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FILED BY HAND

Commissionner Robert McDowell
Federal Communications Commission
445 12th Street SW
Room 8-C302
Washington, DC 20554

Ex Parte

Re: 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**)

Dear Commissioner McDowell,

After reflecting overnight on yesterday's debate with AT&T regarding AT&T's petition seeking forbearance relief from many of the Commission's cost allocation and accounting rules, I write for several purposes.

The first purpose is to thank you again for causing the debate to happen and for your active participation.

The second purpose is to respond to an argument that AT&T made yesterday, and apparently is now making to the press, i.e., that "opponents have not identified a single actual, current Commission use of these cost allocations as they relate to AT&T." As we explained at the debate, the data produced by the cost allocations at issue have been used by the Commission and private parties in the past (*CALLS*), are being used by the Commission and private parties in the present (*272 Sunset Nonstructural Safeguards, Separations* reform and the *Special Access Rulemaking*) and will in all likelihood be used by the Commission and private parties in the future (*Special Access Rulemaking, Inter-Carrier Compensation Reform* and monitoring the efficacy of the *Price Caps* formula). To support these points, we produced pages from Commission decisions that explain the relevance of the data under price caps regulation, and how the data were used, are used and could be used. For the convenience of you and your staff, I have attached those documents to this letter and have added pages from the *CALLS* order. The subject cost allocation rules are clearly required to achieve the statutory goals of advancing competition and protecting consumer

interests. AT&T's assertion that use of the data is speculative and that there is not a sufficiently strong connection between the data and the regulatory purpose to which the data are put is simply not accurate.

Additionally, I would like to respond to AT&T's repeated assertion that it would provide the Commission with cost data in the future at any time that the Commission might care to use such data. AT&T's offer of future, event-specific, cost data is problematic for several reasons. First, the consistency and comparability of the data with prior periods results would be entirely lost. The Commission would lose its ability to evaluate the reasonableness of the data vis-à-vis past filings and trends – something that has been a cornerstone of its regulatory approach over the years. Secondly, there would be no standing rules as to how such cost studies should be prepared – shifting additional burden upon the Commission to specify how such studies should be conducted, or conversely to understand and evaluate the structure of cost studies AT&T may develop. Finally, third parties, (those being forced either to pay potentially unjust and unreasonable prices, or to compete against prices being cross-subsidized by monopoly revenues) would lose all ability to evaluate AT&T's data and identify problems to bring to the Commission's attention either through Petitions or Complaints.

Finally, I want to document for the record our statements that the "burden" imposed on AT&T by the subject cost allocation rules is extremely minimal. AT&T claims (without documentation) to spend $11 million to comply with the subject rules. We explained that $11 million is thousandths of percent of AT&T's 2007 revenues of $118 billion, and that given 2007 revenues AT&T's earns $11 million in about forty five minutes. AT&T's "burden" is laughingly minimal, and outweighed by the benefits to the Commission and private parties of having consistently available data developed pursuant to Commission rules to use for legitimate regulatory purposes.

Sincerely

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CALLS Order

drive out its competitors, and then raise prices to monopoly levels after the competitors have left the market.[373] As evidence that the target rates are not below price cap LECs' incremental costs, we note that interconnection agreements reached through negotiations in the marketplace contain access rates that are below the target rates.[374] In addition, the CALLS signatory LECs have agreed to charge these rates for a sustained period of time, which they would not do if the rates were predatory. Price cap LECs will not be able to increase these prices to monopoly prices; the rates will remain at the target rates until July 1, 2005, at which time the Commission will re-examine them. We find that targeting is appropriate to drive average traffic sensitive charges closer to the cost of providing these services, and that it will not harm efficient competition.

171. Furthermore, we find it reasonable not to target reductions to the common line basket at this time. When price caps were first implemented, initial rates were targeted to produce the same return across all baskets.[375] Currently, however, price cap LECs' basket earnings are significantly higher for traffic sensitive services than for common line services.[376] This is consistent with our observation that the current traffic sensitive rate structure provides price cap LECs with more revenue when demand increases, regardless of whether costs have increased, resulting in higher earnings.[377] Therefore we find it reasonable to target reductions to traffic sensitive services rather than to common line services.

172. We also adopt the creation of a special access basket with a separate X-factor as proposed by CALLS. The creation of a separate special access basket, with its own X-factor, benefits dedicated or high-volume users through the reduction of special access rates. Separating special access into its own basket, in conjunction with the IXC commitments, also will benefit residential and small business end users. Under our current rules, special access is recovered through the trunking basket. If it were to remain in that basket, price cap LECs could reduce special access rates while increasing rates for the other rate elements in that basket so that the

(Continued from previous page)
each price cap basket, and upper pricing bands will continue to apply to service categories and subcategories within the price cap baskets. *See* Appendix B §§ 61.45, and 61.47(e).

[373] *See Price Cap Second FNPRM*, 11 FCC Rcd at 870; Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54 - 63.58, CC Docket No. 87-266, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 244, 343 (1994).

[374] *See* Cable & Wireless Comments at 4.

[375] *See LEC Price Cap Order*, 5 FCC Rcd at 6814-17.

[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. AT&T has also provided estimates based on 1997 data that show rates of return of 45 percent for the switching basket, 15 percent for the trunking basket, and 9 percent for the common line basket. *See* Letter from Bruce K. Cox, Government Affairs Vice President, AT&T, to Magalie R. Salas, Secretary, FCC, CC Docket No. 96-262, Feb. 19, 1999 at 6. *See also* Letter from Pete Sywenki, Director, Sprint, to Magalie R. Salas, Secretary, FCC, May 12, 2000 at 6.

[377] *Pricing Flexibility Order*, 14 FCC Rcd at 14332 (seeking comment on whether to require a one-time downward adjustment to price cap LECs' traffic sensitive PCIs to correct for the earnings imbalance).

BOC and its section 272 separate affiliate "operate independently" hinders their ability to alter business priorities quickly in response to changing market demands. The required duplicative management of the two affiliated companies creates unnecessary inefficiencies in decision making and may therefore increase the costs and delay deployment of new services.[243]

84. We reject arguments that we should retain the section 272 safeguards, in whole or in part, to protect against BOCs' use of any exclusionary market power they may possess.[244] Instead, we find that other existing safeguards, in combination with the safeguards we adopt in this Order, provide sufficient protection against these concerns and impose fewer costs and burdens.[245] We find that commenters advocating retention of the section 272 safeguards do not adequately consider the costs of structural separation, nor do they adequately consider less costly alternatives, such as the targeted safeguards we adopt in this Order.[246]

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[243] Opportunity cost is the value of a foregone alternative action. Slow and ill-coordinated decision making imposes opportunity costs that include the forgone services that could have been provided in the absence of artificial dividing lines between a company's decision makers. *See Section 272(b)(1)'s "Operate Independently" Requirement for Section 272 Affiliates*, WC Docket No. 03-228, CC Docket Nos. 96-149, 98-141, 01-337, Report and Order in WC Docket No. 03-228, Memorandum Opinion and Order in CC Docket Nos. 96-149, 98-141, 01-337, 19 FCC Rcd 5102, 5120, para. 30 n.100 (2004) (*OI&M Order*) (citing *The MIT Dictionary of Modern Economics* 315 (David W. Pearce ed., 4th ed. 1996)). We are also guided by the fact that the BOCs have quantified substantial costs associated with the section 272 separate affiliate requirement. *See, e.g.*, Legacy SBC NPRM Comments at 8; Verizon NPRM Comments at 9; Legacy SBC NPRM Reply at 16.

