BEFORE THE

Federal Communications Commission

WASHINGTON, D.C.

In the Matter of	)	
Petition of AT&T Inc. For Forbearance Under 47 U.S.C. § 160 From Enforcement of Certain of the Commission's Cost Assignment Rules	))	WC Docket No. 07-21
Petition of BellSouth Telecommunications, Inc. For Forbearance Under 47 U.S.C. § 160 From Enforcement of Certain of the Commission's Cost Assignment Rules	)))	

OPPOSITION OF TIME WARNER TELECOM INC.

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TABLE OF CONTENTS

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OPPOSITION OF TIME WARNER TELECOM INC.

Time Warner Telecom Inc., by its attorneys, hereby submits this opposition to the petitions for forbearance filed by AT&T in the above referenced docket.[1]

I. INTRODUCTION AND SUMMARY.

AT&T has asked the Commission to forbear from enforcing virtually every cost accounting requirement to which AT&T is subject[2] and from the ARMIS reporting requirements.

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[1] *See Pleading Cycle Established for AT&T Inc. Petition for Forbearance from the Commission's Cost Assignment Rules, WC Dkt. No. 07-21*, Public Notice, DA 07-731 (rel. Feb. 16, 2007); Petition of AT&T Inc. For Forbearance Under 47 U.S.C. § 160 From Enforcement of Certain of the Commission's Cost Assignment Rules, WC Dkt. No. 07-21 (filed Jan. 25, 2007) ("*AT&T Petition*"); Petition of BellSouth Telecommunications For Forbearance Under 47 U.S.C. § 160 from Enforcement of Certain of the Commission's Cost Assignment Rules, WC Dkt. No. 05-342 (originally filed Dec. 6, 2005) ("*BellSouth Petition*").

[2] *See AT&T Petition* at n.2 ("The rules that are the subject of this Petition are Parts 32.23, 32.27 and 64 Subpart I (referred to as 'cost allocation rules'), Part 36 (referred to as 'jurisdictional separations rules'); Part 69, Subparts D and E (referred to as 'cost apportionment rules'); and

These regulations are necessary to measure, among other things, the costs AT&T incurs (and the profits it earns) in providing switched and special access services.[3] Under Section 10, the Commission may only forbear from enforcing these accounting rules if AT&T demonstrates that (1) the accounting rules are no longer necessary to ensure just, reasonable and not unjustly or unreasonably discriminatory rates; (2) the accounting rules are no longer necessary to protect consumers; and (3) forbearance is in the public interest. AT&T has failed to meet this standard.

AT&T's primary argument in support of its petitions is that cost accounting information is unnecessary since the Commission's existing price cap rules, that no longer include profit sharing or lower cost adjustment components, completely sever the connection between ILEC's prices and ILECs' costs. But this is simply incorrect. As long as the ILECs including AT&T retain market power and the Commission is statutorily bound to ensure that ILECs charge just, reasonable and not unjustly or unreasonably discriminatory rates, ILEC rates must be based to some extent on cost. This is not a theoretical proposition. The Commission has relied, most recently in the *CALLS* proceeding, on measures of costs yielded by the accounting regulations at issue here to set AT&T's and other price cap ILECs' prices. The Commission is also currently

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other related rules that are completely derivative of or dependant on the forgoing rules, including the cost allocation and rate of return reporting requirements in Parts 43.21(d)(1), 43.21(d)(2), 43.21(f), and 65.600)."). The rules from which AT&T seeks forbearance are collectively referred to herein as "accounting rules," unless otherwise specified.

[3] *See id.* n.83 ("The elimination of the cost assignment rules renders four of the Commission reporting requirements meaningless. Accordingly, AT&T seeks forbearance from the requirements to submit the Access Report (ARMIS 43-04), the Rate of Return Monitoring Report (FCC Form 492), the Reg/Non-Reg Forecast Report (FCC Form 495(A) and the Reg/Non-Reg Actual Usage Report (FCC Form 495B).") AT&T also indicates that data currently available under ARMIS reports 43-01 (cost and revenue), 43-02 (Analysis of assets sold to and purchased from Affiliates) and 43-03 (regulated/non-regulated data) will no longer be reported if its requested relief is granted. *See id.* Attach. 6.

reviewing ILEC cost accounting data to determine whether and how to re-impose price caps on special access services. Rates set under price caps are therefore very much tied to regulatory accounting costs. In addition, states rely on costs yielded by FCC cost accounting regulations to set price cap rates and for other regulatory purposes.

Moreover, the continued connection between accounting costs and price cap rates gives AT&T the incentive to misallocate the costs of unregulated and competitive regulated services to cost categories associated with regulated services such as special access and terminating switched access over which AT&T retains market power. The Commission adopted the Part 64 and Part 32 affiliate transaction rules from which AT&T now seeks forbearance to prevent exactly this type of cost misallocation. There is simply no basis for eliminating these regulations, especially since the Commission reiterated their continued importance just 10 days ago in its conditional grant of Qwest's petition for forbearance from dominant carrier regulation of integrated, in-region long distance services.

This is not to say that the current accounting rules applicable to ILECs are ideal. For example, many states have recently indicated that, because of various FCC decisions (*e.g.*, retention of the Part 36 freeze; deregulation of DSL while continuing to treat DSL costs as regulated under Part 64). the data produced by the existing cost accounting rules may no longer reflect ILECs' costs as accurately as possible. But these issues are most appropriately addressed by updating the rules to reflect changed circumstances after consultation with state regulators. There is simply no basis for eliminating the rules.

