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July 29, 2004

Ex Parte

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

Re: Verizon Telephone Companies Petition For Reconsideration, "In the Matter of Stale or Moot Docketed Proceedings", CC Docket Nos. 93-193, 94-65 and 94-157

Dear Ms. Dortch:

On July 28, 2004, Ed Shakin and Susanne Guyer, representing Verizon met with Tamara Preiss and Deena Shetler of the Wireline Competition Bureau to discuss the above-captioned proceeding. In particular, we discussed the attached RAO 20 paper.

Please do not hesitate to contact me with any questions.

Sincerely,

Susanne Guyer

Attachment

cc: Tamara Preiss
Deena Shetler

VERIZON'S 1996 TARIFFED RATES WERE JUST AND REASONABLE

Verizon has demonstrated in its previous submissions that its 1996 tariff filings were made in compliance with the rate base rules then in effect, as well as the Commission's interpretation of those rules, and that the Commission cannot retroactively change its rules. Some parties, however, have claimed that the Commission may, under §§ 201(b) and 204(a), declare a carrier's rates unjust and unreasonable notwithstanding that the carrier's tariff complies with the Commission's rules in every respect, simply by identifying an issue that the Commission did not expressly contemplate at the time it established those rules. But as Verizon has also demonstrated, and the Commission itself has held, the rules that the Commission adopted contain no gaps that could be filled through interpretation; instead, those rules "define[d] explicitly those items to be included in, or excluded from, the interstate rate base" for purposes of calculating a carrier's sharing obligation,[1] such that "a rule change" was necessary to add OPEBs to the list of items to be deducted.[2]

Here, Verizon addresses three additional points. First, 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), in a tariff investigation, to circumvent the statutory requirements for amending, and for modifying its interpretation of, its regulation. Second, even if the Commission had any such authority, Verizon's treatment of OPEBs was just and

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[1] Memorandum Opinion and Order and Notice of Proposed Rulemaking, *Responsible Accounting Officer Letter 20, Uniform Accounting for Postretirement Benefits Other Than Pension in Part 32*; *Amendments to Part 65, Interstate Rate of Return Prescription Procedures and Methodologies, Subpart G, Rate Base*, 11 FCC Rcd 2957, ¶ 25 (1996) ("*RAO 20 Rescission Order*").

[2] *See* Report and Order, *Responsible Accounting Officer Letter 20, Uniform Accounting for Postretirement Benefits Other Than Pension in Part 32*; *Amendments to Part 65, Interstate Rate of Return Prescription Procedures and Methodologies, Subpart G, Rate Base*, 12 FCC Rcd 2321, ¶ 28 (1997) ("*RAO 20 Rulemaking*").

reasonable, particularly in light of the fact that Verizon's tariffs were filed just months after the Commission told carriers that the "Part 65 rules do not specifically provide" for the "exclusion[] [of OPEBs] from . . . the rate base." *RAO 20 Rescission Order* ¶ 25. Third, because refunds are a matter of the Commission's equitable discretion, requiring refunds in these circumstances would be decidedly inequitable.

1. Before 1990, LEC rates were subject to traditional rate-of-return regulation, under which carriers were allowed to "charge rates no higher than necessary to obtain sufficient revenue to cover their costs and achieve a fair return on equity." *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174, 177-78 (D.C. Cir. 1993) (internal quotation marks omitted). In 1990, however, the Commission decided to replace rate-of-return regulation for LECs with a form of "incentive regulation" that focuses on prices rather than returns and that rewards efficiency by "harness[ing] the profit-making incentives common to all businesses." Second Report and Order, *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786, ¶ 2 (1990).[3] In addition to providing more appropriate economic incentives, price cap regulation also "substantially mitigates the administrative burdens carriers face in preparing and filing tariffs" by focusing on whether LECs' "prices are within the cap limitations" calculated under the Commission's rules. *Id.* ¶ 37. Because the Commission designed its price cap rules to result in

[3] Under price cap regulation, the Commission fixed the maximum initial prices a company can charge for its services, represented by the company's "price cap index" or "PCI." The Commission required LECs to reduce their price caps each year by a specified percentage, known as the "productivity offset" or "X-Factor," which reflect the Commission's "estimate of obtainable efficiency gains." *National Rural Telecom*, 988 F.2d at 183. A carrier that could cut its costs by more than the productivity factor would benefit from increased earnings, while a carrier that fell short would suffer decreased earnings, providing a strong incentive to increase productivity.

just and reasonable rates,[4] the Commission could monitor LEC's compliance with those rules in calculating the price caps and thereby avoid the extensive and particularized debates about cost justification that occurred under the prior regime.

