able to inflate interstate access rates for at least one year, with no risk of having to pay refunds.

THE BELLS' CANNOT HAVE IT BOTH WAYS

- Although the LECs may debate about whether they were required to comply with the add-back requirement (in which case more than \$50 million in refunds are due) or had no authorization in 1993 and 1994 to modify their calculated returns with add-back (in which case \$30 million in refunds are due), there can be no serious claim that the Commission's rules permitted the LECs to have it both ways and to apply add-back only when it increased rates.
- Both the LECs and the Commission have expressly rejected such a "bifurcated" approach to add-back as plainly unlawful.
 - Ameritech explained that "sharing and the lower formula adjustment are in reality to sides of the same coin," they "were implemented . . . in order to allow for the fact that a single, industry-wide productivity offset was used for all price cap LECs and that that figure might be understated or overstated in any given year." Ameritech thus concluded that "[t]his fact requires that both sharing and [low-end adjustments] be treated the same for add back purposes." Ameritech 1993 Reply at 3 (CC Docket No. 93-179, filed Sept. 1, 1993).
 - BellSouth explained that "[t]he Commission clearly intended that the two backstop mechanisms, sharing and lower formula adjustment, operate symmetrically." BellSouth 1993 Reply at 12 (CC Docket No. 93-179, filed Sept. 1, 1993).
 - Bell Atlantic explained that such a mechanism "ignores the theoretical underpinnings of the [sharing and low-end adjustment mechanisms]." Bell Atlantic 1993 Reply at 4 (CC Docket No. 93-179, filed Sept. 1, 1993).
 - GTE emphasized that an "asymmetric" rule would be "unlawful" and would "bear[] no resemblance to the Commission's balanced plan." GTE 1993 Reply at 11 (CC Docket No. 93-179, filed Sept. 1, 1993).
 - The Commission rejected a "bifurcated" add-back adjustment, determining that "both the sharing and low-end adjustment mechanisms were intended to compensate for unanticipated errors in the productivity offset and must be treated identically." *1995 Add-Back Order* n. 41.
- Courts also have consistently rejected the "head I win, tails you lose" approach to ratemaking.
 - "[A]ssigning the [regulated] firm the benefit of good outcomes and customer[] [ratepayers] the burden of bad ones" provides the regulated utility with "unhealthy incentives." *Williston Basin Interstate Pipeline Company v. FERC*, 115 F.3d 1042, 1044 (D.C. Cir. 1997).
 - Where a regulatory scheme permits a regulated entity to unilaterally assign costs to ratepayers "the potential for abuse is apparent" and, in such circumstances there is "[n]o protection [for] ratepayer." *Natural Pipeline Gas Co. of America v. FERC*, 765 F.2d 1155, 1162 (D.C. Cir. 1985).

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June 4, 2004

By Electronic Filing

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th St., SW
Washington, D.C. 20554

Re: CC Docket Nos. 93-193, 94-65 and 94-157

Dear Ms. Dortch:

I write on behalf of AT&T Corp. ("AT&T") in response to Verizon's latest *ex parte* arguments that Verizon should be permitted to keep overcharges resulting from unlawful 1996 exogenous cost rate hikes that Verizon based on retroactive restatements of its 1992-1995 rate bases.¹

Specifically, Verizon and the other Bells in 1996 recalculated their rate bases for 1992-1995 by reversing earlier deductions of zero-cost, non-investor supplied funds represented by the "other post-retirement benefits" or "OPEB" liabilities recorded in their regulatory books in those years. The Bells, using those adjusted rate bases, computed how much more they could have charged AT&T and other rate-payers through reduced overearnings sharing obligations in those years. The Bells then added those amounts to their 1996 rates through "exogenous cost" increases to their 1996 price cap indices ("PCIs"). Thus, Verizon and the other Bells' recovered in their 1996 rates amounts that they claim they could have charged, but did not charge, in prior years. The Commission immediately recognized that "the LECs' rate base treatment of OPEBs raises a substantial question of lawfulness under existing rules" and accordingly suspended the

¹ Letter from Joseph Mulieri (Verizon) to Marlene H. Dortch (FCC), CC Docket Nos. 93-193, 94-65 and 94-157 (dated May 24, 2004) ("*Verizon May 24 Letter*"); Letter from Joseph Dibella (Verizon) to Marlene H. Dortch (FCC), CC Docket Nos. 93-193, 94-65 and 94-157 (dated May 13, 2004) ("*Verizon May 13 Letter*").

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Bells' tariffs and set them for investigation in this still-pending proceeding. Memorandum Opinion and Order, *1996 Annual Tariff Filings, et seq.*, 11 FCC Rcd. 7564, ¶ 19 (1996).

