

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554**

In the Matter of)	
)	
Jurisdictional Separations and Referral to the)	CC Docket No. 80-286
Federal-State Joint Board)	
)	

AFFIDAVIT OF
ROBERT LOUBE
on behalf of the
Maine Office of the Public Advocate
and the
National Association of State Utility Consumer Advocates

August 22, 2006

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I. Introduction

A. Introduction and Qualifications

1. My name is Robert Loube. I am the Director of Economic Research for Rhoads & Sinon, LLC. My business address is 10601 Cavalier Drive, Silver Spring, Maryland 20901. My consulting practice specializes in providing technical assistance to state and federal government agencies. Previously, I was an industry economist at the Federal Communications Commission, the Director of the Office of Economics of the Public Service Commission of the District of Columbia, and the econometrician of the Indiana Utility Regulatory Commission. I have served on both the state staff and the federal staff of the Federal-State Joint Board on Separations.
2. My vita is included as Appendix A.

B. Purpose of the Affidavit

3. The purpose of my Affidavit is to respond to the Federal Communications Commission's (the Commission) request for comments regarding the current separations process.¹ In particular, I demonstrate that the current separations process distorts the cost assignment between the jurisdictions. The distortion is aggravated by the fact that most carriers ignore the Part 36 rules associated with the direct assignment of special access.² I review the Freeze Order³ and demonstrate that the direct assignment of Special Access investment is consistent with that Order. I provide a detailed analysis of the impact of the carriers' accounting, showing that

¹ In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board, CC Docket No. 80-286, FCC 06-70, *Order and Further Notice of Proposed Rulemaking*, released May 16, 2006, (Order and FNPRM”).

² *Id.*, ¶38.

³ In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board, CC Docket No. 80-286, FCC 01-162, *Report and Order*, released May 22, 2001, (“Freeze Order”).

cable and wire facilities investment by category has been distorted by the freeze, and that this distortion generates extraordinary special access profits while dampening the profits of all other service categories.

4. I also focus on the question of how to incorporate new technologies into the separations process.⁴ These technologies affect the allocation of outside plant and switching equipment. Carriers use outside plant not only to provide regulated telecommunications services but also to provide non-regulated data and video services. Even though the Commission recently found that some data services are not telecommunications services, it allows carriers to treat the non-regulated services as regulated services for the purpose of determining cost assignment.⁵ The decision to allow non-regulated services to remain within the regulated accounting system creates a cash support flow from the regulated services to non-regulated services. This practice increases regulated prices and distorts the competitive playing field among providers of non-regulated services. Therefore, it is necessary to reform the current system by transferring cost from the basket of services included in the universal service package to non-regulated services. Below I will propose a plan that will accomplish that task.
5. In addition, switching equipment is evolving from circuit switches to package switches. This transformation generates a problem for the separations process because switching equipment is currently separated on the basis of minutes of use measured on circuit switches, and the industry has not developed an alternative usage

⁴ Order and FNPRM, ¶33.

⁵ In the Matter of Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, CC Docket No. 02-33, FCC 05-150, *Report and Order and Notice of Proposed Rulemaking*, released September 23, 2005, (“Wireline Broadband Order”), ¶128.

metric for packet switches. Without a packet metric, it may be necessary to use a fixed allocator to allocate traffic sensitive equipment. The simplest solution would be to use the same gross allocator for both packet switches and loop plant. Such a solution would be reasonable if the loop allocator is changed to reflect the increased use of the loop for the provision of non-regulated services.

6. The relationship between separations and universal service funding must be analyzed.⁶ The embedded High Cost Loop (HCL) and the Interstate Common Line Access (ICLS) mechanisms rely on the separations procedures. The HCL mechanism calculates a loop cost based on the cable and wire facilities (C&WF) Category One loop plant and central office equipment (COE) Category 4.13 plant.⁷ It compares the study area loop cost to the national average loop. If the Commission re-bases the high cost loop mechanism, it will be necessary to re-calculate the national average loop cost. Changes in the separations process will change the current reported C&WF Category One and COE 4.13 investment levels.
7. The ICLS mechanism supports the interstate common line revenue requirement.⁸ As such it acts to constrain the level of the rate of return carriers' subscriber line charges. The determination of the interstate common line revenue requirement is dependent on the separations process. I will review how my proposals to change the separations process affect both the HCL and ICLS mechanisms.
8. Finally I will discuss the need to enhance the proposed data request in order to obtain information required to evaluate the current freeze and proposals to change the freeze.

II. Special Access, the Freeze Order and Direct Assignment

⁶ Order and FNPRM, ¶35.

⁷ 47 C.F.R. §36.621.

A. The Separations Process and Direct Assignment

9. The direct assignment of plant is still required even though there is a general freeze on separations changes. The Freeze Order requires carriers to continue to directly assign investments to categories that were directly assigned prior to the order.

Special Access investment is specifically designated as investment that should be directly assigned.⁹ However, carriers have ignored this requirement. Instead, carriers apply the Freeze to all categories. This failure to directly assign Special Access investment has led to a reduction in the plant that would have been directly assigned to the interstate jurisdiction.

10. The first step in the separations process is to divide the investment into categories.

These categories generally group equipment according to function or service provided. For example, switching equipment is divided by switches providing local end-user service and switches providing tandem service. Cable and wire facilities are grouped according to whether the cable is used to connect end-users to wire centers (Category 1), to connect local offices and provide wide-band services (Category 2), to provide toll message and private line services (Category 3), or to connect host and remote switches (Category 4). The Categories can be further divided into subcategories. For example, cable and wire Category 1 is divided into state private lines (Subcategory 1.1), interstate private lines (Subcategory 1.2), and subscriber loops (Subcategory 1.3).