II. THE COST ACCOUNTING AND ARMIS REGULATIONS FOR WHICH AT&T SEEKS FORBEARANCE ARE NECESSARY FOR EFFECTIVE RATE REGULATION AND FOR OTHER CRITICAL REGULATORY FUNCTIONS

Section 10 of the Communications Act requires that the Commission forbear from applying a statutory provision or regulation if it determines that (1) the requirement is not "necessary" to ensure just, reasonable and not unjustly or unreasonably discriminatory charges and practices; (2) the requirement is "not necessary for the protection of consumers;" and (3) forbearance is in the public interest. *See* 47 U.S.C. § 160(a). As AT&T correctly states, the term "necessary" in this standard does not mean "absolutely required,"[4] but rather that there is a "strong connection between what the [FCC] has done by way of regulation and what the agency permissibly sought to achieve with the disputed regulation." *See CTIA v. FCC* at 512. Crucially, in determining whether a regulation still serves its intended purpose, the Commission must follow the analytical framework it has used in the past or provide an explanation as to why it has departed from that framework.[5] When applied to the petitions at issue here, it is clear that AT&T has failed to meet the Section 10 standard for forbearance.

A. Both The FCC And State Commissions Continue To Rely On Cost Accounting And ARMIS Data To Set Rates Under Price Caps And To Achieve Other Critical Regulatory Goals

Notwithstanding AT&T's claims to the contrary, federal and state ILEC price cap regulation remains critically tied to AT&T's costs as measured by regulatory cost accounting conventions. As the Supreme Court has recognized, price cap plans enacted by the states and the FCC all use a cost of service formula as a starting point for determining rates and then apply inflation and productivity adjustments to determine the cap.[6] In addition, both federal and state

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[4] *See Cellular Telecomms. & Internet Ass'n v. FCC*, 330 F.3d 502, 509-10 (D.C. Cir. 2003) (*CTIA v. FCC*).

[5] *See AT&T Corp. v. FCC*, 236 F.3d 729, 736-737 (D.C. Cir. 2001) (overturning FCC denial of petition for forbearance from dominant carrier regulation where the FCC did not apply its traditional non-dominance analysis and failed to explain why such a departure was reasonable).

[6] *See Verizon v. FCC*, 535 U.S. 467, 487 (2002) ("The price-cap scheme starts with a rate generated by the conventional cost-of-service formula, which it takes as a benchmark to be decreased at an average of some 2-3 percent a year to reflect productivity growth…subject to an upward adjustment if necessary to reflect inflation or certain unavoidable 'exogenous costs.'").

price cap plans generally expire within a certain set amount of time.[7] Upon expiration, the regulators investigate whether the ILEC's rates continue to be reasonable in light of its costs and overall productivity. ILECs are often required to submit cost data to ensure that their prices are at least reasonably related to their costs.[8] Thus, far from severing the connection between costs and prices, price cap regulation applicable to AT&T and other ILECs at the federal and state levels remains fundamentally reliant on regulatory measures of costs.

1. The FCC Has Relied On Cost Accounting And ARMIS Data In The Recent Past, And Must Continue To Do So In The Future To Set AT&T's And Other ILECs' Prices Under Price Caps.

AT&T argues that its prices are no longer subject to regulation that relies on regulatory measures of cost and that, even if the Commission were to establish a new x-factor in the future for price caps, it would rely on total company costs, thus obviating the need for FCC cost accounting requirements. *See AT&T Petition* at 24-25. But AT&T is wrong on both counts. The Commission continues to rely on its review of the costs AT&T incurs to provide specific services subject to price caps to ensure that rates for such services set under price caps continue to comply with the Section 201 and Section 202 requirements for just, reasonable and not unjustly or unreasonably discriminatory rates.

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[7] *See, e.g., Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, Fourth Report and Order and Second Report and Order, 12 FCC Rcd 16642, ¶ 166 (1997) ("*Price Cap Performance Review*") (holding that the Commission will review its price cap rules within 3 years).

[8] *See, e.g., Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low-Volume Long-Distance Users; Federal-State Joint Board on Universal Service,* Sixth Report and Order in CC Dkt. Nos. 96-262 *et al.*, 15 FCC Rcd 12962, ¶ 57 (2000), *subsequent history omitted* (stating that price cap LECs have the option of submitting "a cost study based on forward looking economic cost that will be the basis for reinitializing rates to the appropriate level.") ("*CALLS Order*").

For example, in the *CALLS Order*, the last time the FCC modified ILEC price cap levels, the Commission conducted an explicit review of carrier costs to determine the appropriate rate for various ILEC access services. ILECs electing[9] *CALLS* were given no pricing discretion on a number of services; such ILECs were required to meet target rates, which were in turn tied to the ILECs' costs. The x-factor (which was not a productivity factor *per se*) was set so as to move switched access charges closer to the costs associated with specific service categories, in particular switching and transport.[10] Importantly, price reductions were targeted only at those baskets with excessive rates-of-return.[11] The 15 percent rate-of-return earned by the ILECs on the common-line basket was not targeted for reduction since the Commission believed, based on ARMIS data (likely ARMIS report 43-04), that this was a reasonable rate-of-return.[12] Without the accounting rules from which AT&T seeks forbearance, there would have been no way for the Commission to determine the costs for particular services (*e.g.*, interstate special access) and therefore no way to set the cap to ensure that the ILECs' prices remained within a zone of

[9] Those ILECs that did not elect CALLS were to be subject to a cost-study proceeding to accomplish of the longstanding Commission goal that "interstate access charges [would] reflect the forward looking economic costs of providing interstate access services." *See CALLS Order* ¶ 60. The price cap index of LECs opting out of *CALLS* would be "set at forward looking economic costs." *Id.* ¶ 150.