The Bells' 1996 exogenous cost increases were unlawful. Those increases violated the Commission's exogenous cost rules (47 C.F.R. § 61.45) and a 1995 Commission order that prohibits LECs from seeking exogenous cost increases for OPEBs and other accounting changes that have absolutely no impact on cash flow.² The exogenous cost increases were also unjust and unreasonable in violation of 47 U.S.C. §§ 201 & 202. *Id.*

During the past eight years of the Commission's investigation into Verizon's and the other Bells' exogenous cost increases, Verizon has offered various baseless arguments attempting to justify those patently unlawful increases. In its May 13 and 24, 2004 *ex partes*, Verizon proffers yet another new and equally baseless argument. Verizon now asserts that its 1996 tariffs are *per se* lawful because, according to Verizon, the Commission's rules required Verizon to implement the exogenous cost increases in its 1996 tariffs. *Verizon May 24 Ex Parte* at 1-5 ("when a carrier complies fully with the Commission's price cap rules, its rates are just and reasonable by definition, and the Commission cannot rely on § 201(b) [of the 1996 Act] in a tariff investigation, to circumvent the statutory requirements for amending, and for modifying its interpretation of, its regulation"). As demonstrated below: (1) it is well-established that a tariff is *not per se* lawful merely because it complies with the price cap rules, and (2) in any event, it is not true that the Commission's rules or orders required – or even permitted – Verizon to implement the 1996 exogenous cost increases. Verizon's further claim that equitable considerations nonetheless favor allowing Verizon and the other Bells to keep the overcharges is frivolous.

A Tariff Is Not Per Se Lawful Merely Because It Does Not Violate A Price Cap Rule. Verizon's claim that its 1996 tariffs are *per se* lawful because they complied with the Commission's 1996 price cap rules is baseless. The Commission expressly rejected that precise argument in 1991, immediately after adopting the price cap rules. Order On Reconsideration, *Policy and Rules Concerning Rates for Dominant Carriers*, 6 FCC Rcd 2637, ¶¶ 203-206 (1991) ("*Dominant Carriers Order*"). "U S West contend[ed] that 'there is no such thing as an unlawful rate based on overearnings in a price cap environment when . . . all price cap rules are adhered to.'" *Id.* ¶ 203 (quoting a U S West Petition). The Commission expressly rejected that argument, stating that "we find no adequate support for th[at] absolutist view." *Id.* ¶ 206. The Commission emphasized that "[t]he possibility remains . . . that rates for specific services may be

² Letter from David L. Lawson (AT&T) to Marlene H. Dortch (FCC), CC Docket Nos. 93-193; 94-65 and 94-157 (filed March 15, 2004); Letter from David L. Lawson (AT&T) to Marlene H. Dortch (FCC), CC Docket Nos. 93-193; 94-65 and 94-157 (filed April 13, 2004); Reply Comments of AT&T, at 3-6, 12-16, CC Docket Nos. 93-193; 94-65 and 94-157 (filed April 22, 2003); Comments of AT&T, at 5-39, CC Docket Nos. 93-193; 94-65 and 94-157 (filed April 8, 2003).

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set at unreasonable levels, or be unlawful in other ways” and “compliance with the price cap rules does not necessarily make this impossible.” *Id.*; see also Memorandum Opinion And Order On Reconsideration, *1997 Annual Access Tariff Filings*, 13 FCC Rcd. 10597, ¶ 7 (1998) (“Even under price cap regulation, carriers bear an obligation under the Communications Act to tariff just and reasonable rates”); Memorandum Opinion and Order, *Bell Atlantic Telephone Companies Revisions to Tariff F.C.C. No. 1, et seq.*, 6 FCC Rcd. 4891, ¶¶ 9-10 (1991) (noting that compliance with the price cap rules is “not the sole criteria on which the lawfulness of a rate in a tariff investigation or complaint proceeding is resolved”). The D.C. Circuit also has recognized that “even streamlined tariffs [which comply with the price cap rules] do not escape FCC scrutiny; [carriers] . . . can petition for review of any streamlined tariff that it believes unreasonable.” *National Rural Telecom Association v. FCC*, 988 F.2d 174, 185 (D.C.Cir. 1993).