11. The second step in the separations process is to apportion each category between the jurisdictions according to an allocation factor or by direct assignment. Allocation

⁸ 47 C.F.R. §54.901.

⁹ 47 C.F.R. §36.3(a).

factors can be either relative use factors or fixed factors. A relative use factor measures the use of a particular type of facility or equipment. For example, the dial equipment minutes (DEM) factor measures the use of the local switching equipment. If a switch has 100 minutes of use and 15 minutes are used for interstate services and 85 minutes are used for intrastate services, then the interstate DEM would be 15 percent, and 15 percent of the investment would be assigned to the interstate jurisdiction.¹⁰ A fixed allocator does not change over time. An example of a fixed allocator is the 75/25 percent gross allocator used to assign subscriber loop (Category 1.3) between the jurisdictions. Accordingly, 75 percent of subscriber loop plant is assigned to the intrastate jurisdiction and 25 percent is assigned to the interstate jurisdiction.

12. Under direct assignment, the carrier allocates the investment directly to a category, and because the category is 100 percent assigned to one jurisdiction, the investment is directly assigned to that jurisdiction. This type of direct assignment occurs with regard to intrastate private line investment, Subcategory 1.1.¹¹
13. The FCC released the Freeze Order on May 22, 2001.¹² In general, the freeze maintains the calendar-year 2000 category relationships and cost allocation factors.¹³ For example, if in calendar-year 2000, the cable and wire facilities accounts were allocated 60 percent to Category 1, 20 percent to Category 2, and 10 percent to Categories 3 and 4, then all cable and wire investment from July 1, 2001 forward would be allocated to the categories using those percentages. Thus, in years

¹⁰ For a carrier with multiple switches the DEM is measured across the multiple switches.

¹¹ Freeze Order, Footnote 13.

¹² Freeze Order.

¹³ Id., ¶9.

subsequent to July 2001, for every \$100 of cable and wire investment, \$60 would be assigned to Category 1. Moreover, if Category 1 has a jurisdictional cost allocation factor of 70 percent, then the carrier would place \$42 (\$60 times 70 percent) into the intrastate jurisdiction.

14. The general freeze applies only to investment that is allocated on the basis of relative use or fixed factors.¹⁴ It does not apply to investment allocated through direct assignment. With regard to direct assignment the Order stated:

Categories or portions of categories that have been directly assigned in the past, however, will continue to be directly assigned to each jurisdiction. In other words, the frozen factors shall not have an effect on the direct assignment of costs for categories, or portions of categories, that are directly assigned.¹⁵

15. The immediate impact of Special Access direct assignment is to place cable and wire facilities in the appropriate accounts. In addition, the impact of direct assignment cascades through numerous other accounts. Several circuit equipment investment accounts are directly assigned on the basis of the cable and wire facilities assignments.¹⁶ The directly assigned investments determine the allocations of related depreciation and maintenance.¹⁷ Changes in maintenance expenses alter the allocation of investments and expenses that are allocated on the basis of the “Big Three Expenses” which include general support facilities investment, depreciation and operating expenses, and corporate operations expenses.¹⁸

B. Measuring the Impact of the Failure to Directly Assign Special Access Investment

¹⁴ Id.

¹⁵ Id., ¶23.

¹⁶ See for example, 47 C.F.R. § 36.126(c)(1) & (2).

¹⁷ 47 C.F.R. §36.361, §36.321 and §36.341.

¹⁸ 47 C.F.R. §36.112 and §36.392.

16. The first step in measuring the impact of the failure to direct assign special access

investment is to show that the Bell Operating Companies are maintaining the category freeze with regard to cable and wire special access investment.¹⁹ Table 1 calculates the relationship between interstate special access C&WF investment and total C&WF investment for eight carriers for the years 2000 to 2005. With the exception of 2001 (the category freeze was not in effect during the first half of 2001), the percentages calculated in Table One are essentially the same for each carrier for all years. While it is possible that such events could occur even under a regime of direct assignment the chances of that outcome occurring is very slim. The more likely explanation for the results shown in Table One is that the carriers are maintaining the category freeze.