[10] *See id.* ¶ 158 (noting that the *CALLS* plan will drive "switched access usage charges closer to their *actual costs*…"); *id*. ¶ 167 ("Targeting the x-factor reductions to switching and switched transport charges will more quickly reduce charges for these services *towards cost-based levels* than would be possible under the existing price cap methodology.") (emphasis added).

[11] *See id.* ¶ 171 ("…price cap LECs' basket earnings are significantly higher for traffic-sensitive services than for common line services…Therefore we find it reasonable to target reductions to traffic-sensitive services rather than to common line services.").

[12] *See id.* n.376 ("Based on 1999 ARMIS data, Commission staff calculated approximate rates of return of 85 percent for the traffic-sensitive basket, 20 percent for the trunking basket, and 15 percent for the common line basket."). A fifteen percent rate of return is within the range held to be reasonable in the first price caps order. *See Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, ¶¶ 164- 165 (1990).

reasonableness.[13] For this reason, the Commission made clear that ARMIS data in report 04-03 should continue to be provided until the CALLS regime is replaced.[14]

In addition, the Commission is currently relying on cost data reported by AT&T and other incumbents to determine whether the FCC should re-impose price cap regulation on ILEC special access services subject to *Phase II* pricing flexibility. In the NPRM in WC Docket No. 05-25, the Commission used ARMIS data to examine "the relationship between demand growth and growth in expenses and investment" to determine if incumbent LECs had achieved economies of scale and scope that warrant a reexamination of special access rates.[15] The Commission also examined ARMIS data in connection with whether it should adopt a "g" factor in the special access price cap index formula. *See Special Access NPRM* ¶ 40.

There are other contexts in which the Commission will need to rely on accounting data in the future to ensure that ILEC rates remain just, reasonable and not unjustly or unreasonably discriminatory. In particular, the proponents of the Missoula plan relied heavily on separations data and ARMIS reports in determining the impact of its proposed reforms.[16] Without such data,

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[13] As the National Association of State Utility Consumer Advocates ("NASUCA") argued in its comments in opposition of the BellSouth Petition, "The existence of market dominance is reason to guard against anticompetitive behavior. One way to detect such behavior is to analyze costs to determine whether predatory pricing is being practiced. Without following cost assignment rules, predatory pricing could not be detected." Reply Comments of NASUCA, WC Dkt. No. 05-342, at 6 (filed Feb. 13, 2006) ("*NASUCA Reply Comments in Dkt. No. 05-342*").

[14] *See 2000 Biennial Regulatory Review -- Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase II et al.*, Report and Order, 16 FCC Rcd 19911, ¶ 149 (2001) ("*Phase II Report and Order*").

[15] *Special Access Rates for Price Cap Local Exchange Carriers; AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services,* 20 FCC Rcd 1994, ¶ 29 (2005) ("*Special Access NPRM*").

[16] *See* Missoula Intercarrier Compensation Plan at 107, attached to Letter from Tony Clark, North Dakota PSC Commissioner and Chair, NARUC Committee on Telecommunications; Ray

it would be nearly impossible to measure the effect (and wisdom) of any proposed changes to switched access prices. Indeed, the Commission stated that further changes in intercarrier compensation, including access charge reform post-CALLS, require continued availability of the information reported in ARMIS Report 43-04.[17] For example, the manner in which costs are allocated has an effect on the proper price cap carrier subscriber line charge ("SLC") level in any new intercarrier compensation reform scheme.[18] As long as incumbent LECs retain market power in the provision of terminating switched access services (to say nothing of special access), the Commission is statutorily bound to keep track of incumbent LEC costs to ensure that switched access charges remain just, reasonable and not unjustly discriminatory as required by Sections 201(b) and 202(a).[19]

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Baum, Oregon PUC Commissioner and Chair, NARUC Task Force on Intercarrier Compensation; and Larry Landis, Indiana URC Commissioner and Vice-Chair, NARUC Task Force on Intercarrier Compensation, to Hon. Kevin J. Martin, Chairman, FCC, CC Dkt. No. 01-92 (filed July 24, 2006).

[17] *See Phase II Report and Order* ¶ 148 ("but not for local switching. The Commission's ability to monitor and evaluate local transport access rates would be greatly hindered if it could not identify and track local transport costs separately from local switching costs.").

[18] *See Comments of NASUCA et al.*, CC Dkt. No. 80-286, at 9 (Aug. 22, 2006) ("…if carriers properly allocated and assigned costs to unregulated services, the SLC -- which for the BOCs and other price cap carriers, is currently based on their [part 69] CMT revenue requirement -- would likely decline, as the cost of regulated services would decline.") (citation omitted) ("*NASUCA Comments in Dkt. No. 80-286*").

