Before the
Federal Communications Commission
Washington, DC 20554

In the Matter of	)	
	)	
Petition of BellSouth Telecommunications,	)	WC Docket No. 05-342
Inc. For Forbearance Under 47 U.S.C. § 160	)	
From Enforcement of Certain of the	)	
Commission's Cost Assignment Rules	)	

Opposition of the Ad Hoc Telecommunications Users Committee

Table of Contents

I. Summary 1

II. Standard for Evaluation 3

III. BellSouth's Petition Would Short-Circuit The Special Access Investigation 4

IV. Forbearance Would Violate The Commission's Responsibilities Under Section 201 (b) 10

V. Grant of BellSouth's Petition Would Be Inconsistent With Representations Made To The D.C. Circuit 13

VI. Contrary To BellSouth's Contention, The Commission's Price Caps Rules Do Not Sever The Relationship Between Rates And Costs 14

VII. Digital Networks Do Not Preclude Rational Cost Assignments And Allocations. 17

Conclusion 19

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The Ad Hoc Telecommunications Users Committee ("Ad Hoc") hereby submits its Opposition to the above-captioned petition.[1] BellSouth has not justified forbearance from (1) the cost allocation, jurisdictional separations, cost apportionment and derivative rules identified in its Petition and (2) section 220(a)(2) of the Communication Act.[2]

I. Summary

BellSouth has not justified Commission forbearance from enforcement of the cost assignment and allocation rules identified in its petition for forbearance. Contrary to BellSouth's arguments, costs are still relevant under price caps regulation. Costs are necessary to determine consistently carrier earnings, and earnings are relevant to determinations of whether rates are just and reasonable under section 201 of the Communications Act. Without such costs, consumers of BellSouth's interstate services

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[1] Ad Hoc is an unincorporated association that represents its members' interests in telecommunication matters pending before the FCC and the courts. Its members are among the nation's largest and most sophisticated corporate buyers of telecommunications services and products. Fifteen of Ad Hoc's twenty-one members are Fortune 500 companies, including eleven of the Fortune 100. They estimate their combined annual spend on telecommunication services at between two and three billion dollars per year. Ad Hoc admits no carriers as members and accepts no carrier funding. Ad Hoc's self-interest is served by avoiding the imposition of unnecessary regulatory constraints on incumbent service providers, such as BellSouth. In an effectively competitive market, Ad Hoc's members do not need regulation to protect their interests.

[2] *See*, n. 1 to BellSouth Petition.

would be unable to show in complaints that BellSouth's rates were excessive. Earnings are also relevant to determining whether price caps rules are properly specified. Without costs, revenues and earnings, the Commission would be hard pressed to verify carrier claims that their earnings are deficient and that the rules pursuant to which price cap indices are set should be modified. Similarly, the Commission could not reasonably evaluate claims that the price cap indices are set too high based on supra-competitive carrier earnings.

Without such costs, BellSouth and other price cap local exchange carriers would soon argue that the pending special access rate investigation is meaningless and should be terminated. Without such costs, the Commission would be unable to satisfy its obligation to assure that special access and other rates subject to its jurisdiction are just and reasonable. Without such costs, the Commission would be without important information about the level of competition in telecommunications markets and the degree of regulation appropriate. Although BellSouth may wish that the Commission were without cost information and that rhetoric would suffice, such information is critical to determining the justness and reasonableness of rates and the protection of consumers.

The forgoing does not argue for a return to rate-base rate-of-return regulation. The Commission has, however, never found that regulation of rates pursuant to price caps severs all links to underlying costs. Carriers can avoid detailed tariff filing justifications if they price within the limits set by the price caps rules. Price caps carriers, such as BellSouth, however, may propose rates above price cap ceilings; may urge the Commission to change price caps limits and may seek permission to price

below price cap floors. In such instances, cost information developed pursuant to Commission cost assignment and allocation rules would be critically important in evaluating carrier filings. Obviously, BellSouth has gone too far in arguing that price cap regulation severs any link to underlying costs.