[244] *See, e.g.*, Legacy AT&T NPRM Comments at 7-10 (arguing that the 272 safeguards are critical tools to promote competition); Sprint NPRM Comments at 6-16 (supporting extension of the 272 safeguards); Missouri Commission NPRM Comments at 4 (suggesting the Commission extend the section 272 separate affiliate safeguards); Pennsylvania Commission NPRM Comments at 4 (same); Texas Commission NPRM Comments at 3 (same); Wyoming Commission NPRM Comments at 2 (same); NASUCA NPRM Comments at 2, 6 (urging the Commission to extend by rule the section 272 safeguards); NJ Ratepayer NPRM Comments at 4-5 (same). Because our decision not to extend the section 272 safeguards applies throughout each BOC region, we deny legacy AT&T's petitions to extend those safeguards in particular BOC, in-region states. *See* Legacy AT&T, Petition for Extension of Section 272 Obligations of Southwestern Bell Telephone Co. in the States of Arkansas and Missouri, WC Docket No. 02-112 (filed Sept. 24, 2004) (Legacy AT&T Arkansas and Missouri Petition); Legacy AT&T, Petition for Extension of Section 272 Obligations of Verizon in the State of Massachusetts, WC Docket No. 02-112 (filed Feb. 29, 2004) (Legacy AT&T Massachusetts Petition); Legacy AT&T, Petition for Extension of Section 272 Obligations of Southwestern Bell Telephone Co. in the States of Kansas and Oklahoma, WC Docket No. 02-112 (filed Dec. 8, 2003) (Legacy AT&T Kansas and Oklahoma Petition); Legacy AT&T, Petition for Extension of Section 272 Obligations of Southwestern Bell Telephone Co. in the State of Texas, WC Docket No. 02-112 (filed April 10, 2003) (Legacy AT&T Texas Petition).

[245] *See infra* part III.A.4; *see also Qwest Section 272 Sunset Forbearance Order*, 22 FCC Rcd at 5240-43, paras. 64-70; *Computer III Phase I Order*, 104 FCC 2d at 964, para. 3 (abolishing structural separation requirement upon a finding that targeted nonstructural requirements were sufficient to address discrimination and cross-subsidization concerns); *OI&M Order*, 19 FCC Rcd at 5112-15, paras. 18-22; *see also, e.g.*, *Non-Accounting Safeguards Order*, 11 FCC Rcd at 21983-84, 21986, 21991, paras. 162, 167-68, 179; *Non-Accounting Safeguards Second Order on Recon.*, 12 FCC Rcd at 8683, para. 55; *Competitive Carrier Fifth Report and Order*, 98 FCC 2d at 1197-98, para. 8 (determining that "[w]hile structural separation decreases opportunities for cost-shifting and anticompetitive conduct, it can also decrease efficiency and affect the interexchange carrier's ability to compete").

[246] Commenters, such as state commissions, legacy AT&T, legacy MCI, Sprint, and Covad, argue variously that structural separation is necessary because local telephone competition has not taken root; that the BOCs discriminate in their special access services provisioning; that cross-subsidies are difficult to detect; and that the BOCs maintain market power. *See, e.g.*, Legacy AT&T NPRM Comments at 10-34 (arguing *inter alia* that the BOCs maintain significant market power in all markets and engage in improper cost shifting); Covad NPRM Reply at 1-5 (claiming the section 272 safeguards provide a "bulwark" against abuses of monopoly power); Legacy MCI FNPRM (continued....)

effectively implement the new regulatory framework adopted in this Order if their independent incumbent LEC affiliates are subject to the same targeted safeguards as the rest of the company as a whole.[257] These special circumstances convince us that it is consistent with the public interest to deviate from the general obligations imposed by section 64.1903 of the Commission's rules, conditioned upon the AT&T and Verizon independent incumbent LECs' complying with the targeted safeguards discussed below. We therefore conditionally waive section 64.1903 as applied to SNET, including Woodbury, and former GTE.[258]

4. Other Safeguards

89. As discussed below, we conclude that a new regulatory framework for the BOCs' in-region, long distance services is appropriate. Our new framework is based in part on the substantial legal obligations that continue to apply to the BOCs in addition to the targeted safeguards we adopt below. We find that this regulatory framework adequately and comprehensively addresses the competitive concerns described above, but imposes fewer costs and burdens than full section 272 safeguards.

a. Continuing Requirements

90. AT&T, Verizon, and Qwest remain subject to a number of legal obligations that are an important component of the regulatory framework that we find appropriate for the BOCs and their independent incumbent LEC affiliates. In particular, these carriers are still subject to: dominant carrier regulation of their interstate exchange access services, including price cap regulation of most exchange access services;[259] the Commission's accounting and cost allocation rules and related reporting requirements;[260] equal access obligations under longstanding Commission precedent and section 251(g) of the Act;[261] section 251 obligations;[262] section 271 obligations, including the obligation to continue to

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[257] *See infra* part III.A.4.b. In addition, as discussed below, other existing safeguards apply to the BOC independent incumbent LEC affiliates, such as accounting and tariffing rules. *See infra* part III.A.4.a.

[258] We condition this waiver on AT&T's and Verizon's independent incumbent LECs' compliance with all of the safeguards we impose in this Order on the BOCs. We also condition this waiver as applied to Woodbury on its integration into SNET and on its operating as a price cap LEC for interstate ratemaking purposes once the integration process is complete. *See supra* note 32; *see also* AT&T Apr. 27, 2007 *Ex Parte* Letter at 1 (stating that Woodbury will be integrated into SNET, effective June 1, 2007).

[259] BOCs are not subject to price cap regulation for: (1) the exchange access services for which they have been granted phase II pricing flexibility; and (2) certain of their services that are provided pursuant to rate of return regulation. *See Pricing Flexibility Order*, 14 FCC Rcd 14221; *see also* 47 U.S.C. §§ 203(b), 204(a)(3); 47 C.F.R. §§ 61.38, 61.41, 61.58; *Implementation of Section 402(b)(1)(A) of the Telecommunications Act of 1996*, CC Docket No. 96-187, Report and Order, 12 FCC Rcd 2170, 2182, para. 19, 2188, para. 31, 2191-92, para. 40, & 2202-03, para. 67 (1997); *Petition of Qwest Corporation for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Omaha Metropolitan Statistical Area*, WC Docket No. 04-223, Memorandum Opinion and Order, 20 FCC Rcd 19415, 19424, para. 15 (2005) (*Qwest Omaha Order*), *review denied in part, dismissed in part, Qwest Corp. v. FCC*, 2007 WL 860987 (D.C. Cir. Mar. 23, 2007).