[19] AT&T provides an extensive discussion of its financial accounting practices and obligations in support of its point that Commission cost accounting regulations are unnecessary for ensuring financial transparency. *See, e.g., AT&T Petition* at 32-28. But this is a red herring. Unless sound policy dictates otherwise, the Commission has eliminated or refused to adopt cost accounting requirements where the information at issue would be included in reports filed with the SEC. *See Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase I*, Report and Order, 15 FCC Rcd 8690, ¶ 40 (2000) ("*Phase I Report and Order*"). In any event, the Commission has never placed

2. The States Also Remain Critically Dependent On Cost Accounting And ARMIS Data To Set AT&T's And Other ILECs' Prices And For Other Regulatory Purposes.

States continue to rely on FCC accounting rules, especially Part 36, to regulate AT&T's and other ILECs' rates, including rates for UNEs and rates for intrastate services subject to price caps. They do so because they are legally bound to rely on some form of jurisdictional cost allocation and because it is sound policy for them to do so.

In *Smith v. Illinois Bell Tel. Co.*, the Supreme Court held that some form of jurisdictional separations system, such as Part 36 (in combination with Parts 32 and 64), is *required* to enable the jurisdictions to carry out their respective ratemaking tasks to the extent those are performed in reliance upon the regulated company's costs.[20] States continue to believe that *Smith v. Illinois Bell* mandates that some form of separations continue in effect even under a price cap environment.[21] States believe that while separations rules could be simplified, "So long as there remain two jurisdictions, cost assignment should at least roughly follow jurisdictional authority and revenue assignment." *Glide Path II Paper* at 9. The FCC's Wireline Competition Bureau seems to agree, holding in its Biennial Regulatory Review released just last month that the "WCB staff concludes that Part 36 remains necessary in the public interest, in some form."[22]

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primary reliance on the need to ensure financial transparency as a basis for retaining its cost accounting rules.

[20] *See Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133, 148-51 (1930).

[21] *See Jurisdictional Separations and Referral to the Federal-State Joint* Board, Order and Further Notice of Proposed Rulemaking, 21 FCC Rcd 5516, Appendix B - *Post Freeze Options for Separations*, at 14 ("*Glide Path II Paper*") (2006) ("*Jurisdictional Separations FNPRM*").

[22] *See FCC 2006 Biennial Regulatory Review*, WC Dkt. No. 06-157, Wireline Competition Bureau Staff Report, DA 07-656, at 18 (rel. Feb. 14, 2007) ("*WCB Staff Report*").

Furthermore, states have specifically rejected AT&T's assertion that the adoption of price cap regulation obviates the need for the accounting rules for which AT&T seeks forbearance. States assert that they need Part 36 separations data "to operate universal service plans or for rate design purposes." *Glide Path Paper at 14.*[23] The Texas commission asserted that affiliate transaction rules in Part 36 are necessary in setting UNE rates and state USF requirements.[24] Part 64 rules are also used by states to calculate UNE rates.[25] The FCC has also used data in ARMIS Report 43-04 and separations data when setting UNE rates on behalf of states.[26] States

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[23] *See* Comments of State Members of Separations Joint Board, WC Dkt. No. 04-36, at 5 (filed Oct. 24, 2004) ("…states use intrastate-separated costs as an element in their state universal service fund calculations.")

[24] *See* Phase 3 Reply Comments of the Texas Office of Public Utility Counsel, CC Dkt. Nos. 00-199 *et al.*, at 3 (filed May 7, 2002) (stating that "affiliate transaction rules are still very relevant to the determination of UNE rates and the Universal Service Fund requirements. Texas, for instance, requires the utilization of forward looking long run incremental cost studies for the setting of UNE rates and USF fees. Forward looking LRICS in these cases are highly dependant on historical loop costs, which often include costs incurred through transactions with other affiliates.").

[25] *See* Reply Comments of the Public Utilities Commission of Ohio, CC Dkt. Nos. 00-199 *et al.*, at 7 (filed May 9, 2002) ("Generally, ILECs consider all regulated expense from their corporate books 'Part 64 regulated expenses.' Analysis is performed to such expenses at an accounting code level...The remaining expenses are TELRIC expenses. If the FCC were to subject its reporting requirements to a three-year sunset, it would be impossible to calculate accurate the ILECs' TELRICs.").

[26] *Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration in the Matter of Petition of AT&T Communications of Virginia Inc., Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia Corporation Commission Regarding Interconnection Disputes With Verizon Virginia Inc.*, Memorandum Opinion and Order, 18 FCC Rcd 17722, ¶ 456, n.1162 (2003).

also rely on accounting data to "effectively conduct imputation tests for competitive services" to prevent cost misallocations.[27]

Most crucially, despite AT&T's protestations to the contrary, states, like the FCC, continue to need separated cost information to ensure that rates subject to price caps remain just and reasonable. As NASUCA asserts, "Contrary to the views espoused by various incumbent local exchange carriers…the presence of incentive regulation does not make the separations process irrelevant. Among other reasons…interstate and intrastate rates -- including those that prevail under alternative regulation -- require re-initialization to incorporate correct separations accounting." [28] This is so even if "a company's intrastate rates have been totally de-coupled from costs." *California Comments in Dkt. No. 80-286* at 8. As the Wisconsin commission indicated, "[r]ates are not completely divorced from costs until the potential for adjustments based on earnings levels [is] also eliminated."[29]

States have put this theory into action by regulating price cap carriers, including AT&T, with reference to their costs. For example, in reviewing its three year price cap plan in 2004, Indiana required SBC (now AT&T) to "submit cost studies to support price decreases for existing services and introductory prices for new services."[30] Cost studies were also necessary

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[27] *See* Comments of the People of the State of California and the California Public Utilities Commission ("California"), CC Dkt. No. 80-286, at 10 (Sept. 26, 2000) ("*California Comments in Dkt. No. 80-286*").

