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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
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IN THE MATTER OF THE JOINT NOTICE OF INTENT OF VERIZON COMMUNICATIONS, INC., AND MCI, INC., ON BEHALF OF ITS REGULATED SUBSIDIARIES	**DOCKET NOS: T-01846B-05-0279 T-03258A-05-0279 T-03475A-05-0279 T-03289A-05-0279 T-03198A-05-0279 T-03574A-05-0279 T-02431A-05-0279 T-03197A-05-0279 T-02533A-05-0279 T-03394A-05-0279 T-03291A-05-0279** **NOTICE OF COMPLIANCE FILING**

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This notice is being filed pursuant to Ordering Paragraph 1 and the Arizona Corporation Commission Staff's Recommendation B as outlined in the Arizona Corporation Commission's Decision No. 68348.

On August 22, 2006, Verizon Communications Inc. filed comments with the Federal Communications Commission in the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board, CC Docket No. 80-286, a copy of which is attached to this notice.

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Arizona Corporation Commission
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RESPECTFULLY SUBMITTED this 30th day of August, 2006.

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By: [signature]

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COPY of the foregoing hand-delivered this 30th day of August, 2006, to:

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

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

Comments of Verizon

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August 22, 2006

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

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Comments of Verizon[1]

I. SUMMARY.

Virtually all segments of the communications marketplace operate in fundamentally different ways today than they have at any point in the past. Extensive intermodal competition and new technologies, combined with heightened consumer demand for the benefits of greater efficiency and lower prices they receive from any distance and bundled service offering, have fundamentally transformed the communications marketplace. These changes have both transformed the competitive landscape, and rendered artificial regulatory distinctions between local and long distance services – as well as interstate and intrastate services – unsustainable anachronisms. Because of these fundamental market changes, it is long past time to eliminate any remaining regulatory regimes that regulate the rates or services of only one among many providers. This is especially true of any such regimes that regulate rates based on archaic notions of cost together with any accompanying requirements to implement these antiquated schemes, including rules governing the allocation of costs between services or regulatory jurisdictions, such as the separations rules at issue here.

[1] These comments are being submitted on behalf of the regulated, wholly-owned subsidiaries of Verizon Communications Inc. ("Verizon").

While this Commission and many of the states have undertaken reforms to move away from cost-based regulatory regimes, that is not yet true in all cases, and those states that have not reformed their regulatory regimes generally assert that they rely on the Commission's separations rules for ratemaking purposes. That is not, however, cause to retain burdensome vestiges of historical rate regulation schemes in those states that have implemented reforms. Until the reform process is completed, the Commission should establish a mechanism to eliminate preemptively separations requirements in jurisdictions that have already transitioned to regimes that do not impose regulatory requirements based on archaic notions of cost or otherwise rely on separations and then preempt those states from imposing any new cost allocation rules. In jurisdictions that do still rely on separations, the Commission should extend the current freeze and encourage regulators in those jurisdictions to eliminate archaic rate regulation regimes and accompanying unworkable cost allocation rules in order that consumers may fully realize all the benefits of today's intensely competitive marketplace.

Taking these steps now will advance the goals of competitive neutrality and administrative simplicity that underlie this proceeding and will establish certain, uniform, nationwide rules that are conducive to investment in new technologies and services.[2]

II. IN TODAY'S MARKETPLACE, RATE REGULATION REGIMES AND THE ACCOMPANYING REGULATORY REQUIREMENTS TO IMPLEMENT THOSE REGIMES ARE UNNECESSARY AND ANTICOMPETITIVE AND MUST BE ELIMINATED.