[260] For example, BOCs are required to file on an annual basis a cost allocation manual describing how they allocate costs between regulated and nonregulated activities, and to have an independent auditor audit that cost allocation manual every two years. *See* 47 C.F.R. §§ 43.21(d), 64.901-64.905; *see also* 47 C.F.R. §§ 32.23(c), 32.5280. BOCs are subject to certain reporting requirements under ARMIS. *See Automated Reporting Requirements for Certain Class A and Tier 1 Telephone Companies (Parts 31, 43, 67, and 69 of the FCC's Rules)*, CC Docket No. 86-182, Report and Order, 2 FCC Rcd 5770 (1987) (*ARMIS Order*), *modified on recon.*, 3 FCC Rcd 6375 (1988) (*ARMIS Reconsideration Order*); *see also* 47 C.F.R. § 43.21.

[261] 47 U.S.C. § 251(g); *MTS and WATS Market Structure, Phase III*, Docket No. 78-72, Report and Order, 100 FCC 2d 860 (1985); *Investigation into the Quality of Equal Access Services*, Memorandum Opinion and Order, 60 Rad. Reg. 2d (P&F) 417, 419, 1986 WL 291752 (1986). We note that in part III.B, *infra*, we forbear from application of (continued....)

comply with the market-opening requirements that the BOCs had to meet in order to receive authority to provide in-region, interLATA services;[263] and the continuing general obligation to provide service on just, reasonable, and not unreasonably discriminatory rates, terms, and conditions pursuant to sections 201 and 202 of the Act.[264] In addition, the nondiscrimination requirement in section 272(e)(1) of the Act and the imputation requirement in section 272(e)(3) of the Act (which we discuss below) continue to apply.[265]

91. These continuing legal obligations help address the competitive concerns raised above in a variety of ways. For example, under section 202(a) of the Act, the BOCs and their independent incumbent LEC affiliates will remain obligated to provide any of their special access services that their competitors rely on as inputs for the competitors' own interLATA telecommunications service offerings on rates, terms, and conditions that are not unreasonably discriminatory.[266] The BOCs also will remain obligated, under section 272(e)(1), to "fulfill any requests" from their interLATA telecommunications services competitors "for telephone exchange service and exchange access" within periods no longer than the periods in which they provide such telephone exchange service and exchange access to themselves or their affiliates.[267] Moreover, the BOCs and their independent incumbent LEC affiliates will remain subject to unbundling obligations pursuant to section 251(c)(3), which, as the Commission has found previously, provides "a check on special access pricing.,[268] and the BOCs also have unbundling obligations under section 271(c)(2)(B) as conditions of their authority to provide in-region, interLATA services.[269]

92. The BOCs and their independent incumbent LEC affiliates also remain obligated, under section 251(a), to interconnect with other carriers, and, pursuant to section 251(c), to interconnect on "rates, terms, and conditions that are just, reasonable, and nondiscriminatory," which is an important tool for facilitating intermodal competition.[270] In addition, the BOCs' continuing equal access obligations under longstanding Commission precedent and section 251(g) of the Act should protect against

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the EA Scripting Requirement to the BOCs and find good cause to waive the EA Scripting Requirement for the BOCs' independent incumbent LEC affiliates. However, all other equal access obligations continue to apply.

[262] 47 U.S.C. § 251.

[263] 47 U.S.C. § 271(d)(6). Section 271 does not apply to the BOCs' independent incumbent LEC affiliates.

[264] 47 U.S.C. §§ 201, 202.

[265] 47 U.S.C. § 272(e)(1), (e)(3); *see infra* part III.A.4.b(ii). We note that the safeguards adopted in the *Non-Accounting Safeguards* and the *Accounting Safeguards Orders* to implement these provisions also remain in effect.

[266] 47 U.S.C. § 202(a).

[267] 47 U.S.C. § 272(e)(1).

[268] *Unbundled Access to Network Elements; Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, WC Docket No. 04-313, CC Docket No. 01-338, Order on Remand, 20 FCC Rcd 2533, 2574-75, para. 65 (2004) (*Triennial Review Remand Order*) (subsequent history omitted).

[269] 47 U.S.C. § 271(d)(6).

[270] *See* 47 U.S.C. § 251(c)(2); *cf. Time Warner Cable Request for Declaratory Ruling that Competitive Local Exchange Carriers May Obtain Interconnection Under Section 251 of the Communications Act of 1934, as Amended, to Provide Wholesale Telecommunications Services to VoIP Providers*, WC Docket No. 06-55, Memorandum Opinion and Order, 22 FCC Rcd 3308 (WCB 2007) (clarifying that wholesale telecommunications carriers are entitled to the same rights as retail telecommunications carriers under sections 251(a) and 251(b), ensuring that new entrants have the ability to interconnect to incumbent LECs).

exchange access services. Second, we require disclosure in ARMIS filings of the access charges the independent incumbent LEC affiliates impute to themselves through debits to their nonregulated revenues.[278] This public disclosure requirement will provide interested parties with information they can evaluate to determine whether the BOCs and their independent incumbent LECs properly impute the costs of the access they provide their in-region, long distance service offerings. We note that the BOCs all have petitioned for and been granted pricing flexibility within their service regions.[279] Accordingly, they, and their independent incumbent LEC affiliates, are prohibited from making any low-end adjustments pursuant to section 61.45(d)(1)(vii) of our rules.[280] This fact reduces the incentives of the independent incumbent LEC affiliates to improperly shift costs to local exchange and exchange access services, because they are precluded from seeking rate increases for these services based on low earning levels.

b. Additional Requirements

95. In this Order, we adopt targeted safeguards that will apply to the BOCs to the extent they choose to provide in-region, interstate or international, long distance services either directly or through an affiliate that is not a section 272 separate affiliate. As a further condition of this Order, the BOCs' independent incumbent LEC affiliates also must comply with these safeguards to the extent they provide in-region, interstate, interexchange telecommunications services either directly or through an affiliate that does not comply with the requirements of either section 272 or section 64.1903 of our rules. The targeted safeguards include: (1) special access performance metrics to prevent non-price discrimination in the provision of special access services; (2) imputation requirements to help monitor BOC provisioning of these services for possible price discrimination; (3) the offering of calling plans to protect residential customers who make few interstate, long distance calls; and (4) providing subscribers monthly usage information to enable them to make cost-effective decisions concerning alternative long distance plans. We will carefully monitor the BOCs' compliance with these safeguards and will not hesitate to take appropriate remedial action if necessary. We also retain the authority to adjust these safeguards in the future as appropriate to reflect any competitive changes that might occur in the markets for in-region, long distance services.