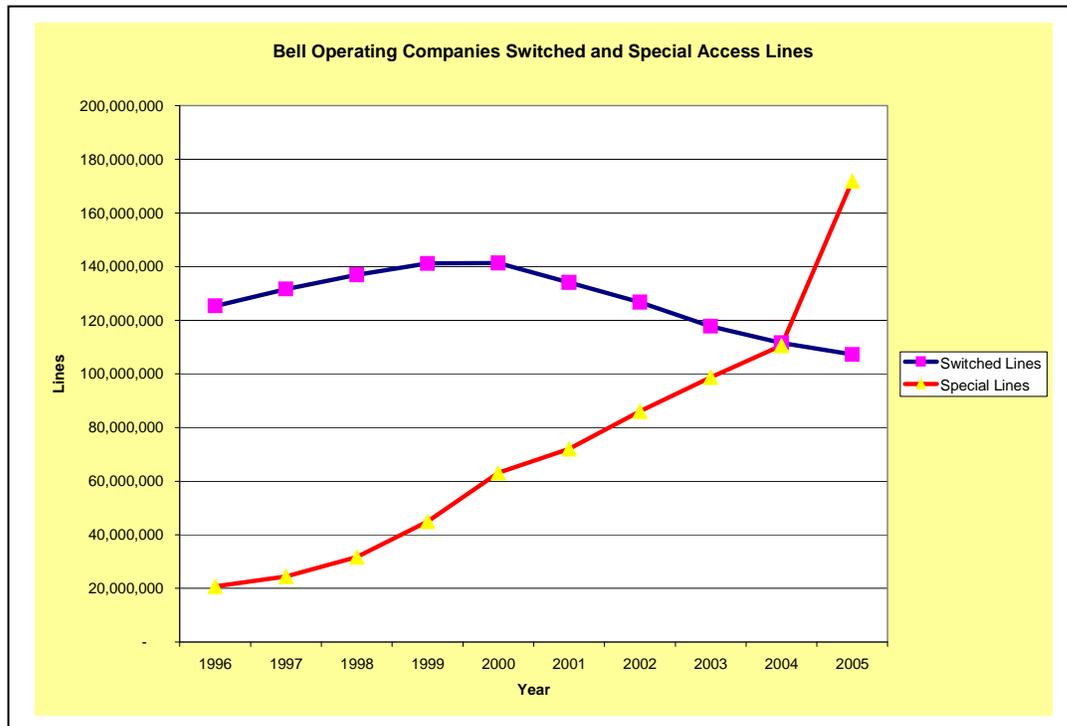
Table One

	Interstate Special Access C&WF Investment as a Percentage of Total C&WF Investment					
Year	2005	2004	2003	2002	2001	2000
AT&T California	4.8%	4.8%	4.8%	4.8%	4.4%	4.7%
AT&T Texas	6.1%	6.1%	6.1%	6.1%	4.9%	6.0%
BellSouth North Carolina	3.4%	3.4%	3.4%	3.4%	3.8%	3.4%
BellSouth Tennessee	3.2%	3.2%	3.2%	3.2%	3.4%	3.1%
Qwest Colorado	5.5%	5.5%	5.5%	5.5%	5.3%	5.5%
Qwest Washington	3.6%	3.6%	3.6%	3.6%	3.7%	3.6%
Verizon Massachusetts	21.9%	21.9%	21.9%	21.9%	24.3%	21.9%
Verizon Pennsylvania	5.4%	5.4%	5.4%	5.4%	5.5%	5.4%
Source: ARMIS 43-04 Reports						

¹⁹ With regard to circuit equipment, Verizon maintains the category freeze on a total company basis, but then makes a limited ad hoc adjustment to the categories when it allocates plant between the jurisdictions. See the Rebuttal Testimony of Sandra Anderson on Behalf of Verizon Maine, Maine Public Utilities

17. Second, the period between 2000 and 2005 was marked by two new and significant trends in the provision of telecommunications services. The first trend is the fact that the number of switched access lines provided by carriers peaked and started to decline. The second trend is that the number of special access lines increased very rapidly. The combination of these trends is shown in Figure One. At the beginning of the period, switched access lines exceeded special access. By 2004, switched and special access lines were approximately the same. In 2005, special lines were far greater than switched lines as the special access line count continued to grow and the switched access line count continued to decline.

Figure One²⁰



Commission Investigation into New Alternative Form of Regulation for Verizon Maine, Docket No. 2005-155, Page 11, lines 6-13.

²⁰ Data source is the ARMIS 43-08 Reports

18. The decline in switched access lines and the increase in special access lines also occurred on an individual carrier basis. At the same time that these line trends exist, C&WF investment for switched and special access grew at approximately the same rate. For example, Figures 2 and 3 compare the percentage change in access lines to the percentage change in investment. For Verizon Massachusetts (Figure 2), switched access lines decreased by 25.7 percent and special access lines increased by 310.9 percent.²¹ However, C&WF investment for switched and special access lines services increased by the same 17 percent. For AT&T California (Figure 3), switched access lines decreased by 21.3 percent and special access lines increased by 85.6 percent. At the same time, switched investment increased by 18.3 percent and special investment increased by 18.8 percent.

²¹ Data sources are the ARMIS 43-04 and 43-08 reports. Appendix B contains the figures for an additional six carriers. The carriers were chosen so that there would be two carriers from each holding company. Also the carriers represent different regions within the holding company. NASUCA is providing the FCC with a CD containing the spreadsheets and data used to develop these figures and all other figures and tables in this affidavit. The data provided will allow an analysis to generate the figures and tables for all Bell Operating Companies. NASUCA will also provide the CD to any interested party in this docket. Please contact bobloube@earthlink.net in order to obtain a copy of the CD.