Finally, BellSouth's argument that assigning and allocating the cost of a digital network is too difficult is not credible. BellSouth has operated under cost assignment and allocation rules for many years because it has offered a variety of regulated and unregulated services. The deployment of digital technology in its network does not make the cost assignment and allocation process more difficult and certainly does not lessen the need for cost assignments and allocations.

The Commission should deny BellSouth's Petition for Forbearance.

II. Standard for Evaluation

Unless prohibited by other sections of the Act, Section 10 of the Communications Act, 47 U.S.C. §160, directs the Commission to forbear from enforcement of statutory provisions and regulations if, and only if, it determines that

> (1) enforcement of such regulation or provision is not necessary to ensure that the charges, practices, classifications, or regulations by, for, or in connection with that telecommunications carrier or telecommunications service are just and reasonable
> and are not unjustly or unreasonable discriminatory;
> (2) enforcement of such regulation or provision is not necessary for the protection of consumers; and
> (3) forbearance from applying such provision or regulation is consistent with the public interest.

BellSouth must do more than claim that the subject rules "create a regulatory chokepoint in the development of broadband networks," and that the "time for

deregulation is now."[3] It must persuasively demonstrate that all elements of the forbearance test have been met. Similarly, the Commission must determine that all elements of the forbearance test have been met. BellSouth has not come close to satisfying the forbearance standard, and the Commission cannot find otherwise.

III. BellSouth's Petition Would Short-Circuit The Special Access Investigation.

The Commission has initiated a rulemaking to determine whether its special access pricing flexibility rules have worked as intended, and if not, whether they should be modified or repealed.[4] In that proceeding, Ad Hoc has demonstrated, based on its member's experience and the incumbent local exchange carriers' (ILECs) astronomical prices for and profits from their special access services, that repeal of the special access pricing flexibility rules is long overdue.

Granting BellSouth's petition would render the ongoing special access rulemaking meaningless. If the Commission grants BellSouth's petition, forbearance petitions from other Bell Operating Companies (BOCs) will follow. Given the Commission's apparent decision to treat the special access rulemaking with no sense of urgency, it takes little experience or sophistication to predict that within a year after grant of BellSouth's petition, BellSouth will argue that the record in the special access investigation is stale. If not stale, BellSouth would argue predictably that no one, not even the Commission, can know whether special access rates are excessive (*i.e.*, not

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[3] BellSouth Petition, at 1.

[4] *Special Access Rates for Price Cap Local Exchange Carriers,* WC Docket No. 05-25, *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services,* RM-10593, Order and Notice of Proposed Rulemaking, FCC 05-18 (rel. January 31, 2005) ("*Special Access Notice*" or "*Special Access NPRM*").

just unreasonable) in relationship to the cost of provisioning special access service because special access costs would not be discernable.

If its petition were granted, BellSouth would be free to intermingle regulated services costs and unregulated services costs. The jurisdictional character of costs would also be indiscernible, and the allocation of common costs among services would be irrelevant. Even it does not make "the record is stale" argument, BellSouth will argue that the Commission has determined by granting its Petition for Forbearance that past special access earnings are irrelevant because of a decision to gut virtually all cost assignment and allocation rules. No one should be surprised when other ILECs make the same arguments. Surely the Commission will conclude that it cannot grant BellSouth's petition given the pendency of the special access rulemaking. Surely, the Commission will not allow BellSouth to effectively terminate a proceeding that is examining whether special access rules that allow BellSouth to earn a margin of over 80% from interstate special access services are in the public interest.

In the *Special Access NPRM,* the Commission asks that parties identify, justify, and explain an objective benchmark against which to measure the most recent rate level data.[5] Ad Hoc explained in its comments that in addition to evidence regarding the actual prices charged by the ILECs, an additional and appropriate method of measuring whether the Commission's predictive judgment was correct is an evaluation of the ILECs' earnings for the special access category. The appropriate benchmark to use for

[5] *Special Access NPRM* at para. 74.

that purpose is the Commission's last-approved rate of return of 11.25%.[6] Earnings, of course, cannot be determined without reference to underlying costs.