(i) Special Access Performance Metrics

96. As part of the Commission's implementation of the section 272 structural safeguards, the BOCs have implemented special access performance metrics designed to help ensure that they refrain from non-price discrimination in their provision of special access services.[281] Once a BOC chooses to provide in-region, interLATA telecommunications services either directly or through an affiliate that is not a section 272 separate affiliate, those metrics would cease to be available. AT&T, Verizon, and Qwest also are required to implement special access metrics in accordance with their voluntary commitments in connection with the *BOC Merger Orders* and the *Qwest Section 272 Sunset Forbearance*

[278] *See supra* part III.A.4.b(ii).

[279] *Qwest Petition for Pricing Flexibility for Special Access and Dedicated Transport Services*, CCB/CPD No. 02-01, Memorandum Opinion and Order, 17 FCC Rcd 7363 (WCB 2002); *Petition of Ameritech Illinois, et al., for Pricing Flexibility*, CCB/CPD Nos. 00-26, 00-23, 00-25, Memorandum Opinion and Order, 16 FCC Rcd 5889 (Com. Car. Bur. 2001); *Verizon Petitions for Pricing Flexibility for Special Access and Dedicated Transport Services*, CCB/CPD Nos. 00-24, 00-28, Memorandum Opinion and Order, 16 FCC Rcd 5876 (Com. Car. Bur. 2001); *BellSouth Petition for Pricing Flexibility for Special Access and Dedicated Transport Services*, CCB/CPD No. 00-20, Memorandum Opinion and Order, 15 FCC Rcd 24588 (Com. Car. Bur. 2000).

[280] 47 C.F.R. § 69.731; *Pricing Flexibility Order*, 14 FCC Rcd at 14307, para. 167.

[281] The BOCs' implementation of these metrics is reviewed as part of the biennial audits.

transparency of each carrier's imputation of in-region, long distance costs, we require AT&T, Qwest, and Verizon, as a condition of this Order, to include the imputation charges it debits to account 32.5280 in its ARMIS filings, accompanied by an explanatory footnote for each line item identifying the amount imputed.[300] This requirement should pose at most a minimal additional burden to the carriers because they already record imputation charges in a subsidiary record account for revenues derived from regulated services treated as nonregulated for federal accounting purposes,[301] and already must file ARMIS reports.[302]

105. We conclude that the requirements set forth above adequately address the commenters' concerns regarding the incentives and ability of the BOCs and BOC independent incumbent LEC affiliates to use their pricing of access services, including special access services, to impede competition in the provision of in-region, long distance services.[303] At the same time, these imputation and access charge requirements should not in any way hamper the BOCs' and their independent incumbent LEC affiliates' ability to compete. Instead, they should give AT&T, Qwest, and Verizon, their access services customers, and the Commission meaningful information for evaluating whether these carriers' imputation and access charge practices and procedures comply with section 272(e)(3) and this Order. We also believe that, in comparison with dominant carrier regulation, these imputation requirements provide a less costly but more effective method of assuring that the BOCs and their independent incumbent LEC affiliates will not discriminate between their own operations and their competitors in the pricing of special access services.

(iii) Low-Volume Usage Plans

106. As discussed above, although we find that Qwest, Verizon, and AT&T generally lack classical market power in the provision of in-region, interstate, long distance services, we are concerned that their customers who make relatively few interstate long distance calls and who do not also subscribe to wireless or broadband Internet access service may have fewer competitive choices among interstate, long distance providers and may not be able to avoid the impact of a price increase by engaging in usage substitution. To address this concern, AT&T and Verizon each have committed for three years to offer a rate plan tailored to these customers' needs.[304] We note that, under the *Qwest Section 272 Sunset Forbearance Order*, Qwest committed to freeze for two years the per-minute prices for two calling plans

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[300] These data values with explanatory footnotes are to be provided in FCC Report 43-01, ARMIS Annual Summary Report, table I, row 1045, columns (b) and (c); FCC Report 43-02, ARMIS USOA Report, table I-1, row 5280, column (b); and in FCC Report 43-03, ARMIS Joint Cost Report, table I, row 5280, columns (b), (d), and (j).

[301] *See* 47 C.F.R. § 32.5280(c) (specifying that separate subsidiary record categories be maintained for nonregulated revenues).

[302] *See, e.g.*, *ARMIS Order*, 2 FCC Rcd at 5772, para. 22; *see also* 47 C.F.R. § 43.21.

[303] *See, e.g.*, Legacy MCI FNPRM Comments at 19-23; Legacy MCI FNPRM Reply at 8-12; Ad Hoc Comments at 17-18; Ad Hoc Reply at 5-6. We reject legacy AT&T's and legacy MCI's calls for more intrusive imputation requirements. *See, e.g.*, Legacy MCI FNPRM Reply at 14-16; Legacy AT&T FNPRM Comments at 51, 70 (arguing that the Commission should adopt rules requiring BOCs to impute access costs for each identifiable service offering, including each component in a bundled offering of multiple services, to prevent cross-subsidization). We find that the current regime with narrowly-targeted accounting and pricing safeguards remains adequate to address competitive concerns.

[304] *See* AT&T Aug. 15, 2007 *Ex Parte* at 1-2; Verizon Aug. 21, 2007 *Ex Parte* at 1-2. Specifically, AT&T and Verizon each commit to offer a rate plan under which residential consumers with a local access line may obtain 1+ long distance telecommunications services at a rate of 12 cents per minute with no monthly minimum or monthly recurring charge. AT&T and Verizon both agree to make these rate plans available within 60 days of the effective date of this Order, and continuing for 36 months thereafter. *Id.*

short run, the behavior of individual companies has no effect on the prices they are permitted to charge, and they are able to keep any additional profits resulting from reduced costs. This creates an incentive to cut costs and to produce efficiently. In this way, price caps act as a transitional regulatory scheme until the advent of actual competition makes price cap regulation unnecessary.[29]

12. Although price cap regulation diminished the direct link between changes in allocated accounting costs and change in prices, it did not sever the connection between accounting costs and prices entirely. Rather, because the rates to which the price cap formulae were originally applied resulted from rate-of-return regulation, overall price cap LEC interstate revenue levels continued generally to reflect the accounting and cost allocation rules used to develop access charges.[30] Moreover, earnings remain relevant to price cap regulation on several respects. First, price cap indices may be adjusted upward if a price cap carrier earns returns below a specified level in a given year (referred to as a "low-end" adjustment).[31] Second, a price cap LEC may petition the Commission to set its rates above the levels permitted by the price cap indices based on a showing that the authorized rate levels will produce earnings that are so low as to be confiscatory (referred to as an "above-cap filing").[32] Third, in the past, all or some price cap LECs were required to "share," or return to ratepayers, earnings above specified levels. This sharing requirement was eliminated in 1997.[33]

13. With the passage of the Telecommunications Act of 1996 (1996 Act),[34] the Commission determined that it was necessary to undertake substantial access charge reform.[35] In 1997 in the *Access Charge Reform Order*, for example, the Commission instituted reforms that changed the manner in which price cap LECs recover access costs by aligning the rate structure more closely with the manner in which costs are incurred.[36] The Commission stated, moreover, that it would rely on competition as the primary method for bringing about cost-based access charges.[37] It anticipated creating, in a later stage of access

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the portion of revenue that may be recovered from specific services. Subject to certain restrictions, this flexibility allows incumbent LECs to alter the rate level associated with a given service. *CALLS Order*, 15 FCC Rcd at 12968-69, para. 16 n.15.