Figure Two

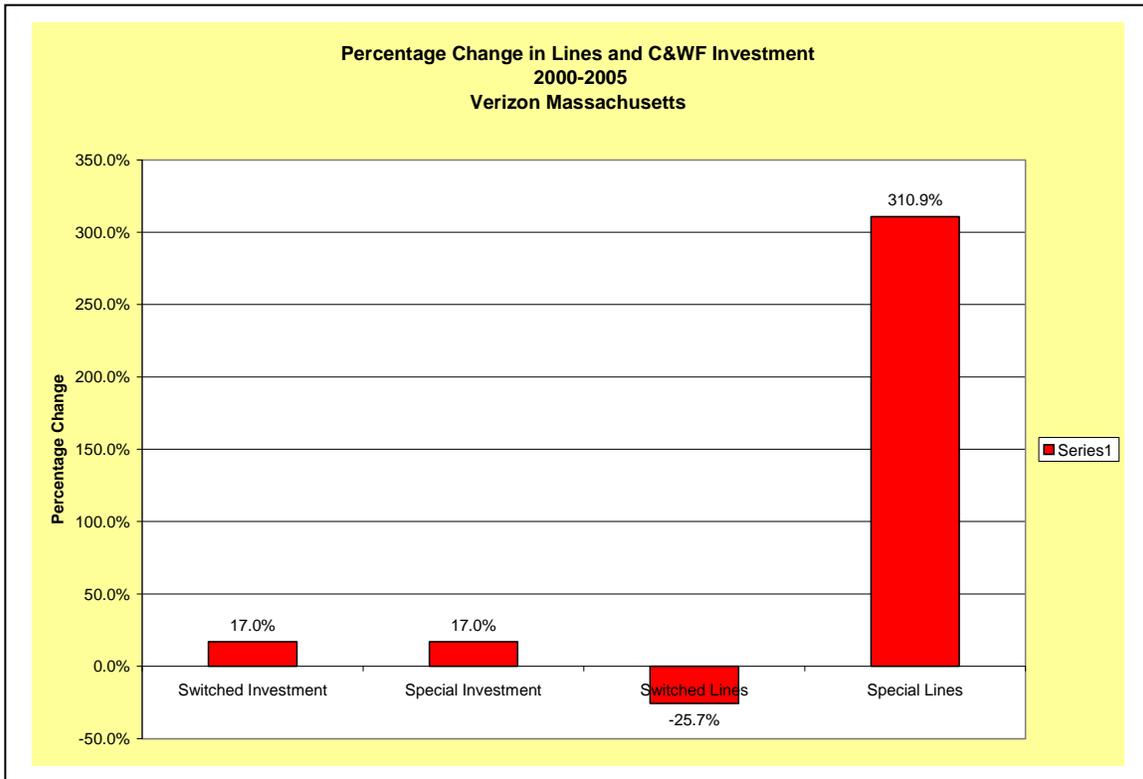
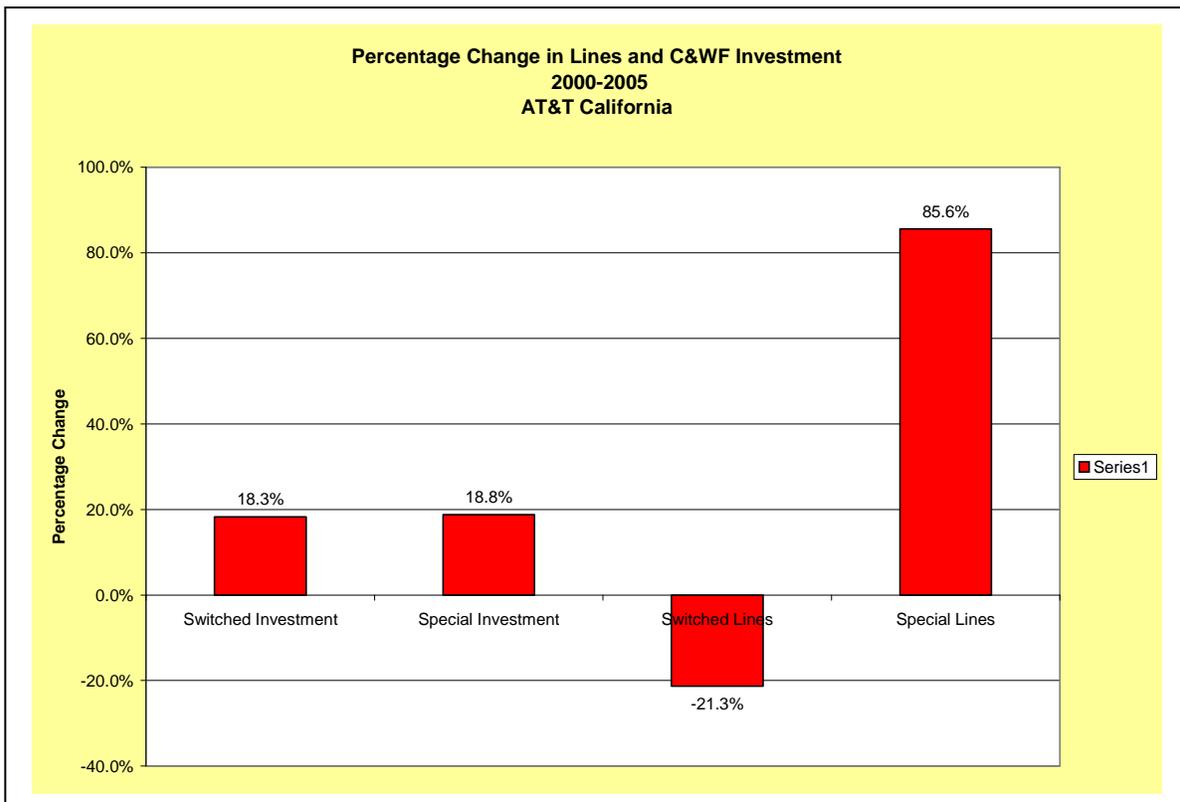


Figure Three



19. Figures Two and Three provide a vivid comparison of line and investment growth rates. While there are many factors that affect the growth in investment, it is reasonable to expect that growth in lines would be a major determinant of the growth in investment. An exact determination of that relationship would require additional information not available at this time, and there is no evidence to support a one-to-one relationship where a 10 percent increase in lines should generate a 10 percent increase in investment. However, it is reasonable to assert that a 311 percent increase in special access lines should generate a special access investment increase that is substantially greater than the switched access investment increase that is associated with 26 percent decrease in switched access lines. The fact that Verizon Massachusetts recorded a 17 percent increase and AT&T California recorded an 18 percent increase for both switched and special access investment clearly indicates that the separation freeze is distorting recorded investment. Far too little investment is being recorded as special access investment and excessive amounts of investment are being recorded in all other accounts.
20. Fourth, the failure to directly assign special access investment contributes to excessive reported rate of return for special access services, and in turn reduces the rate of return associated with other services. The low rate of return for other services may induce carriers to ask for rate increases for basic services or to provide a defense for not reducing basic service prices.
21. Special Access reported returns and excess earnings by holding company are shown in Table Two.²² Excess earnings are calculated in Table Two as the difference between reported earnings and 11.25 percent (the FCC's interstate allowed rate of

return) times the special access rate base. The rate of return for the holding companies ranges from 42 to 109 percent on investment, while the combined excess earnings exceeds \$7 billion. These returns are clearly affected by the failure to directly assign special access investment.