Verizon ignores these consistent holdings and instead relies on out-of-context snippets from ¶ 202 and footnote 211 of the *Dominant Carriers Orders*, apparently hoping that the Commission will not bother to read those orders. Those portions of the *Dominant Carriers Order* merely suggest that a complaint challenging a carrier’s tariff *solely* on the ground that the carriers’ earnings are too high would be foreclosed if the carrier complied with the Commission’s price cap rules. *Id.* ¶ 202 (“[a] complaint against a price cap carrier that is based solely upon the theory that rates are unjust and unreasonable because the rates produced [high] . . . earnings would be dismissed”); *id.* n.211 (“Only filings that make price changes within cap and band limits are presumed lawful and streamlined, and even filings that are subject to streamlining may be investigated. The only complaints foreclosed by price cap regulation are those based upon total interstate earnings”). These provisions clearly have no application here because Verizon’s tariffs are being investigated not solely because Verizon’s total interstate earnings were too high, but because Verizon’s rate base-generated exogeneous cost increase to its PCIs was unjust and unreasonable (and, indeed, as detailed in prior AT&T submissions (*see* n. 2, *surpa*), in direct violation of the Commission’s rules), resulting in tens of millions of dollars of unjustified rate increases for specific interstate services.³

Verizon suggests that even if the Commission is not absolutely barred from assessing whether rates that comply with the price cap rules also comply with the Act’s just and reasonable rate requirements, the Commission has stated that it will do so only where the price cap rules do not identify the “precise steps” for computing a rate. *Verizon May 24, 2004 Ex Parte*, at 4. But, as noted, when the Commission addressed this issue in the *Dominant Carriers Order*, it did not purport to limit its authority or willingness to reject unjust and unreasonable rates, even if the rates otherwise complied with the price cap rules. And Verizon identifies no Commission rule or order to the contrary. Verizon only refers the Commission to cases where, according to Verizon, there *was* an ambiguity in the Commission’s rules, and the Commission

³ The other orders cited by Verizon (at 2-3) merely state that the Commission’s price cap rules were designed to produce just and reasonable rates, and thus compliance with those rules is necessary to produce just and reasonable rates. But those orders do not even remotely suggest that mere compliance with the price cap rules is *sufficient* to produce just and reasonable rates.

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warned that when carriers' resolve such ambiguities in setting rates, the Commission will vigilantly monitor whether the carriers' did so in a manner that complies with the just and reasonable standards. Nothing in those cases purports to limit the Commission's authority to monitor whether rates are just and reasonable to *only* such cases.

But even if (contrary to law), the Commission's authority was so limited, that condition is satisfied here. As noted, Verizon and the other Bells' retroactively recomputed their rate bases to reverse prior years' OPEB deductions. Nothing in the price cap rules expressly authorizes such retroactive restatements. On the contrary, to the extent that the Commission's rules even address restating the rate base, the Bells' can do so only for the *current* rate base using updated data from the past *15 months* – not for prior year rate bases using data as much as *four years* old, as the Bells did in 1996. 47 C.F.R. § 61.3(e). And even if the Commission's rules did address and permit the Bells to restate prior year rate bases, the Commission's rules do not expressly authorize the Bells to implement exogenous cost increases to the current year's PCIs to recover potential differences in revenues based on the restated rate bases. Those Part 61 rules *preclude* the Bells from implementing such exogenous cost increases. Thus, even under Verizon's cramped theory – where the Commission is limited to applying the just and reasonable standard only in cases where its price cap rules do not identify the “precise steps” for computing rates – the Commission has ample authority to apply that standard here.

And the Commission *has in fact determined* that rates computed using a rate base that reflects unfunded OPEB amounts – as Verizon and the other Bells did in 1996 – are unjust and unreasonable because such amounts are the type of “zero-cost sources of funds” that the Commission routinely has determined cannot, consistent with the requirements of the Act, be included in carriers' rates. Report and Order, *Responsible Accounting Officer Letter 20, Uniform Accounting for Postretirement Benefits Other Than Pensions in Part 32, et seq.*, 12 FCC Rcd. 2321, ¶ 19 (1997) (“*Zero-Cost OPEB Order*”). It is thus already well-established that raising rates on the basis of prior OPEB accounting changes is unjust and unreasonable.

Verizon purports to advance a “new” argument that unfunded OPEBs are not really zero-cost sources of funds. But this “new” argument was first advanced by Verizon's predecessor, Bell Atlantic, and others in the proceeding that resulted in the *Zero-Cost OPEB Order* and, based on the full record addressing that issue, the Commission properly rejected the that argument. *Zero-Cost OPEB Order* ¶¶ 16-17. Specifically, Verizon argues here, as it did there, “that OPEB and other Account 4310 amounts are not rate-payer supplied funds because these amounts were not factored into price cap rates” and that “only those items that have been included in the rates should be removed from the rate base.” *Id.* ¶ 16. The Commission was “not persuaded by the argument that amounts recorded in 4310 are investor-supplied funds because they were not factored into pre-price cap rates or have not been given exogenous treatment.” *Id.* ¶ 17. “To the extent that carriers are earning a positive return on assets funded in part by the liabilities recorded in 4310, these carriers are recovering their costs.” *Id.*⁴ Indeed, Verizon's

⁴ Verizon criticizes these Commission findings because they were made “without explanation.” *Verizon May 24, 2004 Ex Parte*, n.13. But the substantial record in that proceeding fully

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argument that its PCIs were never reflected OPEBs is a red herring. The issue is whether the *rate base* on which reasonable returns are computed to determine the Bells' sharing obligations should include OPEBs. Verizon's PCIs do not factor into that equation, rendering Verizon's complaint that its PCIs never reflected OPEBs irrelevant.