[29] *See id.*, 15 FCC Rcd at 12968-69, para. 16 (citing *Price Cap Performance Review for Local Exchange Carriers*, Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, 11 FCC Rcd 858, 862, paras. 5-6 (1995) (*Price Cap Second FNPRM*)).

[30] *See id.*, 15 FCC Rcd at 12968, para. 17.

[31] *See id*. In 1999, the low-end adjustment was eliminated for those LECs that receive and exercise pricing flexibility. *See infra* section II.B.

[32] *See CALLS Order*, 15 FCC Rcd at 12968, para. 17.

[33] *See id.* (citing *Price Cap Performance Review for Local Exchange Carriers*, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, 12 FCC Rcd 16642, 16991, 16700-03, paras. 127, 148-55 (1997) (*1997 Price Cap Review Order*), *aff'd in part, rev'd in part, United States Telecom Ass'n v. FCC*, 188 F.3d 521 (D.C. Cir. 1999)).

[34] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996). The 1996 Act amended the Communications Act of 1934, 47 U.S.C. § 151 *et seq*. We refer to these Acts collectively as the "Communications Act."

[35] *See CALLS Order*, 15 FCC Rcd at 12969-70, para. 18.

[36] *Access Charge Reform*, CC Docket Nos. 96-262, 94-1, 91-213, 95-72, First Report and Order, 12 FCC Rcd 15982, 16007-34, paras. 67-122 (1997) (*Access Charge Reform Order*), *aff'd Southwestern Bell Tel. Co. v. FCC*, 153 F.3d 523 (8th Cir. 1998).

[37] *Access Charge Reform Order*, 12 FCC Rcd at 16001-02, para.44.

February 1, 2005.[81] The Commission provided the court with the required status report on December 1, 2004.[82]

III. DISCUSSION

22. Given the importance of special access services to carriers and customers alike, we commence this proceeding to seek comment on the interstate special access regime that we should put in place post-CALLS. To ensure that our examination is complete, we also seek comment on whether, as part of that regime, we should maintain, modify, or repeal the Commission's pricing flexibility rules. Finally, because this proceeding likely will not be completed in time for a new special access regime to be implemented in the 2005 annual access tariff filings, we seek comment on whether interim relief may be warranted and, if so, under what circumstances.

23. As a threshold matter, we request that any party that comments on the appropriate post-CALLS special access regulatory regime and/or that proposes the Commission alter in any way the existing pricing flexibility rules include in its comments specific language that would codify its proposed special access regulatory regime and/or its proposed pricing flexibility rule change(s).[83]

A. Interstate Special Access Rates of Price Cap LECs Post-CALLS

24. The first step in establishing the post-CALLS special access rate regulatory regime is to determine the type of rate regulation, if any, that should apply. We tentatively conclude that we should continue to regulate special access rates under a price cap regime and that the price cap regime should continue to include pricing flexibility rules that apply where competitive market forces constrain special access rates. This approach will allow the market to determine rates where competitive market forces exist, while protecting special access consumers from unreasonable rates where competition is lacking. Such a regime, we tentatively conclude, would result in just and reasonable rates as required under section 201 of the Communications Act.[84] We seek comment on these tentative conclusions.

25. Consistent with these tentative conclusions, in this section we discuss the major issues with respect to implementing a price cap method to regulate special access rates and seek comment on how to resolve these issues. In section III.B, *infra*, we discuss and seek comment on the appropriate pricing flexibility aspects of a price cap regime.

1. Changes in the Special Access Market

26. Special access services have significant economies of scale and scope. Most of the cost of providing a special access line is in the support structure, *i.e.*, the trenches, manholes, poles, and conduits, the rights-of-way, and the access to buildings, not in the fiber strand or copper wires that share the support

[81] *AT&T Corp., et al.*, D.C. Circuit Case No. 03-1397, Order (Oct. 25, 2004) (holding the matter in abeyance and requiring the Commission submit a status report on Dec. 1, 2004); *AT&T Corp., et al.*, D.C. Circuit Case No. 03-1397, Order (Dec. 8, 2004) (continuing to hold the matter in abeyance and requiring the Commission to submit a second status report on Feb. 1, 2005).

[82] *AT&T Corp., et al.*, D.C. Circuit Case No. 03-1397, Status Report of Federal Communications Commission (filed Dec. 1, 2004).

[83] For example, in support of the CALLS proposal, the CALLS members submitted specific proposed rule changes. *See, e.g., Access Charge Reform*, CC Docket Nos. 96-262, 94-1, 99-245, 96-45, Memorandum in Support of the Coalition for Affordable Local and Long Distance Service Plan at App. B (filed Aug. 20, 1999). Parties should likewise submit their proposed specific rule changes as part of their comments in this proceeding.

[84] *See* 47 U.S.C. § 201(b).

structure, rights, and access.[85] Structure, rights, and access costs vary little with respect to the number of fiber strands or copper wires, thereby producing economies of scale. Price cap LECs can, moreover, increase capacity on many special access routes at a relatively low incremental cost (relative to the total cost of trenching and placing poles, manholes, conduit, fiber, and copper, and securing rights and access) by adding or upgrading terminating electronics.[86]

27. The first full year of the CALLS plan and the first year that price cap LECs exercised significant pricing flexibility was 2001.[87] ARMIS data show that, in the 2001-2003 period, BOC special access operating revenues, operating expenses, accounting rates of return, and the number of special access lines increased annually (*i.e.*, compound annual growth rates over the period) by approximately 12, 7, 17, and 18 percent, respectively.[88] BOC special access average investment decreased at a compounded annual rate of less than one percent over the same period.[89] The overall (*i.e.*, not compounded annually) BOC interstate special access accounting rates of return were approximately 38, 40, and 44 percent in 2001, 2002, and 2003, respectively.[90]

28. In the period 1992-2000, a period that precedes the CALLS plan and significant pricing flexibility, BOC interstate special access operating revenues, operating expenses, average investment, accounting rates of return, and special access lines increased at a compounded annual rate of

[85] *See AT&T Petition for Rulemaking* at 29; Kahn/Taylor Decl. at 10-11.