[28] Reply Comments of NASUCA *et al.*, CC Dkt. No. 80-286, at 2 (Nov. 20, 2006); *see also California Comments in Dkt. No. 80-286* at 7 ("For companies with intrastate price cap mechanisms, such increases [from a jurisdictional freeze] could arise either by direct recognition of the separations changes through exogenous factor adjustments or more directly through earnings-related components of the regulatory mechanisms.").

[29] Comments of the Wisconsin PSC, CC Dkt. No. 80-286, at 5 (Aug. 17, 2006).

[30] *Petition of Indiana Bell Telephone Company, Incorporated ("SBC Indiana") For the Commission to Exercise its Statutory Authority Under IC. 8-1-2.6 Et. Seq. to Decline to Exercise*

for bundled pricing plans. *See SBC Indiana Order* *68. As a part of its three-year long price cap review, an audit by the California PUC determined that SBC had "significantly overstated the expenses it had reported" during the late 1990s.[31] The commission planned to take that finding into account in determining how to revise its price-cap plan. *See SBC California Opinion* at *257-8.

Finally, jurisdictionally separated accounting data is also necessary for states to properly calculate exogenous cost increases for price cap carriers. As NASUCA demonstrated in its initial comments on the *BellSouth Petition*, resetting of price cap rates and the calculation of exogenous costs "can only be reflected by using costs recorded pursuant to the Commissions' accounting rules." *NASUCA Reply Comments in Dkt. No. 05-342* at 6. Similarly, Vermont and Nebraska have indicated that even under price caps, "separations rules can still affect [switched access rates]" through the calculation of exogenous adjustments.[32] Accounting data is necessary so that exogenous adjustments at the state and Federal level do not result in ILEC over-earnings.[33]

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its Jurisdiction, in Whole or in Part, and use Alternative Regulatory Procedures and Standards and Approve SBC Indiana's Alternative Regulation Plan for the Pricing and Other Regulation of SBC Indiana's Retail and Carrier Access Services, et al., Cause No. 42405, 2004 Ind. PUC LEXIS 253, *18 (2004) ("*SBC Indiana Order*").

[31] *Order Instituting Rulemaking on the Commission's Own Motion to Assess and Revise the New Regulatory Framework for Pacific Bell and Verizon California Incorporated*, Interim Opinion Regarding Selected Issues Related to the Audi of SBC Pacific Bell Telephone Company, 2004 Cal. PUC LEXIS 55, *1 (2004) ("*SBC California Opinion*").

[32] Comments of Vermont Public Service Board, Vermont Department of Public Utilities, and Nebraska Public Services Commission, CC Dkt. No. 80-286, at 7 (Aug. 22, 2006).

[33] *See* California Reply Comments, CC Dkt. No. 80-286, at 9 (Oct. 10, 2000).

B. In Light Of The Strong Connection Between AT&T's Regulated Prices And AT&T's Costs, Part 64 And Part 32 Affiliate Transaction Rules Remain Necessary To Prevent AT&T From Engaging In Anticompetitive And Inefficient Cost Misallocation

It is bedrock FCC policy that ILECs subject to some form of cost-based regulation have strong incentives to misallocate the costs of unregulated and even regulated services subject to competition to cost accounting categories associated with regulated services over which ILECs have market power. In light of the strong connection between AT&T's federal and state regulated rates and the regulatory cost accounting categories maintained by the FCC, it is clear that the Part 64 and Part 32 affiliate transaction rules that are designed to prevent cost misallocation remain necessary to ensure just, reasonable and nondiscriminatory rates and to protect consumers against the distortions and inequities of cross-subsidy.

There should be no dispute that the Commission's established policy is to apply appropriate cost accounting rules to ILECs as long as ILEC prices are based to some degree on regulatory accounting costs. Even when most BOCs offered unregulated services *via* separate corporate affiliates, the Commission imposed accounting requirements, most importantly the affiliate transaction rules, to ensure that BOCs would not subsidize unregulated service offerings by inappropriately shifting costs from the affiliate to the regulated rate base. But proper cost allocation rules became especially critical when, in the *Computer III* proceeding, the Commission eliminated the requirement that BOCs provide enhanced services through a separate affiliate (which had obviated much of the need for comprehensive accounting safeguards) and instead permitted them to offer those services on an integrated basis. As the Commission explained in its initial *Computer III* order, the elimination of structural separation requirements created the risk that, "unless checked in some fashion, [the BOCs] would be able to shift costs properly attributable to their enhanced services offerings to those regulated services for which they still have market power."[34] The Commission correctly observed that "[s]uch cost-shifting can have adverse impacts on ratepayers, by improperly increasing the prices they pay for their use of regulated services, and on competition in unregulated markets, by providing an opportunity for carriers to charge artificially low prices for their unregulated goods and services." *See Computer III Report and Order* ¶ 234.