Table Two²³

Special Access Return and Earnings (\$ thousands)						
Year	2003		2004		2005	
Holding Company	Rate of Return	Over Earnings	Rate of Return	Over Earnings	Rate of Return	Over Earnings
AT&T	60.3%	1,972,308	73.0%	2,145,280	91.7%	2,525,367
BellSouth	69.1%	1,173,118	81.9%	1,340,770	98.4%	1,554,366
Qwest	65.8%	887,723	75.1%	868,624	109.4%	1,113,256
Verizon	23.1%	963,403	31.6%	1,501,306	42.0%	2,048,250

22. The improper assignment of special access investment and the resulting excessive reported special access profits destroys the Commission’s ability to measure the impact of its policy changes. For example, the Commission has allowed carriers to flexibly price special access in many markets. The rationale for flexible pricing is that these markets are competitive.²⁴ However, it is nearly impossible to claim that any market is competitive where reported profits range from 42 to 109 percent. At least one wireless carrier has asked Congress to change the Telecommunications Act to require the Commission to re-regulate special access rates.²⁵ Whether or not there are some special access markets that are competitive is not the subject of this affidavit.

²² The rate of return and excess earnings by carrier are provided in Appendix C.

²³ Data Source is the ARMIS 43-01 Reports

²⁴ In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, FCC 99-206, *Fifth Report and Order and Further Notice of Proposed Rulemaking*, released August 27, 1999.

²⁵ Written Testimony of Robert S. Foosaner, Senior Vice President-Government Affairs, Sprint Nextel Corporation on S.2686, The Communications Consumers’ Choice and Broadband Deployment Act of 2006, Before the U.S. Senate Committee On Commerce, Science and Transportation. June 13, 2006.

However, the separations Freeze, as implemented by the carriers, clearly limits the ability of a rational person to determine whether such competition exists.

23. More importantly, the improper assignment of special access investment and related costs reduces the rate of return associated with universal service offerings. These low rates of return contribute to the maintenance of high basic service rates, lower telephone penetration rates and the false belief that basic service rates are subsidized.
24. Because rationale and effective policy decision-making requires accurate reporting, and the current reporting practices clearly distort relevant levels of investment, cost and return, I recommend that the Commission require ILECs to directly assign special access investment. This requirement should not generate excessive administrative costs. Rate-of-return carriers are able to perform the studies that allow a carrier to directly assign investment. If the rate-of-return carriers can perform the studies despite their limited resources and the fact that they do not enjoy the economies of scale that a price-cap carrier would achieve in performing the studies, it is reasonable to expect that price-cap carriers will be able to perform the required studies without incurring excessive administrative expenses.

III. Non-regulated Broadband Services and the Separations Process

A. The Growth in Broadband Services

25. Broadband services include data and video services. The major data service provided by the incumbent local exchange carriers (ILECs) is asymmetric digital subscriber line (ADSL). The number of ADSL customers has exploded from approximately

370,000 customers in December 1999 to over 1.9 million customers in December 2005.²⁶

26. Verizon and AT&T are rolling out video services. Verizon is building a fiber-to-the-premise network. This network allows Verizon to provide “the bandwidth and speed to make available an array of new services called FIOS: super-fast, high speed Internet Access, crystal clear voice and a full suite of video services.”²⁷ Verizon has deployed its fiber to the home network in at least 16 states and over 137 communities. AT&T is providing video services as part of its Project Lightspeed. As part of this project, AT&T is building fiber-to-the-premise and fiber-to-the-neighborhood networks. It is adding 40,000 miles of fiber to its local networks.²⁸ The AT&T service package is called U-verse. The U-verse package builds a strategy around integrating three screens (video, computer and wireless) along with telephone service to provide a quadruple play.²⁹
27. At least three states, Texas, New Jersey and Virginia, have approved statewide video franchising procedures.³⁰ Telephone companies are aggressively urging other states and Congress to reform video franchising laws to allow telephone companies to enter video markets.³¹ Communities with video franchising authority are allowing

²⁶ FCC, Industry Analysis and Technology Division, “High Speed Services for Internet Access: Status as of December 31, 2005,” http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-266596A1.pdf, Table 1.

²⁷ <http://newscenter.verizon.com/kit/fiber/>

²⁸ <http://att.sbc.com/gen/press-room?pid=5838>

²⁹ http://att.sbc.com/Common/files/pdf/AT&T-3_ScreensFactSheet_0530.pdf

³⁰ <http://www.telecomweb.com/news/tpr/18527.html>; <http://www.washingtonpost.com/wp-dyn/content/article/2006/03/10/AR2006031001930.html>; <http://www.heartland.org/Article.cfm?artId=18899>.

³¹ <http://newscenter.verizon.com/proactive/newsroom/release.vtml?id=93654>;
<http://newscenter.verizon.com/proactive/newsroom/release.vtml?id=93244>.

telephone carriers into video markets.³² Thus, in the near future, it is expected that telephone carriers will have a significant number of video customers.