In all events, even if compliance with the price cap rules did, as Verizon asserts, provide a safe-harbor against allegations of unjust and unreasonable rates, Verizon's argument fails because, as AT&T has demonstrated, the price cap rules in 1996 *did not permit* the Bells to retroactively restate prior years' rate bases and to seek exogenous cost adjustments to their 1996 PCIs and rates. *See* n.2, *supra*. Verizon and the other Bells 1996 tariffs thus did *not* comply with the price cap rules.

There Are No Policy Justifications For Allowing Verizon To Keep Its Overcharges. Verizon suggests that public policy considerations militate against issuing refunds and that Verizon should be permitted to keep the overcharges that it earned from its unlawful exogenous cost increases. *Verizon May 24, 2004 Letter* at 7-8. But as the Commission has repeatedly recognized, "[e]very customer has the right to be charged lawful rates." Memorandum Opinion and Order, 17 FCC Rcd 24201, *Communications Vending Corporation of Arizona, Inc., et al. v. Citizens Communications Company*, 17 FCC Rcd 24201, ¶ 47 (2002). The Bells, "having initially filed the rates and . . . collected an illegal return . . . must . . . shoulder the hazards incident to [their] . . . actions including . . . refund[ing] of any illegal gain." *Id.* There is simply no legitimate basis for allowing the Bells, who were fully on notice that refunds would be required if their 1996 exogenous cost increases were ruled unlawful, to keep those amounts.

Verizon first claims that that it would be unfair to issue refunds because "Verizon was simply following the Commission's clear, contemporaneous instructions." *Id.* at 8. But, as demonstrated above, that is not true. Verizon's exogenous cost increases violated multiple Commission rules. Verizon next claims that it should not be required to issue refunds because the carriers that paid its overcharges recovered those overcharges from their own end user customers through increased rates in the unregulated long-distance markets. But that precise argument has been rejected by the Commission. *See* Memorandum Opinion and Order, 17 FCC Rcd 24201, *Communications Vending Corporation of Arizona, Inc., et al. v. Citizens Communications Company*, 17 FCC Rcd 24201, (2002). There, defendants argued, as Verizon does here, "that carriers should not receive a refund because they have already recovered from their customers the full [overcharge] . . . [and therefore] a refund would amount to double recovery." *Id.* ¶ 47. In rejecting that argument, the Commission explained that

In a market with unregulated prices, the carriers were entitled to charge their customers a surcharge for per-call compensation or, indeed, to raise the retail rate to any level they think the market

supported the Commission's findings. And there is no basis for the Commission to reverse those findings here.

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June 4, 2004
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will bear. But the recovery of the surcharge does not undermine the legitimacy of the expectation that the carriers would eventually recover a refund because they paid an unlawful rate. . . . Carriers may have set their base rates or made other business plans in reliance on such an expectation, and we will not disturb those expectations because of the possibility of an appearance of double recovery. Indeed, the concept of double recovery is not particularly meaningful in a market where prices are not regulated.

Id. ¶ 47.

In any event, Verizon has provided *no evidence* that AT&T or any other carrier fully recovered these overcharges from end user customers. In fact, it is not even clear that AT&T and other carriers could have fully recovered the Bells overcharges through increased rates. Basic economics teaches that increased rates result in decreased demand. Therefore, even if AT&T and other carriers tried to pass on the Bells unlawful overcharges to end-user customers, the demand for AT&T's and other carriers' services would have declined which, in turn, would have reduced revenues. And Verizon has provided no evidence that, even if AT&T and other carriers increased rates, the corresponding revenues were sufficiently compensatory. This is fatal to Verizon's argument. *E.g.*, Memorandum Opinion and Order on Reconsideration, *1997 Annual Access Tariff Filings*, 13 FCC Rcd 10597, ¶ 9 (1998) (finding that "excessive . . . CCL charges . . . artificially depress[ed] demand . . . [and] also . . . transfer[red] . . . revenues to the LECs from their potential competitors, the IXCs" and "refunds are necessary to protect end-users' and IXCs' interests in the development of competition and in obtaining just and reasonable toll calling rates")

Verizon's argument also fails on fundamental policy considerations. Permitting the Bells to keep tens of millions of dollars in overcharges would create additional incentives for Verizon and other carriers to implement unlawful tariffs that include substantial overcharges.

Respectfully submitted,

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