Ad Hoc does not maintain that any price that results in a rate of return in excess of 11.25% is automatically "unjust" or "unreasonable." But the substantial and sustained growth in special access earnings levels that has occurred since the pricing flexibility rules were implemented is indicative of a market in which service provider prices are not being disciplined by competitive forces. RBOC special access returns ranged between 4.0% and 16.0% in 1996.[7] Ad Hoc's Comments in the *Special Access NPRM* used recent Commission data to show that the "average" BOC return on special access services has grown from a more than healthy average of 31.6% in 2000 to a whopping 81.9% in 2004. Returns at these levels simply could not be sustained over a multi-year period in a mature market subject to competition.

Ad Hoc also pointed out that current special access rates are grossly excessive when compared to just about *any* benchmark.[8] BOCs' returns are at almost unbelievable levels for special access services, with the group taken together boasting an average special access rate of return for 2004 of 53.71%.[9] Individually, Verizon

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[6] *Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, CC Docket No. 89-624, *Order*, 5 FCC Rcd 7507 (1990) at para. 1, ("*Represcribing Order*").

[7] Attachment A to Ad Hoc's Comments in response to the *Special Access NPRM,* "*Competition in Access Markets: Reality or Illusion. A Proposal for Regulating Uncertain Markets*," Economics and Technology, Inc. (August 2004) ("*ETI White Paper*"), as amended by Attachment B, Declaration of Susan M. Gately (June 13, 2005), at 54. Attachment A was also filed as an *ex parte* presentation in *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM-10593. *See* Letter from Colleen Boothby, Counsel for the Ad Hoc Telecommunications Users Committee, to Marlene H. Dortch, Sec'y, Federal Communications Commission, Att. (filed Aug. 26, 2004).

[8] *ETI White Paper* at 3.

[9] Federal Communications Commission, ARMIS Report 43-04, Access Report, YE 2004. Available at http://www.fcc.gov/wcb/eafs/ (accessed April 25, 2005).

earns the lowest, but still substantial, rate of return of 31.64%, while BellSouth's reported earnings go well beyond substantial, with an astronomical rate of return of 81.90%.[10] The Commission's statutory obligations under section 201(b) of the Act demand that the agency stop this blatant use of market power to gouge consumers of special access services. Surely the Commission would not attempt to obviate claims of price gouging by eliminating the cost basis on which such claims rest.

The ILECs' primary response to evidence of the extraordinarily high level of profit on special access services was not to assert that earnings are irrelevant to whether rates are just and reasonable but to claim that the regulatory accounting data found in the Commission's ARMIS reports could not be credibly used for ratemaking purposes.[11] Ad Hoc demonstrated, however, that the ILEC criticism of earnings results based on ARMIS data is at least disingenuous. *First*, the ARMIS financial results simply document the costing and accounting rules that have been implemented by the Commission over several decades. The ILECs themselves have had as large or larger a role in the development of these rules as any other party. If the rules and reporting requirements do not reflect reality, now is hardly the time to complain. Instead, BellSouth would have the rules rendered inapplicable.

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[10] *Id.*

[11] The ILECs' claims in this area can be found throughout the comment cycles in response to *AT&T's Special Access Petition* to re-regulate special access services (RM-10593) and in response to AT&T's Petition for Writ of Mandamus relative to that proceeding. *See AT&T Corp. Petition for Rulemaking To Reform Regulation of Incumbent Local Exchange Carrier Rates For Interstate Special Access Services,* RM-10593 ("*AT&T Special Access Petition*"), *Opposition of Qwest Communications,* filed December 2, 2002, at pp. 8-13; *Opposition of SBC Communications,* filed December 2, 2002, at pp. 19-22; *Comments of BellSouth,* filed December 2, 2002, at pp. 4-6; *Opposition of Verizon*, filed December 2, 2002, at pp. 21-23. In addition BellSouth and Qwest suggested that the inclusion of DSL revenues in the Special Access Revenue category skewed results. In a declaration by Dr. Lee Selwyn, attached to AT&T's reply comments, Selwyn calculated that adjusting for DSL revenues would only reduce overall return rates by a couple of percentage points. *See* Reply Declaration of Lee L. Selwyn, Reply Comments of AT&T, filed January 23, 2003, at pp. 46-58, in *AT&T Special Access Petition.*