B. The Current Accounting Procedures for ADSL Service.

28. The Commission has established two regulatory regimes for ADSL service. First, it found that ADSL is an interstate special access service. The Commission noted that ADSL service may provide both intrastate and interstate service. However, it agreed with GTE in finding that under the Commission's "ten percent" rule the entire service should be subject to federal regulation.³³

29. The National Association of Regulatory Utility Commissioners (NARUC) filed a request for clarification of the GTE DSL Order.³⁴ NARUC requested the Commission to clarify the question of whether there needed to be a change in the Part 36 rules to accommodate the GTE DSL service. NARUC noted that under current rules, investments associated with interstate special services are directly assigned to the interstate jurisdiction.³⁵ The Commission refused to make a determination with regard to the request. Instead, it found that the issue of cost allocation was beyond the scope of the particular proceeding and referred the issue to the Federal-State Separations Joint Board.³⁶

³² <http://newscenter.verizon.com/kit/fiber/layout-fiostrv.vtml>

³³ In the Matter of GTE Telephone Operating Cos., CC Docket No. 98-79, FCC 98-79, *Memorandum and Order*, released October 30, 1998 (GTE DSL Order)

³⁴ Request for Clarification and/or Reconsideration of the National Association of Regulatory Utility Commissioners, CC Docket No. 98-79, filed November 30, 1998, http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6005545687.

³⁵ *Id.*, pages 3-7.

³⁶ In the Matter of GTE Telephone Operating Cos., CC Docket No. 98-79, FCC 99-41, *Memorandum and Order*, released February 26, 1999.

30. The Commission next decided that ADSL service is no longer a telecommunications service. Rather it is the telecommunications portion of an information service.³⁷

Normally, a carrier would have to apply the Part 64 rules to allocate a portion of the joint use plant to the non-regulated service. However, the Commission decided to allow the carriers to forgo using the Part 64 rules, and to continue to treat the newly non-regulated service as a regulated service for the purpose of cost allocation.³⁸

31. Thus, it appears that the current accounting treatment of ADSL service is to include the revenue in the interstate jurisdiction, and to ignore ADSL cost allocation issues. The C&WF used to provide ADSL service are considered Category 1.3 loops. The interstate jurisdiction was allocated 25 percent of the cost of those loops prior to the provision of ADSL service, but the 25 percent allocation is not changed by the use of the loop to provide ADSL service. Therefore, the interstate jurisdiction receives the additional revenue associated with the service but does not include any cost associated with the provision of the service.

C. The Current Accounting Procedures for Video Services.

32. Video services are non-regulated services. Investments that provide both regulated and non-regulated services should be allocated according to the Part 64 rules. With regard to outside plant investment, the Part 64 rules state:

The allocation of central office equipment and outside plant investment costs between regulated and non-regulated activities shall be based upon the relative usage of the investment during the calendar year when non-regulated usage is greatest in comparison to regulated usage during the three calendar years beginning with the calendar year during which the investment usage forecast is filed.³⁹

³⁷ Wireline Broadband Order, ¶5.

³⁸ Id., ¶128.

³⁹ 47 C.F.R. §64.901(b)(4).

33. Accordingly, even if a carrier is not currently providing video services, but expects to provide service in the near future, it should allocate a portion of the jointly used plant to the non-regulated sector in the current year.

34. Many carriers are just beginning to provide video service. The justification for investment in video equipment and fiber networks probably includes significant ramp-ups of customer video take rates. However, inspection of carrier filings reveals that carriers do not appear to be forecasting large increases in video services. Table 3 shows the non-regulated C&WF investment for eight carriers. Verizon Pennsylvania is allocating zero investment to the non-regulated sector in 2005. This occurs even though Verizon: 1) previously allocated a positive amount to the non-regulated sector, 2) is building its fiber-to-the-premise network that supports FiOS services in numerous Pennsylvania communities,⁴⁰ and 3) is urging the state to pass statewide video franchising legislation.⁴¹ Table 3 also shows that AT&T Texas reports very little non-regulated investment and that the level of non-regulated investment has not changed in the past three years. This is in a state where there is a statewide franchise and AT&T Texas has aggressively promoted its video services.⁴²

⁴⁰ <http://newscenter.verizon.com/kit/fiber/layout-releasesbystate.vtml>.

⁴¹ <http://newscenter.verizon.com/proactive/newsroom/release.vtml?id=93654>.

⁴² <http://www.heartland.org/Article.cfm?artId=18899>, <http://att.sbc.com/gen/press-room?pid=5838>.

Table 3⁴³

Non-Regulated C&WF Investment (\$ thousands)			
Year	2005	2004	2003
AT&T California	11,349	11,349	11,349
AT&T Texas	23	23	23
BellSouth North Carolina	10,028	9,965	9,140
BellSouth Tennessee	6,914	6,893	6,658
Qwest Colorado	-	-	-
Qwest Washington	-	-	-
Verizon Massachusetts	23,807	-	-
Verizon Pennsylvania	-	2,464	-

35. Table 3 highlights the difference between a reasonable expectation and the carriers' actual practices. It appears that the carriers are not following the rules. That is, insufficient plant is being assigned to the non-regulated sector. It is not clear if the carriers are deliberately providing low estimates of non-regulated service usage or if it is just hard to develop the estimates. The Commission has acknowledged that the Part 64 rules are hard to implement.⁴⁴ Therefore, I recommend that Commission adopt the alternative approach I will discuss below to allocating jointly used plant between the regulated and the non-regulated sectors.

D. An Alternative Approach to Allocating Investment to the Non-Regulated Sector.

⁴³ Data source is ARMIS 43-03 Reports. Data for the other Bell Operating Companies are provided in Appendix D.

⁴⁴ Wireline Broadband Order, ¶134-135.