[86] *See AT&T Petition for Rulemaking* at 29.

[87] *See supra* sections II.A.2 (CALLS), II.B (pricing flexibility).

[88] The compound annual growth rates for operating revenues, operating expenses, and rate of return were calculated using ARMIS data reported for interstate special access services (entered as of September 29, 2004). The underlying operating revenues and operating expenses data are from ARMIS 43-01, Table I, Cost and Revenue, rows 1090, 1190, cols. s. Net return is divided by average net investment to calculate annual rates of return for which the compound annual growth rate is calculated. The underlying net return and average net investment data are from ARMIS 43-01, Table 1, Cost and Revenue, rows 1910, 1915, col. s. We calculated the compound annual growth rate for special access analog and digital lines collectively using ARMIS data reported for interstate and state special access services. These special access lines are expressed in voice grade equivalents in the ARMIS reports. The underlying special access analog and digital line data are in ARMIS, 43-08, Table III, Access Lines in Service by Customer, row 910, cols. fj and fk. The ARMIS report does not identify separately the number of interstate and the number of state special access lines. The compound annual growth rate for state and interstate special access lines should be similar to the growth rate for interstate special access lines alone, because state special access revenues alone represent a relatively small fraction of combined state and interstate special access service revenues. Specifically, BOC interstate special access operating revenues were approximately $13.5 billion in 2003. *See* ARMIS 43-01, Table I, Cost and Revenue, row 1090, col. s. Of this amount, approximately $12.9 billion, or 96 percent, is reported as network access service revenue for special access services. *See* ARMIS 43-01, Table I, Cost and Revenue, row 1020, col. s. Although ARMIS does not report a figure for the state jurisdiction that is directly comparable to special access operating revenues, it does report that, in 2003, approximately $1.6 billion revenues for state network access service revenues-special access. *See* ARMIS 43-04, Table I, Separations and Access Data, row 4012, col c. The state network access service revenue-special access is approximately 11 percent of the total for state and interstate network access service revenue-special access. The state share of the total of state and the interstate special access lines should be similar. Moreover, use of the compound annual growth rate for state and interstate special access lines collectively to estimate the growth rate for interstate special access lines alone is reasonable because there is no evidence that state special access lines are growing at a significantly different rates than are interstate special access lines.

[89] The compound annual growth rate for average net investment is calculated from ARMIS data reported for interstate special access services. *See* ARMIS 43-01, Table I, Cost and Revenue, row 1910, col. s.

[90] The annual rates of return were calculated using ARMIS data reported for interstate special access services. Specifically, we divided the net return by average net investment to calculate the rates of return. *See* ARMIS 43-01, Table 1, Cost and Revenue, rows 1910, 1915, col. s.

approximately 16, 12, 11, 11, and 32 percent, respectively.[91] The overall (non-compounded) BOC special access accounting rates of return varied over this period from a low of approximately 7 percent in 1995 to a high of approximately 28 percent in 2000.[92]

29. These accounting data suggest that the BOCs have realized special access scale economies throughout the entire period of price cap regulation, including before and after the CALLS plan and pricing flexibility were implemented. That is, special access line demand increased at a significantly higher rate than did operating expenses and investment throughout these periods, suggesting that the BOCs realized scale economies in both periods. We note that some parties contend that the accounting rates of return derived from ARMIS data are meaningless.[93] Here, we use ARMIS data for the limited purpose of examining the relationship between demand growth and growth in expenses and investment. To the extent the accounting rules have remained the same over the period analyzed, the analysis of growth rates and scale economies should not be significantly affected by the cost allocation issues these parties raise. We invite parties to comment on the relevance of these data and the relationship between demand growth and growth in expenses and investment in the special access market. To demonstrate the possible impact of cost allocations during the price cap period of regulation, including before and after the CALLS plan and pricing flexibility were implemented, we invite parties (1) to remove from the BOCs' interstate special access operating expenses and average investment data reported in ARMIS any expenses and investments that are not directly assignable; and (2) to calculate the compound annual growth rates for BOC interstate special access operating expenses and average investment using these adjusted data. To the extent parties have concerns about the consideration of ARMIS data for purposes of evaluating the degree to which special access rates and therefore earnings exceed a reasonable level, we solicit comment on that issue below.[94]

2. Developing a Special Access Price Cap Regime

30. The core component of price cap regulation is the Price Cap Index (PCI). As the Commission explained in the *LEC Price Cap Order*, the PCI is designed to limit the prices LECs charge for service.[95] The PCI provides a benchmark of LEC cost changes that encourages price cap LECs to become more productive and innovative by permitting them to retain reasonably higher earnings.[96] The PCI has three basic components: (1) a measure of inflation, *i.e.*, the Gross Domestic Product (chain weighted) Price Index (GDP-PI);[97] (2) a productivity factor or "X-Factor," that represents the amount by

[91] *See supra* notes 88-89. We begin our analysis with 1992, rather than 1991, data because ARMIS does not contain line count data for 1990; thus, the compound annual growth rate cannot be calculated from these data in 1991.

[92] *See supra* note 90.

[93] *See, e.g.*, SBC Opposition at 19-23; Kahn/Taylor Decl. at 6-9 (claiming that accounting rates of return for services such as interstate special access services are meaningless because these returns reflect arbitrary allocations of fixed costs between regulated and non-regulated services, between interstate and intrastate jurisdictions, and among interstate services).

[94] *See infra* section III.A.4.

[95] *LEC Price Cap Order*, 5 FCC Rcd at 6792, para. 47. To ascertain compliance with the PCI, LEC rate levels within each basket are measured through the use of an Annual Price Index (API). The API is the weighted sum of the percentage change in LEC prices. The API weights the rate for each rate element in the basket based on the quantity of each element sold in a historical base year. The historical base year is the calendar year that immediately precedes the annual tariff filing on July 1. A price cap LEC's rates are in compliance with the cap for a basket if the API is less than or equal to the PCI.

[96] *Id.*, 5 FCC Rcd at 6787, 6792, paras. 2-3, 47.

[97] *CALLS Order*, 15 FCC Rcd at 13038-39, paras. 183-84.

coalition filed its access charge proposal, the Commission noted that the CALLS proposal would eliminate the need to adjust the X-factor retrospectively in response to the court's remand, or to calculate an X-factor on a going-forward basis.[108] In response to the *1999 Price Cap FNPRM*, commenters proposed X-factors ranging from 3.71 percent to 11.2 percent.[109]

34. In the *CALLS Order*, the Commission changed the X-factor from a productivity-based factor to a transitional mechanism that reduced switched access rates to a specific target and lowered special access rates for a specified period of time.[110] As noted above, the special access X-factor was set at 3.0 percent in 2000, 6.5 percent for the next three years, and equal to the GDP-PI thereafter, essentially freezing the special access PCI (after accounting for exogenous cost adjustments).[111]

35. In recent years, the BOCs have earned special access accounting rates of return substantially in excess of the prescribed 11.25 rate of return that applies to rate of return LECs. The BOCs' collective average special access accounting rates of return over the last six years (1998-2003) have been 18, 23, 28, 38, 40, and 44 percent, respectively. We seek comment on whether a rate of return in excess of the Commission's prescribed rate of return for rate-of-return LECs is a valid benchmark for determining the need for an X-factor, or an X-factor that is higher than the factor under the CALLS plan or the pre-CALLS price cap regime.[112] If it is appropriate for us to examine an X-factor in light of these rates of return, we seek comment on whether we should re-impose a productivity-based X-factor as a method of reducing the special access PCI.