Second, whether or not ARMIS data includes minor cost misallocations at the margins does not affect the overall integrity of *trends* in the data, since those alleged misallocations do not change from period to period. In other words, even if the absolute rate of return developed for the special access category using ARMIS data is off by some small percentage, the trend in the data (in this case steadily *up*) is nevertheless a reliable indicator of the BOCs' ability to increase prices to supracompetitive levels without fear of attracting competitive entry.

Third, the ILECs themselves rely on ARMIS and emphasize its value and utility in other contexts. While the ILECs reject the use of ARMIS results when these reveal *excessive* earnings, they have argued in favor of using ARMIS when ARMIS results suggest an earnings deficiency or "below cost" pricing.[12] The ILECs' claims that

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[12] For example, in May 2003 in Federal District Court in Chicago, Illinois, just five months after having challenged the use of ARMIS data for evaluating the reasonableness of special access prices in response to the *AT&T Special Access Petition*, SBC relied specifically upon ARMIS results to support its contention that UNE rates were not covering their costs. According to SBC's expert witness:

> SBC Illinois' average revenue per loop (for UNE-L) and revenue per line (for UNE-P) per month is substantially below the costs that SBC Illinois recognizes on its books to provide those UNEs. I used the FCC's financial accounting information as reported in its Automated Reporting Management Information System ("ARMIS") files to obtain the historical cost data specifically for SBC Illinois. These data are reported to the FCC for purposes of tracking the interstate rate of return and are subject to a highly detailed set of reporting guidelines.

See, Affidavit of Debra J. Aron on behalf of SBC in United States District Court for the Northern District of Illinois, Eastern Division, Case No. 03-C3290, filed May 27, 2003.

Several months later, in December 2003, SBC was joined by USTA and other BOCs in lauding ARMIS as the source for the "actual" costs of UNEs in the response to the FCC's *TELRIC NPRM*. *See, e.g.*, *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, Comments of United States Telecom Association, (filed December 16, 2003), at p. 10; Comments of the Verizon Telephone Companies at pp. 40, 46, 58, 94; Opening Comments of SBC Communications, Exhibit A*, "The Economics of UNE Pricing,"* prepared by Debra J. Aron, PhD and William Rogerson, PhD (filed December 16, 2003), at pp. 28-32.

One month later, in January 2004, SBC and its sister RBOCs argued to the United States Court of Appeals for the District of Columbia Circuit (in opposing AT&T's Petition for Writ of Mandamus) that "ARMIS data contain arbitrary allocations that are economically irrational." See *AT&T Corp. et al.,* No. 03-1397 (D.C. Cir.), Response of Intervenors in Opposition to AT&T's Petition for a Writ of Mandamus, filed January 9, 2004, (*"03-1397 BOC Opposition"*) at 13.

ARMIS-based rates of return for special access are inflated by the misallocation of costs to other services (*i.e.*, the Common Line category)[13] are belied by their simultaneous defense in other proceedings and venues of the accuracy of ARMIS cost allocations to the Common Line category, thus admitting that special access costs are *not* being misallocated to that category.[14]

In other words, to explain away excessive profit levels for special access, the ILECs in the past have asserted that in ARMIS, costs associated with special access are being misallocated to the Common Line category. But when the shoe is on the other foot, when the ILECs are fighting arguments that ARMIS produces an inappropriately high measure of Common Line costs, they staunchly defend the use of

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Flip-flopping yet again only two months later, SBC defended the validity of ARMIS as the correct basis for benchmarking UNE costs in testimony filed with the Illinois Commerce Commission on March 5, 2004. SBC's witness, Dr. Aron, stated,

> In the final analysis, ARMIS is no better or worse than any cost accounting system for a large, multiproduct firm. It is subject to strict reporting requirements and a consistent set of rules across carriers. Virtually all cost accounting systems will be subject to the criticism that they make allocations, and to the criticism that any full cost estimate (which, as I noted, includes TELRIC-based UNE prices as well) will reflect such allocations. However, the fact nevertheless remains that accounting systems are the basis for decision making in our economy, and that it is reasonable to look at accounting estimates of costs for benchmarking purposes such as this one.