To limit the ILECs' opportunities to misallocate the costs of unregulated service offerings, the Commission adopted its Part 64 cost allocation rules. Those rules utilize a fully distributed cost methodology and a hierarchy of cost apportionment rules to separate the costs of regulated and unregulated services. In establishing these rules, the Commission's express intention was to (1) "keep regulated common carriers from using the revenues from their regulated services to subsidize nonregulated enterprises," and (2) "ensure that ratepayers receive their appropriate share of the benefits [in the form of economies of scope] arising from the offering of regulated and nonregulated services on a structurally unseparated basis."[35] The Commission adopted these requirements as the most appropriate means of preventing BOCs from charging unjust and unreasonable rates in violation of Section 201(b) for their *regulated* service offerings.[36] It is important to note in this regard that the Commission adopted the Part 64 rules notwithstanding the fact that the market for unregulated enhanced services was

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[34] *See Third Computer Inquiry*, Report and Order, 104 FCC 2d 958, ¶ 234 (1986), *subsequent history omitted* ("*Computer III Report and Order*").

[35] *See Separation of Costs of Regulated Telephone Service from Costs of Non Regulated Activities et al.;* Report and Order, 2 FCC Rcd 1298, ¶ 69 ("*Joint Cost Order*") (1987).

[36] *See id.* ¶ 37 ("protecting ratepayers from unjust and unreasonable interstate rates is the primary purpose behind the accounting separation of regulated from nonregulated activities"); ¶ 39 ("assurance of just and reasonable rates does not stop with assuring that regulated operations do no cross-subsidize nonregulated activities. Rather, if there are savings to be gained from the integration of regulated and nonregulated ventures, those savings must be shared equitably with ratepayers in order to achieve regulated service rates that are just and reasonable.").

competitive. The focus of the Commission's concern was the consequences for regulated rates of the BOCs' entry into unregulated, competitive markets.

The Commission has also adopted accounting requirements designed to limit ILECs' ability to act on their incentives to misallocate the costs of competitive, regulated services to cost categories associated with regulated services over which ILECs have market power. In every case, the Commission adopted these requirements notwithstanding the fact that the ILECs lacked market power or any significant market share in the would-be subsidized service. For example, the Commission established special accounting requirements to prevent ILECs from misallocating the costs of facilities deployed for the purpose of providing video dialtone. Video dialtone was a common carrier video transmission service to be provided *via* facilities that shared substantial joint and common costs with the facilities used to provide local exchange and exchange access services. Then, as now, the ILECs argued that there was no need for detailed accounting regulations because the ILECs had no market power in the provision of video services, a market dominated by the incumbent cable companies that were (and are) not subject to cost allocation regulations.[37] The Commission rejected these arguments, and found that accounting requirements were necessary to "ensure that telephone ratepayers do not have to bear the costs of video dialtone" and also to "protect cable operators from potential anticompetitive actions by LECs, stemming from LEC incentives and opportunities to price video dialtone

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[37] *See Telephone Company - Cable Television Cross Ownership Rules Sections 63.54 - 63.58 and Amendments of Parts 32, 36, 61, 64, and 69 of the Commission Rules to Establish and Implement Regulatory Procedures for Video Dialtone Services*, Memorandum Opinion and Order on Reconsideration, 10 FCC Rcd 244, ¶ 159 (1994) ("*VDT Recon Order*") (describing ILEC arguments that accounting regulation "is unnecessary because LECs offering video dialtone have no market power as new entrants competing against established video monopolies"). *See also id.* ¶ 203 (same).

service unreasonably low relative to the costs of providing such service." *See VDT Recon Order* ¶ 2.[38]

Accordingly, the Commission required that ILECs establish separate accounting categories to capture "the revenues, investments, and expenses wholly dedicated to video dialtone" and to capture the "revenues, investments and expenses that are shared between video dialtone and the provision of other services." *Id.* ¶ 173. *See also id.* ¶¶ 215-220 (explaining the need for these requirements to avoid cross-subsidy). The Commission also required ILECs to seek waivers to establish new Part 69 rate elements for video dialtone ("to help ensure that interstate video dialtone costs are not recovered through charges for access services provided to interexchange carriers" *id*. ¶ 195) and established a separate price cap basket for video dialtone service charges to "prevent potential cross-subsidization"[39] These same concerns have added relevance now that AT&T, among other ILECs, is entering the video market in earnest and providing (thus far) unregulated video service over the same facilities used to provide regulated exchange access and local exchange services.

Furthermore, in order to "protect against improper cost allocations from one regulated activity [*i.e.*, one subject to competition] to another regulated activity [*i.e.*, one not subject to competition]," the Commission has appropriately required BOCs to treat in-region interLATA

[38] Notably, the Commission observed that cost misallocation issues were not as serious for video dialtone as they would have been if the ILECs had planned to utilize a "fiber-to-the-home architecture," (*see VDT Recon Order* ¶ 163) as at least one ILEC is now doing. The obvious point here is that such an architecture would include a much higher proportion of joint and common costs and therefore a much greater risk of cost misallocation.

[39] *See Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulations,* Second Report and Order, 10 FCC Rcd 11098, ¶ 15 (1995) ("*VDT Price Cap Order*").

services provided on an integrated basis as non-regulated services under Part 64.[40] Just last year, long after the current price cap rules took effect, the Commission relied on the applicable affiliate transaction and cost allocation rules to "protect against cross-subsidization of section 272 affiliates by the BOCs' local customers."[41] Indeed, precisely because of the likelihood that the BOCs would engage in cross-subsidy if left unchecked, the Commission required that BOCs modify their cost allocation manuals to address specifically the allocation of OI&M services shared with Section 272 affiliates. *See OI&M Order* ¶ 20. The Commission also pointed out that cost allocation issues would be subject to a biennial audit. *See id.* ¶ 21.