36. I recommend that the Commission adopt the following gross allocators of C&WF Category 1.3 plant for the purposes of allocating plant between the non-regulated and regulated services. First, for lines serving customers who purchase only telephone services, the current 25 percent interstate gross allocator should be retained. Second, for lines serving customers who purchase ADSL service and not video service, the interstate gross allocator should be set at 50 percent, and for lines serving with customers who purchase video service, the interstate gross allocator should be set at 75 percent.
37. The following example illustrates the impact of the recommended rule. Assume that a carrier has 100 customers, with 40 customers purchasing voice only, 30 purchasing ADSL and not video, and 30 purchasing video services. Under the current practices, the carrier would allocate only 25 percent of the loop investment to the interstate jurisdiction. Under my recommendation, however, the interstate jurisdiction would be assigned 47.5 percent (the sum of 40 lines times 25 percent plus 30 lines times 50 percent plus 30 lines times 75 percent) of the loop investment. This weighted average gross allocator would be defined as the adjusted gross allocator and would be used to allocate Category 1.3 plant.
38. The recommendation is administratively simple. The carriers would only have to record their line counts by the type of service sold. Such data are easy to find and compile. They would not have to perform any special studies.
39. States that adopt these procedures would not have to open their own Part 64 type proceedings to deal with the growth in ADSL and video services. This would reduce

the administrative burden of the growth in non-regulated services on the industry and on the state commissions.

40. This would establish nation-wide consistent treatment of non-regulated services.⁴⁵

This uniformity will promote investment and reduce the risk associated with the investments.

41. The cost of my recommended rule is that customers purchasing regulated services will finance the building of the non-regulated network until the carrier is selling significant amounts of non-regulated services. This differs from the current Part 64 rule that directs the carriers to assign investment on forecasted sales rather than on actual sales. However, because it appears that the forecasted sales have not actually been used to assigned investment, and thus, regulated customers are currently financing these networks, in the short term regulated customers will not experience a change. However, in the long term, the customers of regulated services will benefit because a reasonable amount of investment, an amount that can be accurately measured and recorded, will be assigned to the non-regulated sector as carriers sell these non-regulated services to increasing numbers of customers.

IV. Traffic Sensitive Issues

42. Traffic sensitive (TS) costs are costs that vary with usage. With the adoption of the Part 36 rules, the Commission found that circuit switches should be considered traffic sensitive equipment.⁴⁶ From January 1, 1993 to July 1, 2001, switches were allocated between the jurisdiction on the basis of relative usage. Dial equipment minutes

⁴⁵ While states would not be preempted by the federal guideline for allocating costs to the non-regulated sector, I believe that most states would adopt a reasonable federal guideline.

⁴⁶MTS and WATS Market Structure, Amendments of Part 67 (New Part 36) of the Commission's Rules and the Establishment of a Federal-State Joint Board, *Report and Order*, 2 FCC Rcd 2639 (1987).

(DEM) is the metric employed to measure switch usage. Switch investment was allocated on the basis of the relative number of interstate and state DEMs.⁴⁷

Beginning in July 1, 2001, the DEM allocator was frozen at the average DEM that existed for the twelve months ending December 31, 2000.⁴⁸

43. The Commission requested comment on whether it is feasible to replace the DEM factor with a fixed allocator.⁴⁹ One of the reasons for adopting a fixed factor is that switching technology is transiting from circuit switching to packet switching and the industry has developed a metric that measures usage on a packet switch. Also complicating the issue is the growth of Internet traffic. For the purpose of traffic studies, carriers have counted Internet minutes as local minutes, even though the Commission has declared Internet traffic to be interstate traffic. The growth in Internet traffic, therefore, increases the percentage of switching investment that is assigned to the local jurisdiction. The Joint Board recommended that a part of local traffic be added to the Interstate traffic in recognition of the growth of Internet traffic.⁵⁰ However, the Commission refused to adopt that recommendation.⁵¹

44. The causes of the transition to packet switching are complex. However, several of the determinants of that transition include the desire to integrate voice transmission with

⁴⁷ 47 C.F.R. §36.125(b). Between 1988 and 1993 the new rule was phased-in, gradually replacing the old rule, which had allocated switch costs using a variety of TS and non-TS allocators. Carriers with less than 50,000 lines per study area were allowed to use the weighted DEM system.

⁴⁸ 47 C.F.R. §36.125(I).

⁴⁹ Order and FNPRM, ¶30 and Appendix B, page 11.

⁵⁰ In the Matter of the Jurisdictional Separations Reform and Referral to the Federal-State Joint Board, CC Docket No. 80-286, FCC 00J-2, *Recommended Decision*, released July 21, 2000, ¶28-30.

⁵¹ Freeze Order, ¶42.

the Internet, and the cost advantages of packet networks in the provision of data and high-speed services.⁵²

45. Because packet switching technology is being used to provide enhanced data communications, it is advantageous to allocate packet switches based on a factor that measures the increased use of the network for data and information purposes. However, it may be difficult to accurately measure the data traffic because carriers, as common carriers, should not be inspecting the packets as the packets move about the network. A reasonable proxy for the increase in data and high-speed services usage is the number of customers purchasing ADSL and video services. The adjusted gross allocator discussed above in paragraph 36 is a fixed factor that changes annually with the changes in consumer demand for voice, data and video services. Thus, the adjusted gross allocator would be a reasonable proxy for the relative usage of the network.
46. Adopting the adjusted gross allocator used to allocate C&WF Category 1.3 plant as the allocator of packet switches simplifies the separations process by reducing the need to measure traffic. It also assigns switching costs on the basis of the switch use.
47. With regard to the remaining legacy circuit switches, it is possible and reasonable to reinstate DEM measurable studies. The results of these studies should be augmented by a measure of Internet traffic so that Internet traffic no longer distorts the relative state and interstate usage pattern. While it might be difficult to identify all Internet traffic, there are two types of Internet traffic that should be easy to identify. First, all traffic that terminates at an ISP that is affiliated with the carrier should be counted as

⁵² Ray Horak with Mark A. Miller, *Systems and Networks: Voice, Data and Broadband Technologies*, pages 20-212; Terrence McGarty and Lee Mcknight, "Virtually Global Telcos: International Internet

Interstate traffic. Second, any ISP-Bound traffic terminating at a CLEC should also be counted as Internet traffic.⁵³ These two traffic streams can be identified and are defined as interstate traffic.