For these reasons, the Commission long-ago made clear that, under its price cap regime, "the extent to which the rates and other terms of [a LEC's] tariff are just and reasonable could *only be determined* with reference to price cap regulation."[5] As a result, and as the Commission has held, when a carrier "compl[ies] fully with price cap requirements," the "overall earnings produced by [its] rates . . . *will be* just and reasonable." Order on Reconsideration, *Policy and Rules Concerning Rates for Dominant Carriers*, 6 FCC Rcd 2637, ¶ 202 (1992) (emphasis added). Indeed, the Commission went further and held that challenges "based upon total interstate earnings" are "*foreclosed* by price cap regulation." *Id.* ¶ 153 n.211 (emphasis added).

These rules apply here to preclude the Commission from relying on § 201(b) to find that Verizon's 1996 tariffed rates were unjust and unreasonable notwithstanding Verizon's full compliance with the price cap requirements in effect at that time. Indeed, the Commission has never had the authority — either under rate-of-return or price-cap regulation — to amend its rate regulations in the course of a tariff investigation. As Verizon has previously demonstrated, the rules in effect in 1996, by their terms, were mandatory and precluded carriers from including any assets in — or excluding any liabilities from — the rate base that were not expressly set forth in

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[4] *See, e.g.*, First Report and Order, *Access Charge Reform*; *Price Cap Performance Review for Local Exchange Carriers*; *Transport Rate Structure and Pricing*; *End User Common Line Charges*, 12 FCC Rcd 15982, ¶ 273 (1997) ("[o]ur access charge and price cap rules are designed to ensure that access charges remain within the zone of reasonableness defining rates that are just and reasonable") (internal quotation marks omitted).

[5] Memorandum Opinion and Order on Remand, *Southwestern Bell Tel. Co. Application for Review*, 8 FCC Rcd 2261, ¶ 7 n.9 (1993) (emphasis added).

those rules.[6] Accordingly, in its 1996 tariff filings, Verizon complied with terms of the price cap rules, by not deducting OPEBs from its rate base and by reversing prior deductions of OPEBs, which had been made pursuant to the unlawful RAO 20 Letter. The effect of Verizon's treatment of OPEBs was to reduce the amount of the sharing obligation that would otherwise have been included in Verizon's price caps in its 1996 tariff filings and thus to permit higher overall rates.[7] A finding that Verizon's treatment of OPEBs was unjust and unreasonable, therefore, would constitute precisely the type of challenge that the Commission has held is "foreclosed by price cap regulation" because "rates that comply fully with price cap requirements will be just and reasonable." *Id.* ¶¶ 153 n.211, 202.

Although price cap regulation does not eliminate all of the Commission's authority under § 201(b) to "ensur[e] th[at] price cap LEC rates are just and reasonable,"[8] the Commission's authority is limited to instances where, unlike in determining what to deduct from the rate base, the price cap rules, by their terms, are ambiguous. Thus, when the Commission did "*not specify the precise steps* that price cap LECs must take to implement [a] permitted revenue methodology for each exogenous adjustment," it "emphasize[d] that price cap LECs must implement this methodology in a manner consistent with their obligation . . . to tariff just and reasonable rates" and stated that it would "carefully review the . . . methodology" each LEC selected. *Access Charge Reform Tariff Order* ¶ 89 (emphasis added). In that same order, the Commission rejected claims by one LEC that the Commission lacked authority under § 201(b) to find that

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[6] *See*, *e.g.*, Letter from Joseph DiBella, Verizon, to Marlene H. Dortch, FCC, CC Docket Nos. 93-193 *et al.*, Attach. 1 at 3-5 (filed May 13, 2004).