Most recently, only *10 days ago*, the FCC held in the *Qwest IXC Dominance Order*[42] that the need for cost-allocation rules as applied to price cap carriers remains undiminished. There, the FCC reiterated that Qwest retained market power over the "bottleneck" telephone exchange and exchange access facilities in its region. *See Qwest IXC Dominance Order* ¶ 47. To ensure that the integration of its interexchange operations would not permit Qwest to misallocate its costs between competitive and non-competitive services, the Commission ruled that "Qwest still will be subject to…the Commission's accounting and cost allocation rules and related reporting requirements." *See id.* ¶ 54. For example, pursuant to Part 32 and 64 rules from which AT&T seeks forbearance, "Qwest is required to file on an annual basis a cost allocation manual…describing how it allocates costs between regulated and non-regulated activities, and to

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[40] *See Accounting Safeguards Under the Telecommunications Act of 1996*, Report and Order, 11 FCC Rcd 17539, ¶ 75 (1996) ("*Accounting Safeguards Order*").

[41] *See Section 272(b)(1)'s "Operate Independently" Requirement for Section 272 Affiliates,* Report and Order, 19 FCC Rcd 5102, ¶ 20 (2004) ("*OI&M Order*").

[42] *Petition of Qwest Communications International Inc. for Forbearance from Enforcement of the Commission's Dominant Carrier Rules As They Apply After Section 272 Sunsets*, Memorandum Opinion and Order, WC Dkt. No. 05-333, FCC 07-13 (rel. Mar. 9, 2007) ("*Qwest IXC Dominance Order*").

have an independent auditor audit the CAM every two years. *See* C.F.R.§§ 43.21(d), 64.901-.905; *see also* 47 C.F.R. §§ 32.23(c), 32.5280." The FCC also mandated that Qwest comply with Section 272(e)(3) and "impute to itself, at its tariffed rates, charges for access services used to provide interLATA services." *See id.* ¶ 67. "Pursuant to Section 64.903," the Commission held that Qwest must update its CAM to "include its imputation methodology, and the revised CAM [will] be subject to public comment." *Id.* The FCC concluded that the imputation requirements addressed "Qwest's incentives and ability to use its pricing of special access service to impede competition in the provision of in-region, interstate, intraLATA telecommunications services." *Id.* ¶ 69. There is no basis for concluding that the Commission's conclusions in the *Qwest IXC Dominance Order* are inapplicable to AT&T.

Forbearance from the Part 64 rules would also run-afoul of the clear congressional prohibition in Section 254(k) that ILECs may "not use services that are not competitive to subsidize services that are subject to competition." 47 U.S.C. § 254(k). As long as AT&T's rates are set directly or indirectly with reference to its costs as is the case under a price cap regime, Section 254(k) mandates the continuing operation of Part 64. Many other provisions of the Act also address the duty to prevent cross-subsidization and would be violated by the elimination of Part 64 rules.[43]

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[43] *See, e.g.,* 47 U.S.C. §§ 260(a)(1) (stating that a LEC "shall not subsidize its tele-messaging service directly or indirectly from its telephone exchange service or its exchange access"); 271(h) ("[t]he Commission shall ensure that the provision of services authorized under [section 271(g)] by a Bell operating company or its affiliate will not adversely affect telephone exchange service ratepayers or competition in any telecommunications market"); 272(e)(4) (permitting a BOC to provide services or facilities to its interLATA affiliate "so long as the costs are appropriately allocated"); 276(a)(1) ("any Bell operating company that provides payphone service shall not subsidize its payphone service directly or indirectly from its telephone exchange service operations or its exchange access operations").

C. Any Reform Of The Accounting Rules Should Be Accomplished In A Proceeding Of General Applicability In Close Consultation With The States.

Even if certain accounting rules require reform,, such concerns should be addressed in a proceeding of general applicability in close consultation with the states.[44] In any case, in light of the continued need for cost accounting rules, demonstrated above, there is no merit to AT&T's assertion that any flaws in current accounting rules justifies their elimination.[45] If the current rules do not properly track AT&T's costs, changes can and should be made to the rules to ensure that the costs are properly captured. Indeed, NASUCA, among others, urgently advocated changes to the accounting rules because state price cap rates "cannot be considered just and reasonable" in light of rates that are based on distorted and inaccurate accounting data.[46] As the GAO has recently found, the FCC must collect more accurate information regarding ILECs' services to ensure that ILECs do not abuse their market power.[47]

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[44] In the prior BellSouth forbearance docket (05-342), the Florida PSC was the only state commission to file, and it filed very late in the proceeding. At the same time, many state commissions filed last year in the NPRM on reform of the Part 36 rules. This disparity in participation cannot be explained by the lack of interest as nearly every state commission in the Part 36 NPRM advocated retention and reform of the Part 36 rules while BellSouth's petition would gut Part 36 as well as many other accounting rules. The key difference between these proceedings was that the Federal-State Joint Board on Separations was intimately involved in the Part 36 NPRM but had no role in the BellSouth forbearance proceeding. Indeed, it appears that many state commissions were not even aware that BellSouth's petition was pending until only weeks before the statutory forbearance deadline was set to run. To ensure state participation on these issues going forward, the FCC should dismiss these petitions, and a Federal-State Joint Board brought into the process of reforming the rules.