V. Universal Service Issues

A. The HCL mechanism

48. The HCL mechanism provides support to rural carriers based on the difference between the carrier's study area loop cost of service and the national average loop cost of service.⁵⁴ The loop cost algorithm determines the revenue requirement or cost of service for each study area. The algorithm develops the cost associated with un-separated C&WF Category One Investment.

49. Because the study area cost is determined prior to separation, a change from the current gross allocator to the recommended adjusted gross allocator will not affect the study area cost, and thus will not affect rural carrier support.

50. Direct assignment of special access investment may transfer cost from Category One to other categories and thus will affect the rural carrier's cost. However, rate of return carriers currently directly assign special access investment and thus, for rate of return rural carriers, a requirement to directly assign special access will not change the current reported costs or support levels. However, for the 105 price-cap carriers out of total of 1356 rural carriers,⁵⁵ the requirement to directly assign special access would be a change from their current accounting procedures and would lead to changes in cost and support. The reduction in support associated with this

Telephony Architectures," in *Internet Telephony*, edited by Lee Mcknight, William Lehr and David Clark.

⁵³ In the Matter of ISP-Bound Traffic, CC Docket No. 99-68, FCC 01-131, Order on Remand and Report and Order, released April 27, 2001.

⁵⁴ 47 C.F.R. §36.631.

mechanism would probably be very small and would be offset by the benefits that all consumers would gain for a reasonable allocation of investment among the categories.

51. In addition, the Missoula Plan for intercarrier compensation includes a provision to re-base the high cost fund.⁵⁶ Re-basing the fund requires the Commission to lift the fund cap for an instance in time, and then recalculate the fund size without the fund cap. The support would depend only on the difference between the national average and carriers' study area cost and would not be limited by the fund cap. There are two ways to re-base the fund. First, the fund could be re-based using the frozen \$240 national average cost.⁵⁷ If the frozen national average cost is used, then the Missoula Plan would not be affected by changes to non-rural carriers' costs. The second re-basing method would use the actual national average cost. The national average cost includes the cost of both rural and non-rural carriers. This average cost would be affected by a requirement for the non-rural carriers to directly assign special access investment. It is not clear which re-base method the Missoula Plan is supporting.

B. The ICLS mechanism

52. Support provided by the ICLS mechanism is based on the difference between the common line revenue requirement and common line revenues.⁵⁸ The common line revenue requirement depends on the amount of C&WF Category 1.3 plant that is allocated to the interstate jurisdiction. Adopting the above-recommended adjusted

⁵⁵ USAC FCC filings, HC05 and HC12 for the fourth quarter 2006.

⁵⁶ Letter from Tony Clark, Commissioner and Chair, NARUC Committee on Telecommunications, Ray Baum Commissioner and Chair, NARUC Task Force, and Larry Landis, Commissioner and Vice-Chair, NARUC Task Force, CC Docketn No. 01-92, at 2 (filed July 24, 2006) (attaching the Missoula Plan).

⁵⁷ 47 C.F.R. §36.222(a)

⁵⁸ 47 C.F.R. §54.901(a)

gross allocator would increase the amount of C&WF Category 1.3 plant allocated to the interstate jurisdiction and therefore, it would increase the common line revenue requirement and ICLS support. However, the Commission could prevent the increase in support from occurring by finding that the common revenue requirement used for the purposes of determining ICLS should be based on the current 25 percent gross allocator. This finding is consistent with the requirement that universal service support should be used only for support of the designated services, and broadband services are not included in the list of designated services.

VI. Additional Data Requests

53. The data requests attached to the notice are designed to gather information that will help the Joint Board in its deliberations. However, there is a need to add a few more questions to the list. I recommend the following:

- 1) For each study area, provide the information reported in the ARMIS Report 43-02, Table B-1B and Table B-5 for circuit switches and packet switches, and for cable sub-accounts, where the sub-accounts provide information on fiber and copper cable separately for the years 2000 to 2005.
- 2) For each study area, provide the year when you expect the circuit switching account's accumulated depreciation to equal 90 percent of the gross investment.
- 3) If you provide ADSL service as part of an unregulated service, for each study area, provide the amount of revenue received by the affiliate from the sale of unregulated service that uses the ADSL service. Also, provide the amount of

revenue that the regulated entity receives from non-regulated affiliate for the provision of the ADSL portion of the service for the year 2005.

- 4) For each study area, provide the actual and forecasted number of video customers for the years 2005, 2006 and 2007.
- 5) For each study area, explain how you developed the estimate of non-regulated cable investment reported in the ARMIS 43-03 Report, row 2410 for the year 2005. Include in that explanation a discussion of how the forecasted number of video customers affects the reported cable investment value. Provide all work papers used to generate the 2005 non-regulated cable investment.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

A handwritten signature in black ink, appearing to read "Robert Loube", written in a cursive style.

Executed on August 18, 2006