[7] There is no challenge to the reasonableness of any of the specific rates in the 1996 tariff filings.

[8] Memorandum Opinion and Order, *Tariffs Implementing Access Charge Reform*, 13 FCC Rcd 14683, ¶ 53 (1998) ("*Access Charge Reform Tariff Order*").

carriers had miscalculated their CCL rates by understating the "base factor cost" projections ("BFP") used to establish the level of end-user common line rates. *See id.* ¶ 53. Because the price cap rules did not establish "any particular methodology for use by the LECs in preparing their BFP[s],"[9] the Commission found that it retained the authority under § 201 "to determine whether price cap LECs have . . . us[ed] this methodology correctly." *Access Charge Reform Tariff Order* ¶ 55.

None of these situations is present here — the Part 65 rules "prescribe[]" and "specify" the "precise steps" that a LEC must follow with respect to calculating its rate base, and there is no dispute that Verizon followed those steps "correctly." Accordingly, the Commission cannot now find, under § 201(b), that Verizon should have ignored the explicit accounting practices in the Commission's rate base rules. Indeed, the Common Carrier Bureau ("Bureau"), in setting the 1996 tariff filings for investigations, recognized that such an investigation is limited to determining "lawfulness under *existing* rules." Memorandum Opinion and Order, *1996 Annual Access Tariff Filings*, 11 FCC 7564, ¶ 19 (Comm. Carr. Bur. 1996) (emphasis added) ("*1996 Annual Access Tariff Filings*"). Thus, the Bureau explained that "the Commission . . . should determine the correct application of our rules to the LECs' treatment of OPEBs in their 1996 annual filings." *Id.* The Bureau did not suggest that the Commission could determine that the LECs' treatment of OPEBs was unlawful notwithstanding the requirements of the Commission's rules.[10]

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[9] Memorandum Opinion and Order, *1997 Annual Access Tariff Filings*, 13 FCC Rcd. 3815, ¶ 76 (1997).

[10] Although the Bureau suggested that it might "be possible to interpret our rules to permit a case-by-case evaluation of the correct rate base treatment of costs not explicitly identified in Part 65," *1996 Annual Access Tariff Filings* ¶ 19, the Commission rejected that possibility in 1997, holding that requiring deduction of OPEBs "constitute[d] a rule change" and

2. In any event, Verizon's treatment of OPEBs was independently just and reasonable. In the *RAO 20 Rulemaking*, the Commission revised its previous rule requiring rate base deductions only for pensions and not for any of the other long-term liabilities in Account 4310, and in its place adopted a rule that requires deduction of "all of the zero-cost funds recorded in Account 4310." *RAO 20 Rulemaking* ¶ 14.[11] Contrary to the Commission's conclusion in that order, however, OPEBs are not a "source[] of funds that provide[s] capital [to the LEC] at 'zero cost' to investors."[12] Because carriers did not begin accounting for OPEBs on an accrual basis — that is, recognizing OPEBs as an expense at the time employees earn their future benefits, as opposed to when the carrier incurs the cost of the OPEBs — until after the Commission adopted price caps, those OPEB expenses were not part of the revenue requirements under rate-of-return regulation and were not included in the initial price caps. Moreover, the Commission has limited carriers' ability to recover their accrued OPEB expenses from ratepayers, by denying exogenous treatment of these costs on an on-going basis. From a rate recovery perspective, therefore, OPEBs are unlike pensions — which had been accounted for on an accrual basis prior to the institution of price cap regulation and were thus part of the rate base included in the initial price caps. That is, while carriers recovered their pension costs from

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could not be accomplished "through an interpretation" of the existing rules, *RAO 20 Rulemaking* ¶¶ 25, 28.

[11] As Verizon has demonstrated previously, in 1986 the Commission proposed a rule that would have required rate base deduction of all zero-cost funds included in Account 4310, but ultimately chose to require deduction only of the portion of Account 4310 representing pensions. *See* Notice of Proposed Rulemaking, *Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Bases and Net Incomes of Dominant Carriers*, 2 FCC Rcd 332, App. A (1986) (proposed 47 C.F.R. §§ 65.810(b), 65.830); Report and Order, *Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Base and Net Income of Dominant Carriers*, 3 FCC Rcd 269, App. B (1987) ("*Amendment of Part 65*") (promulgating 47 C.F.R. § 65.830).