36. We ask parties to submit studies quantifying an appropriate X-factor for special access services. In a previous order, the Commission eliminated the requirement that LECs report the expense matrix data used in calculating the X-factor.[113] The Commission recognized, however, the need for certain information provided by the expense matrix and expected companies to keep such data available and be prepared to provide the data upon request.[114] We now request that price cap LECs submit their expense matrix data from 1994 to 2004 (or 2003, if 2004 data are not yet available). These data should correspond exactly to the expense matrix data previously required under Part 32 of the Commission's rules.[115]

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[108] *Price Cap Performance Review for Local Exchange Carriers*, CC Docket Nos. 94-1, 96-262, Further Notice of Proposed Rulemaking, 14 FCC Rcd 19717, 19718, para. 4 (1999) (*1999 Price Cap FNPRM*).

[109] *CALLS Order*, 15 FCC Rcd at 13020, para. 139 (citing USTA Reply at 13 and AT&T Comments at 12-15, respectively).

[110] *Id.*, 15 FCC Rcd at 13020-21, para. 140.

[111] *Id.*, 15 FCC Rcd at 13025, para. 149.

[112] *See infra* section III.A.4 (discussing the 11.25 rate of return at greater length).

[113] *Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase I*, CC Docket No. 99-253, Report and Order, 15 FCC Rcd 8690, 8694, para. 7 (2000) (*Phase I Accounting Streamlining Order*).

[114] *Id.* These continuing obligations for the LECs to maintain expense matrix data and to provide them to the Commission upon request were approved by the Office of Management and Budget (OMB) on June 19, 2000. *See Notice of Office of Management and Budget Action*, OMB No. 3060-0370 (June 19, 2000). The expense matrix assists in calculation of a productivity offset because it separates labor and material expense, and labor and material prices do not necessarily move together.

[115] 47 C.F.R. § 32.5999(f) (1999). The relevant expense categories include (1) Salaries and Wages, (2) Benefits, (3) Rents, (4) Other Expenses, and (5) Clearances. This rule was eliminated in the 2000 *Phase I Accounting Streamlining Order*.

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also contains annual reports including the USOA report,[525] the joint cost report,[526] and the access report,[527] as well as three-year investment usage forecasts and actuals reports. The LECs also file their Tariff Review Plans (TRPs) in ARMIS. These reports will permit us to monitor a variety of LEC activities, including cost allocations between regulated and nonregulated activities and allocations between the state and interstate jurisdictions.

(1) Modify ARMIS for Tier 1 LECs

376. Several LECs request that ARMIS data be required only at the aggregated, total interstate level, not at the current, disaggregated level of Part 69 rate elements.[528] They state that the more detailed information is unnecessary for price cap regulation,[529] and argue that rate level calculations based on rate of return are inappropriate in a price cap environment,[530] and will effectively stifle the incentives we seek to establish.[531]

377. We presently collect data on a Part 69 rate element level, and we believe it is desirable, if not essential, for purposes of monitoring and evaluation, to continue to collect most data on this level, which corresponds generally to the level of services that customers actually use. As with any consideration of increased aggregation, we are concerned with the potential loss of precision. For example, undesirable state-interstate shifting would be more difficult to detect if data were more highly aggregated. An error that is readily detectable at a high level of detail may be masked when the level of detail is decreased. The phasing-in of dial equipment minute (DEM) measurements, for example, can be monitored if we retain current data collection requirements; these changes would be obscured if the data were more aggregated. Our intention is to assure that jurisdictional separations and regulated-nonregulated allocations are made correctly; in order to assure this, we need to maintain the same levels of aggregation of data as are established in Part 69 and the Separations Manual.

378. ARMIS data serves more and broader purposes than merely the regulation and enforcement of rate of return. While ARMIS includes some data not directly necessary to price cap regulation, such as revenue and expense data on a rate element level, we believe that removing these parts of the ARMIS format would detract from the usefulness, consistency, and reliability of the system as a whole, both historically and on a single-filing basis. As discussed below, we believe it is inappropriate to collect price cap LECs' rate of return data on this level; but deletion from ARMIS of all category-level data would remove much that is useful, and would considerably reduce the Commission's ability to monitor LEC performance in a meaningful way.

379. We have accordingly concluded that we should retain the ARMIS data requirements at their present level of detail. These reports will allow us to monitor LEC performance carefully in the initial years of the price cap program and for the scheduled review. This monitoring will also allow us to assure that cost allocations between regulated and nonregulated activities and allocations between the state and interstate jurisdictions are correctly calculated. We therefore reject the suggestions to modify ARMIS substantially.[532]

380. We do agree in part, however, with the suggestions of commenters who assert that the collection of rate of return data on an access category or rate element level is improper and unnecessary for price cap LECs.[533] While we believe that cost, revenue, and demand data are essential to monitor LEC performance under price caps, we see no need for disaggregated rate of return data. Our sharing and adjustment mechanisms are based on total interstate rate of return, and that is the only earnings data used in the price caps plan. We accordingly determine that we should remove from ARMIS, for LECs under the price cap plan, any rate of return reporting that requires data at less aggregated levels than total interstate earnings. We will also modify the tariff review plans (TRPs) of price cap LECs to the same effect. While we continue to collect other data from price cap LECs on a disaggregated basis, this collection is solely for monitoring purposes. This disaggregated data does not serve a ratemaking purpose for these carriers, nor is there any reason to expect that results under price caps will correspond to data from previous years. We have modified our Part 69 rules to reflect this expectation that our collection of disaggregated data from price cap LECs is for monitoring purposes only.[534] We delegate to the Chief, Common Carrier Bureau the task of effecting these modifications to the ARMIS reporting requirements for price cap LECs.[535]

(2) Modify ARMIS for small LECs

381. All Tier 1 LECs are already subject to ARMIS filing requirements, and so face no additional burdens (except for the service quality and network investment indicators, newly required of all price cap carriers) under price cap regulation. But in response to the suggestion in the *Second Further Notice* that we might develop ARMIS reports for Tier 2 LECs,[536] some commenters argue that small LECs should be able to elect price caps without being subjected to ARMIS reporting requirements.[537] Tier 2 LECs have always been exempted from these requirements, these parties argue, in acknowledgment of their limited data collecting capabilities; these capabilities will not change or expand when a Tier 2 LEC elects price caps.[538]