See Illinois Commerce Commission, Docket No. 02-0864 SBC Illinois Ex. 2.2 (Surrebuttal Testimony of Dr. Debra J. Aron) (*"Illinois - Aron Surrebuttal Testimony*") filed March 5, 2004, at p. 9.

[13] In its Response to AT&T's Petition for Writ of Mandamus, ILECs (including SBC) claimed that the apparently high rates of return on special access arises because ARMIS rules require that certain special access-related costs be assigned elsewhere. See *03-1397 BOC Opposition* at 14. In fact, in the interstate jurisdiction, the only other place where these costs *could be* allocated is to the Common Line category.

[14] For example, in a recent UNE proceeding, SBC submitted testimony that claimed that ARMIS costs for the switched access loop are "fairly straightforward" and reliable indicators of the investment and associated expenses specifically associated with that category (and element)." In this context, SBC's witness stated, "... the costs that ARMIS associates with the loop are fairly straightforward and, except for the shared and common costs of the sort that affect TELRIC costs as well, these costs are reliable indicators of the investment and associated expenses specifically associated with that category (and element). The shared and common costs represent a portion of the costs associated with support assets (and expenses) such as land, buildings, trucks, tools, and personnel, a share of which are appropriately assigned to elements in ARMIS. These costs are also allocated to elements in a TELRIC analysis." *See, Illinois - Aron Surrebuttal Testimony* at p. 9.

ARMIS Common Line data as the basis for UNE-Loop prices and claim that prices based on ARMIS include only costs actually attributable to switched access loops (and certainly not costs attributable to interstate special access). At least one of these two patently conflicting claims must be false. The Commission cannot ignore ARMIS earnings data on the basis of irreconcilable and self-serving claims that ARMIS is (1) reliable for determining the cost of a single disaggregated service element but (2) unreliable for calculating the aggregate (and excessive) rate of return for the entire special access category.

Now BellSouth has another tactic in mind to avoid claims that its special access rates are patently excessive and violate section 201(b) of the Act. It would have the Commission eliminate the cost assignment and allocation rules that are necessary to calculate their earnings from special access service, or from any service or in any jurisdiction. BellSouth has over-reached by a wide margin.

IV. Forbearance Would Violate The Commission's Responsibilities Under Section 201 (b).

Pursuant to the Communications Act of 1934 (the "Act"),[15] the Federal Communications Commission (the "FCC" or "Commission") is obligated to ensure that the charges of common carriers for regulated interstate telecommunications services are "just and reasonable."[16] This regulatory obligation extends to the interstate access service rates and charges of local exchange carriers ("LECs"), including BellSouth, subject to price cap regulation.

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[15] 47 U.S.C. §§ 151, *et seq.*, as amended by the Telecommunications Act of 1996, Pub. L. No. 104-104, 111 Stat. 56 (1996) (the "Act" or "Communications Act").

[16] 47 U.S.C. § 201(b) (rates shall be just and reasonable); 47 U.S.C. § 151 (Commission "shall execute and enforce" provisions of Communications Act).

The courts have recognized that the Commission must "execute and enforce" the provisions of the Communications Act and that it may not abdicate its duty to ensure that statutory standards are met. As part of this obligation, the Commission must ensure that the LECs' charges are "just and reasonable." 47 U.S.C. § 201(b); *see MCI Telecommunications Corp. v. FCC*, 765 F.2d 1186, 1192 (D.C. Cir. 1985) (*quoting* 47 U.S.C. § 151); *cf. Southwestern Bell Telephone Company v. FCC*, 10 F.3d 892, 894 (D.C. Cir. 1993). As the U.S. Court of Appeals for the Second Circuit recognized in *American Telephone & Telegraph Co. v. FCC*,

> [t]he Communications Act requires . . . that rates . . . be *just*, fair, *reasonable* and nondiscriminatory. . . . We are aware of no authority for the proposition that the FCC may abdicate its responsibility to perform [this duty] and ensure that these statutory standards are met.