[45] At least with respect to special access, the Commission tentatively (and correctly) rejected the argument that ARMIS data is unreliable for the purpose of determining whether ILECs have achieved substantial special access economies of scale and scope. *See Special Access NPRM* ¶ 29.

[46] *See NASUCA Comments in Dkt. No. 80-286*, Attach. A, Declaration of Susan Baldwin, ¶ 53.

[47] *See GAO, FCC Needs to Improve Its Ability to Monitor and Determine the Extent of Competition in Dedicated Access Services*, GAO-07-80, at 43-44 (Washington, D.C., Nov. 2006).

The FCC has already begun the reform process in a piecemeal fashion. In the past several years, the Commission has released a series of NPRMs and Orders in consultation with the Federal-State Joint Board on Accounting to reform its Part 32 rules.[48] As then Commissioner Martin indicated in his separate statement on the 2003 Report of the Federal-State Joint Conference on Accounting, states must participate in any changes in the accounting rules: "I believe it is extremely important that a forum be developed for notifying the Commission of accounting-related concerns and for identifying issues of concern to the states. In this regard, the Joint Conference on Accounting has been extremely successful at facilitating state commission input into the Commission's decision-making process for accounting issues and for renewing and beginning to formalize a dialog on the broader issues related to accounting."[49] The report provided a forum for states to provide input as to whether and why certain Part 32 accounting rules should be retained, and others expanded, while others should be eliminated. The FCC then acted on the state recommendations the following year.

Just last year, the FCC initiated a similar proceeding to evaluate the Part 36 jurisdictional separations rules.[50] In that order, the FCC extended the separations freeze for an additional three years. The Commission released an accompanying FNPRM regarding "proposals relating to comprehensive separations reform," with a specific focus on the effect that changes to the Part 36 rules would have on state regulation. *Jurisdictional Separations Order and FNPRM* ¶ 25. Among other things, the FCC sought "comment on specific proposals for comprehensive

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[48] *See generally Phase I Report and Order; see also Phase II Report and Order*; *Federal-State Joint Conference On Accounting Issues et al.*, Report and Order, 19 FCC Rcd 11732, ¶ 2 (2004) ("*Joint Conference Order*").

[49] *Federal-State Joint Conference on Accounting Issues*, Recommendation by Joint Conference, WC Dkt. No. 02-269, Separate Statement of Commissioner Kevin J. Martin, at 2 (Oct. 9, 2003).

[50] *See generally Jurisdictional Separations Order and FNPRM.*

separations reform advanced by the State Members of the Joint Board, as well as a draft data request prepared by the State Members that is intended to elicit data that may be helpful in formulating a reformed separations process." *Id.* ¶ 26. Prior to the release of the NPRM, the state members of the Separations Joint board had authored two papers outlining the possible options for reforming the Part 36 rules and the continuing need for those rules.[51] These papers were placed out for comment as part of the NRPM.

There is no reason that the FCC cannot also initiate similar collaborative proceedings to review the continuing utility of all of its accounting rules.[52] Indeed, it is likely that the FCC *is statutorily required to* utilize a Joint Board to change any of the Part 64, 32 and 36 accounting rules through rulemaking because any changes in the manner in which regulated and non-regulated activities are categorized under Part 64 and any changes to Part 32 will flow through to jurisdictional separations under Part 36.[53] State utility commissioners favor such an approach with respect to AT&T's petitions: in its original comments on the *BellSouth Petition*, NASUCA stated that it "agrees with the recommendation of the [New Jersey Ratepayer Advocate] to refer the issues raised in BellSouth's petition to a federal-state Joint Board…given the complexity of the issues and the impact on both federal and state regulators ability to regulate, a review of these issues by both federal and state regulators is necessary. The proposals of the joint board could then be issued for comment by all interested parties." *NASUCA Comments in Dkt. No. 80-286* at

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[51] *See id.* App. A.

[52] The Joint Federal-State Joint Board on Accounting has recently been allowed to expire. The FCC should reauthorize the board so that it can address any outstanding accounting reform issues.

[53] *See* 47 U.S.C. § 410(c) ("The Commission *shall* refer any proceeding regarding the jurisdictional separation of common carrier property and expenses between interstate and intrastate operations, which it institutes pursuant to a notice of proposed rulemaking….") (emphasis added).

2-3. Just last month, the Wireline Competition Bureau recommended exactly this approach.[54] The FCC should therefore dismiss AT&T's petitions and initiate a broad ranging deliberative process in partnership with the states to reevaluate its accounting rules.

III. CONCLUSION.

For the preceding reasons, AT&T's petitions for forbearance should be denied.

Respectfully submitted,
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ATTORNEYS FOR TIME WARNER TELECOM

March 19, 2007

[54] *See WCB Staff Report* at 18 ("Staff recommends that the Commission consider, in the context of the record in the Separations Freeze FNPRM proceeding, whether the Part 36 rules are necessary in the public interest and, if not, to repeal or modify any rule so that it is in the public interest.").

CERTIFICATE OF SERVICE

I, Jonathan Lechter, do hereby certify that on this 19th day of March, 2007 a copy of the foregoing "Opposition to Petitions For Forbearance" was delivered via first class mail, e-mail and electronically on the FCC's electronic comment filing system (ECFS) to the following parties:

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