[12] *Amendment of Part 65* ¶ 51.

ratepayers at the time of accrual — making them zero-cost funds — carriers do not recover OPEB costs from rate payers at the time of accrual. Because OPEBs thus are not zero-cost funds, it is just and reasonable to treat them different from pensions and not to deduct them from the rate base.[13]

But the Commission need not — and should not — reach this question. As shown above, only months before Verizon's 1996 tariff filings, the Commission expressly held that its rules did not permit the deduction of OPEBs from the rate base. Because Verizon unquestionably followed the clear instructions that the Commission had so recently provided, its treatment of OPEBs was necessarily just and reasonable. It would be profoundly inequitable for the Commission to find, eight years later, that Verizon acted unlawfully by following those instructions.

3. For the same reason, the Commission should not require refunds here. As the Commission has repeatedly recognized, the Commission "can exercise [its] discretion not to order refunds even when there is a finding of overearnings."[14] Refunds, as the federal courts have held and the Commission explained long ago, are "a matter of equity," and the Commission must "balance the interests of both the carrier and the customer in determining the public

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[13] In requiring deduction of OPEBs from the rate base, the Commission stated without explanation that it was not "persuaded . . . that the amounts recorded in Account 4310 [for OPEBs] . . . were not factored into pre-price cap rates [and] have not been given exogenous treatment." *RAO 20 Rulemaking* ¶ 17. But it offered no explanation for how an expense that *was not recognized at the time* could have been factored into pre-price cap rates, and it is undeniable that the Commission has refused carriers' requests to give OPEBs exogenous treatment on an ongoing basis. The Commission also asserted that "carriers are recovering their OPEB costs," insofar as they "are earning a positive return on assets funded in part by the liabilities recorded in Account 4310." *Id.* But because carriers are not recovering OPEBs from rate payers, there are no "assets funded in party by the [OPEB] liabilities recorded in Account 4310." *Id.*

[14] Order on Reconsideration, *800 Data Base Access Tariffs and the 800 Service Management System Tariff and Provision of 800 Services*, 12 FCC Rcd 5188, ¶ 18 (1997) (emphasis omitted) ("*800 Data Base Order on Reconsideration*").

interest," with "each case . . . examined in light of its own particular circumstances." *American Television Relay,*[15] 67 F.C.C.2d at 708-09, ¶ 15; *see Public Service Comm'n v. Economic Regulatory Admin.*, 777 F.2d 31, 36 & n.5 (D.C. Cir. 1985); *Las Cruces TV Cable v. FCC*, 645 F.2d 1041, 1047 (D.C. Cir. 1981).

Equitable considerations demonstrate that refunds are not warranted here. *First*, as explained above, it would be inequitable eight years later to hold that Verizon acted unlawfully — and even worse to require refunds — when Verizon was simply following the Commission's clear, contemporaneous instructions. *Second,* a decision not to require refunds would create no inequities, because carriers such as AT&T recovered additional costs *from their customers* based on Verizon's and other LECs' treatment of OPEBs in their 1996 tariffs. Refunds would provide these carriers with unjustified windfalls because the carriers — many of which no longer exist or have avoided debts owed to Verizon through bankruptcy — would have no legal obligation or practical reason to pass through any refunds to the consumers they overcharged. Because such refunds would be virtually impossible in any event — many of their former customers have shifted to long-distance calling options that did not exist in 1996 — these carriers would simply pocket the money and, therefore, would be unjustly enriched. Taken together with the other facts and circumstances of this investigation, including the extraordinary delay in review, the dismissal and resurrection of the investigation, and the several changes in instructions to local carriers for accounting for the rate base (all of which were complied with), the balance of the equities all point to no refund requirement here.

[15] Memorandum Opinion and Order, *American Television Relay, Inc., Refunds Resulting from the Findings and Conclusions in Docket 19609*, 17 F.C.C.2d 703 (1978).