572 F.2d 17, 25 (2d Cir.), *cert. denied*, 439 U.S. 875 (1978) (citations omitted). Although section 10 of Act would allow the Commission to forbear from enforcing Section 201 if it could reasonably find that enforcement of section 201 was not necessary to protect special access consumers, the Commission cannot make such a finding with respect to special access rates given the record in the *Special Access* investigation and that presented by BellSouth in this proceeding.

The federal courts have determined that, when Congress requires an agency to set or oversee regulated companies' rates, which is the case with respect to special access rates, the agency must ensure that those rates fall within a "zone of reasonableness." *See, e.g.*, *Permian Basin Area Rate Cases*, 390 U.S. 747, 767, (1968); *United States v. FCC*, 707 F.2d 610, 612 (D.C. Cir. 1983). The "zone of reasonableness" encompasses both the minimum and maximum rate levels that an

agency may authorize a regulated company to charge. In *Farmers Union Central Exchange v. FERC*, this Court explained:

> When the inquiry is on whether the rate is reasonable to a producer, the underlying focus of concern is on the question of whether it is high enough to both maintain the producer's credit and attract capital. . . . When the inquiry is whether a given rate is just and reasonable to the consumer, the underlying concern is whether it is low enough so that exploitation by the [regulated business] is prevented.

734 F.2d 1486, 1502 (D.C. Cir. 1984). Forbearing from enforcing the subject cost assignment and allocation rules, without a reasonable finding that the special access market is effectively competitive (which the Commission cannot make), would foreclose such an inquiry and would contravene the Commission's statutory responsibilities.

Federal courts have consistently looked at the earnings of regulated companies in addressing claims regarding the reasonableness of carrier rates. *See, e.g., FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *American Telephone and Telegraph Co. v. FCC*, 836 F.2d 1386, 1390 (D.C. Cir. 1988). In *Hope Natural Gas*, the Supreme Court held that, at a minimum, a regulated entity's rates must produce sufficient revenues to cover operating expenses and capital costs and yield a return "commensurate with returns on investments in other enterprises having corresponding risks." 320 U.S. at 603. Similarly, in its more recent decision in *Duquesne Light Co. v. Barasch,* the Supreme Court explained that the reasonableness of a regulated company's rates turns on whether the company is earning a fair return on investment, given the risks the company faces under the ratemaking system to which it is subject. 488 U.S. 299, 310 (1989).

Moreover, the just-and-reasonable standard does not permit regulated entities to earn unlimited profits. As this Court explained in *United States v. FCC,* regulated utilities are entitled to earn enough revenue to cover operating expenses and capital costs, but "[t]he return should not be higher than necessary for this purpose . . . because otherwise ratepayers would pay the excessive prices that regulation is intended to prevent." 707 F.2d at 612 (citations omitted).

Ad Hoc does not dispute that the Commission has broad discretion to craft a regulatory scheme to satisfy the requirement that carriers' charges be just and reasonable. Such discretion must, however, be exercised in a manner that produces rates within the zone of reasonableness. Granting BellSouth's petition would be utterly incompatible with the Commission's responsibilities under the Act, including section 10 of the Act.