382. In establishing the ARMIS system in 1987, the Commission decided that the reporting requirements would apply only to Tier 1 LECs.[539] Although the Commission had proposed in its notice of proposed Rule Making that the ARMIS requirements apply also to Class A carriers with revenues over $50 million, LEC commenters urged the raising of the threshold to $100 million in view of the difficulty that smaller carriers would have meeting the automating and reporting standards. The Commission complied, and stated that filing requirements for Tier 2 carriers with revenues over $50 million would not be specified in the ARMIS proceeding. The Commission has historically been sensitive to the difficulties faced by smaller LECs in providing cost, demand, and revenue data.[540]

383. We are not persuaded that the implementation of price caps requires that we abandon this sensitivity to small carriers' concerns. We note an added difficulty in extending ARMIS reporting requirements to Tier 2 LECs; some of these LECs are not subject to Part 32 or USOA requirements. Since these requirements are a major underpinning of the ARMIS reporting format, applying ARMIS requirements to these LECs would mean either making them subject to Part 32/USOA, or receiving ARMIS reports with inconsistent and possibly incompatible data. Neither of these seems to us an acceptable outcome, and we are not convinced that ARMIS should be required of Tier 2 LECs. Further, we believe that

296. The Commission's proposal to require 90 days' notice for any tariff filing which proposes to raise rates above the 5 percent price band similarly stimulated much comment.[381] Some LECs contend that the 90 day notice period is excessive,[382] or that the whole proposal is burdensome and could result in unconstitutional confiscation.[383] They also assert that the proposal in fact would afford ratepayers ample protection from cross-subsidization and large price increases.[384] USTA generally supports our proposal as balancing the needs for limited pricing flexibility and additional customer safeguards.[385]

297. The Commission's conclusion that such tariffs would face a high probability of suspension and that, to become effective, they would have to be supported by a showing of substantial cause, did not assuage the concerns of some commenters. Some opponents assert that "substantial cause" is too light a burden,[386] and that carriers filing such rates should be required to show that they will suffer "unconstitutional confiscation" of their property if their requested above-band rate increase is not allowed to take effect.[387] Several other parties attack our proposed above-band standards as too vague or too weak.[388]

298. We conclude that we will require 90 days' notice for any tariff filing which would raise rates above the 5 percent price band. We have chosen a 90 day notice period because above-band rates raise questions about the distribution of rate increase burdens that require the fullest possible consideration by this Commission. Furthermore, a 90 day period will enable interested parties to conduct the type of analysis necessary to submit meaningful, substantive comments. Above-band, within-cap rate level changes will also face a high probability of suspension.

299. We expect LECs to present a compelling argument that the above-band increase was due to unexpected, unforeseeable, and unusual circumstances. We are satisfied that substantial cause is the proper standard for evaluating these filings. In the *AT & T Price Cap Order* the Commission defined the test and stated how it will be applied. [389] The Commission specifically designed the substantial cause test to aid in the evaluation of tariff changes in circumstances in which customers have a legitimate expectation that change will not occur.[390] Above-band rate increases fit this mold. Our price cap plan creates in ratepayers the legitimate expectation that no individual rate will rise more than 5 percent each year, adjusted for changes in the price cap. Above-band increases act to undermine this expectation. While LECs may, in their discretion, file above-band rates, we consider it appropriate, as part of our carefully calibrated balance of ratepayer and shareholder interests, to impose the higher burden of substantial cause when carriers choose to exceed our pricing bands.[391]

4. Above-cap filings

300. The *Second Further Notice* suggested a higher standard for tariffs proposing above-cap rates,[392] and we adopt that proposal here. In response to the *Second Further Notice* proposal, two LECs argue that the standards for above-cap filings are too strenuous,[393] and a third asserts that this policy violates the doctrine of "carrier-initiated" rates.[394] Ad Hoc reasserts its position that the Commission should permit above-cap filings only if the carrier demonstrates that it will suffer unconstitutional confiscation of its property without the above-cap rate increase.[395]

301. We do not find these arguments persuasive. We believe our standards for above-cap filings are appropriate in light of the overall degree of pricing flexibility we are affording the LECs. We find it unlikely that within the next four years our price cap formula will stray so far from actual costs that the cap will produce unreasonably low rates. We are initializing price caps based on existing rates. We are also allowing rates to move with inflation and changes in other exogenous costs. Thus, we conclude that it is only fair, from a ratepayer perspective, to set high hurdles for above-cap increases.

302. US West claims that we risk violating the doctrine of carrier-initiated rates if we require a LEC subject to mandatory price cap regulation, to meet a high standard for an above-cap rate filing. We understand the doctrine of carrier-initated rates to limit our ability to bar the filing of tariff revisions by a carrier in such a way as to require that current tariffs be retained without change.[396] The regulatory regime we are adopting for LECs does not disturb this doctrine. With our above-cap filing requirement, we impose no bar on tariff filings by LECs subject to mandatory price cap regulation. Instead, we simply clarify, in accordance with our authority to set standards for tariff review and pursuant to our obligation to assure that rates remain just and reasonable, that when above-cap rates are filed, a different and higher review standard will be applied than when the rates filed are within the cap. We are not prescribing any particular rates, nor are we requiring or forbidding any particular tariff revisions --carriers remain free to decide when tariff revisions are to be filed and the nature and extent of those revisions.[397]

303. We conclude that we will permit LECs to file tariffs proposing above-cap rate increases on 90 days' notice. Our review of these filings will be thorough and exacting.[398] LECs should be prepared to submit extensive support materials in defense of their above-cap rate proposals.[399] We have chosen stringent review standards in order to preserve the price cap incentive to reduce costs and keep rates within a zone of reasonableness. In support of an above-cap rate increase, LECs shall include with their proposals: (1) cost support data broken down to the lowest possible level for each relevant basket for each of the most recent four years under price cap regulation; (2) a detailed explanation of the reasons for the prices of all rate elements to which the LEC does not assign costs; (3) a comprehensive explanation of how the carrier allocated costs among rate elements in the relevant basket; and (4) an explanation of the manner in which the LEC has allocated all costs, not just exogenous costs, among all baskets. This last element is particularly important if we are to guard against any cross-subsidy between less- and more-competitive services.

304. Above-cap filings will be found lawful only in the unlikely event that these rules have the effect of denying a LEC the opportunity to attract capital and continue to operate, despite the low end adjustment mechanism and the opportunity provided the LEC to increase its earnings through greater efficiency.[400] A LEC may request an above-cap rate increase by filing a tariff transmittal that complies with specific rules for such filings, a showing that includes but is not limited to the cost support information normally required in annual access tariff filings for LECs subject to rate of return regulation, and other information sufficient to establish that the increase is needed if the LEC is to have an opportunity to attract capital. We anticipate that any such increase will present