V. Grant of BellSouth's Petition Would Be Inconsistent With Representations Made To The D.C. Circuit.

Grant of the BellSouth's petition would put the Commission in an indefensible position before the United States Court of Appeals for the District of Columbia. In opposing AT&T's petition to the D.C. Circuit for a writ of mandamus ordering the FCC to issue a notice of proposed rulemaking vacating its special access pricing rules and adopting new rules to govern special access rates, the Commission, *inter alia*, stated to the Court that special access customers should not be entitled to the requested relief because complaints under section 208 of the Act would be an adequate remedy.[17]

[17] Opposition of the Federal Communications Commission To Petition For Writ Of Mandamus, U.S. Court of Appeals for the D.C. Circuit, No. 03-1397, at 26-27. The Court dismissed as moot AT&T's Petition for Writ of Mandamus after the Commission issued the *Special Access NPRM.*

Complaints about excessive special access rates obviously would be futile because no relevant cost data would exist if BellSouth's Petition were granted, and thus, earnings could not be calculated using revenue and cost data. Indeed, as noted above, the *Special Access Rulemaking* would be an empty proceeding. The Commission could not credibly reconcile grant of BellSouth's petition with the Commission's statements to the Court and release of the *Special Access NPRM*.

VI. Contrary To BellSouth's Contention, The Commission's Price Caps Rules Do Not Sever The Relationship Between Rates And Costs.

In addition to the relevance of costs to section 201(b) determinations, costs continue to be independently important under the Commission's price cap rules. BellSouth's contention that, "Under price caps, the cost assignment rules have no connection, to ensuring that BST's rates are just and reasonable," is simply wrong.[18] Price cap regulation as prescribed by the Commission does not sever all links between rate setting and costs.

Price caps, at the federal and state levels, are based on various indices and measurements of productivity. This form of regulation is intended to encourage carrier efficiency and produce results very similar to those that competitive markets would yield. Regulatory authorities, including the Commission, do not prescribe price caps formulae and then never evaluate the operation of the formulae or revise the formulae. Important information regarding the efficacy of such formulae would include carrier earnings. Carrier earnings that consistently were too low or too high would suggest

[18] *See, e.g.,* BellSouth Petition at 23.

revisions to the formulae.[19] Without cost assignment and allocation rules, carriers subject to price cap regulation could misallocate costs to repress earnings levels and thus (1) avoid formulae adjustments that would result in rate reductions and (2) support formulae adjustments that would yield rate increases.[20] Grant of BellSouth's petition would without doubt create such an environment, and would be unjustified under the section 10 forbearance standards.

A more detailed consideration of the price caps rules also confirms that those rules do not render costs irrelevant to BellSouth's ratemaking and the Commission's evaluation of BellSouth's rates. The Commission has explained that price caps carriers' tariff filings that include rate changes below the pricing bands established by the Commission, "[m]ust be accompanied by an average variable cost showing…."[21] Tariff filings by price caps carriers that include above-band rates "[m]ust be accompanied by a detailed cost showing that will enable the Commission to determine compliance with statutory requirements of just and reasonable rates that are not unjustly discriminatory."[22]

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[19] BellSouth currently must file Form 492A "to enable the Commission to monitor access tariff and price-caps earnings." FCC Form 492A, "General Instructions." BellSouth, of course, asks the Commission to forbear from enforcing this requirement.

[20] *See,* Kenneth Train, *Optimal Regulation* 327 (1991) (under price cap regulation, a firm will have an incentive to "waste so as to convince the regulator to allow a higher cap"). A Commission convened Joint Conference on Accounting, which was comprised of members of the FCC and state public utility commissioners, concluded that a dominant local carrier can benefit from cost allocation by "making its regulated earnings appear as low as possible, such as when it is pursuing a takings claim, seeking regulatory relief based on allegedly depressed earnings, or is subject to a profit-sharing requirement. Recommendation by Joint Conference, *Federal-State Joint Conference On Accounting Issues,* WC Docket No. 02-269, at 24 (Oct. 9, 2003).

[21] *Policy and Rules Concerning Rates for Dominant Carriers,* CC Docket No. 87-313, 5 FCC Rcd 6786, 6789 (1990).

[22] *Id.*

Moreover, under the Commission's price caps rules, all exogenous cost changes set forth in section 61.45(d) of the Commission's rules involve changes in the underlying regulated interstate costs of the BellSouth, and require BellSouth to adjust its price caps indices to reflect such cost changes. Exogenous costs are not limited to those specified in 61.45(d). The Commission at one point stated that it has "[r]etained the discretion to consider extending exogenous cost treatments to 'other extraordinary *cost* changes that the Commission shall permit or require.'"[23] Ad Hoc believes that since the inception of price cap regulation for incumbent LECs in 1991, the BOCs have made exogenous adjustments to their price cap indices every, or virtually every, year.

The foregoing discussion demonstrates that BellSouth's costs are relevant to setting the indices that generally control BellSouth's prices. BellSouth's claim that costs are irrelevant under current price caps regulation is simply wrong.

Finally, the Commission must recognize that the so-called CALLS plan has expired and may be replaced with a form of price cap regulation that uses a productivity offset to calculate price cap indices.[24] Historically costs have been relevant to setting the productivity offset, the "X-Factor", in the Commission's price caps rules. Total factor productivity (TFP) studies, the method most recently used by the Commission to measure the productivity of local exchange price caps carriers is the "[r]elationship between the output of goods and services to inputs of basic factors of production –

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[23] *Price Cap Performance Review for Local Exchange Carriers,* 12 FCC Rcd 16642, 16711 (1997) (emphasis added).

[24] *Access Charge Reform,* Sixth Report and Order, CC Docket Nos. 96-262 and 94-1, Report and Order, CC Docket No. 99-249, Eleventh Report and Order, CC Docket No. 96-45, 15 FCC Rcd 12962 (released May 31, 2000) (*CALLS Order).*

capital, labor, and materials."[25] The Commission's description of the TFP methodology that it most recently used makes clear that costs, including accounting costs are critical to the methodology.[26] Determining the costs relevant to TFP studies would be an exercise in futility if BellSouth's petition were granted. The Commission cannot now reasonably conclude that TFP studies will be irrelevant to future regulation of BellSouth's rates.

VII. Digital Networks Do Not Preclude Rational Cost Assignments And Allocations.

BellSouth's contention that cost assignment and allocation rules are particularly onerous and counter-productive given contemporary digital networks is an overstatement and erroneous. Carriers have been subject to jurisdictional cost allocations pursuant to Separations Process for decades. Allocation of costs among the interstate and intrastate jurisdictions has been, and still is mandated by *Smith v. Illinois Bell Telephone Company*, 282 U.S. 133 (1930). Similarly, carriers have been required to allocate costs between and regulated and unregulated services and between services for years. There is nothing about digital networks that obviates the importance of such allocations.

BellSouth argues that it "[i]s forced to try to shoehorn compliance with cost assignment rules designed for an analog, single purpose, circuit switched network" for its multi-function digital network.[27] BellSouth asserts that it could accomplish detailed

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[25] *Price Cap Performance Review for Local Exchange Carriers,* 12 FCC Rcd 16642, 16679 (1997); *reversed and remanded in part, United States Telephone Association v. Federal Communications Commission,* 188 F3d 521 (D.C. Cir. 1999).

[26] *Id. at 16679, 16773, 16776-77, 16782.*

[27] BellSouth Petition at 25.

cost allocations as long as its network was single purpose and analog.[28] It is, however, hard to remember when BellSouth's network was last single purpose. It has provided a variety of transport services, ranging from transmission of broadcast quality video to low speed private line data to frame relay service to "plain old telephone service" for decades. It has also been free to provide information/enhanced services for years. BellSouth has not explained what is unique about the current network (which undoubtedly is a mix of analog and digital facilities) that makes the kinds of cost allocations that it has performed for years more difficult. As long as BellSouth has market power, which is still the case, cost assignment rules are necessary to protect consumers of regulated services. Price caps regulation is not the same as rate deregulation, and, as explained above, costs are still relevant. The increasing digitization of BellSouth's network should not make the cost assignments and allocations any more difficult than has been the case, and certainly does not eliminate the need for cost assignments and allocations.

[28] *Id.* at 11.

Conclusion

In view of the foregoing, the Commission cannot reasonably make the findings required by section 10 of the Act, and thus, must deny BellSouth's petition.

Respectfully submitted,

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