Rate regulation regimes and their accompanying requirements, particularly when applied to only one of many service providers, are irrational and counter-productive in

[2] *See Jurisdictional Separations and Referral to the Federal-State Joint Board*, Order and Further Notice of Proposed Rulemaking, 21 FCC Rcd 5516, ¶ 28 (2006) ("FNPRM").

today's competitive marketplace. The deployment of new technologies and services combined with intense competition have changed both the services demanded by customers and the way in which carriers provide those services. At a time when the telecommunications market was considered a natural monopoly, rate regulation regimes in general, and the separations process in particular, were aimed at preventing carriers from overcharging ratepayers, in the latter case by setting intrastate and interstate rates to recover the same investment. FNPRM, ¶ 2. Today, the prevalence of meaningful competitive alternatives ensures that rates will remain reasonable even in the absence of regulatory oversight.[3] Moreover, in any multiple-product, multiple-jurisdiction firm, allocating costs among services and jurisdictions is an arbitrary exercise that no longer rationally or economically reflects how services are provided. In this regard, Dr. William Taylor has emphasized "the impossibility – not just in practice but in principle – of assigning fixed common costs and network investment in any economically meaningful way to particular services in particular jurisdictions." *See* Declaration of William Taylor, ¶ 94, Attachment C to Comments of Verizon, WC Docket No. 05-25, filed June 13, 2005 ("Taylor Decl."). And that problem is all the more pronounced given the deployment of new technologies and services.

[3] *See Verizon Communications Inc. and MCI Inc. Applications for Approval of Transfer of Control*, Memorandum Opinion and Order, 20 FCC Rcd 18433, ¶¶ 3, 91 (2005) (noting "the rapid growth of intermodal competitors – particularly cable telephony providers (whether circuit-switched or voice over IP (VoIP) – as an increasingly significant competitive force in [the mass] market," anticipating "that such competitors likely will play an increasingly important role with respect to future mass market competition," and explaining that "the record reveals that growing numbers of subscribers in particular segments of the mass market are choosing mobile wireless service in lieu of wireline local services").

A. Intense Competition Eliminates the Need for Historical Rate Regulation Regimes and the Rules that Accompanied Them.

There is no longer any serious dispute that the communications marketplace has undergone a fundamental transformation.

Cable telephony alone provides intense competition for traditional telephone service. Cable companies already offer voice telephone service to the large majority of customers across the country and are expected to offer service to some 84 percent of households by the end of this year, with that figure increasing to more than 90 percent by the middle of 2007 alone.[4] For example, Comcast now markets its phone service to 26 million homes (60 percent of homes passed), expects to be marketing to 80 percent of homes in its footprint by year end, and added more than 300,000 VoIP customers in the second quarter alone for a total of 1.7 million voice customers.[5] Time Warner Cable has been offering VoIP service in all 31 of its markets since the end of 2004,[6] and added some 234,000 digital voice customers in the second quarter for a total of 1.6 million.[7] Cox has announced that it would offer voice service in all of its markets by the end of 2006, that it has 1.8 million residential customers and another 150,000 business

[4] Craig Moffett, *et al.*, Bernstein Research Call, *Quarterly VoIP Monitor: Six Million and Counting* at Exhibit 17 (2006). *See also* John C. Hodulik, *et al.*, UBS, *Vonage Holding Corp.* at 10 (2006) ("Cable telephony is available in roughly 70% of homes passed by cable infrastructure today. This is expected to grow to more than 90% of homes passed by mid-2007.").

[5] Comcast Press Release, *Comcast Reports Second Quarter 2006 Results* (July 27, 2006) http://www.cmcsk.com/phoenix.zhtml?c=147565&p=irol-newsArticle&ID=888265&highlight=. This does not include systems recently acquired from Adelphia and Time Warner Cable.

[6] Time Warner Earnings Release, *Time Warner Reports Results for 2004 Full Year and Fourth Quarter* (Feb. 4, 2005) http://ir.timewarner.com/releases.cfm?ptype=1. This does not include systems recently acquired from Adelphia and Comcast.

[7] Time Warner News Release, *Time Warner Inc. Reports Second Quarter 2006 Results*, http://ir.timewarner.com/downloads/2Q06release080206.pdf (Aug. 2, 2006).

customers, and that its telephone penetration is nearly one-quarter of all homes passed by its network.[8] Cablevision – which in 2003 became the first cable operator in the U.S. to deploy IP-based telephone service *throughout* its cable service territory[9] – recently announced that it has surpassed one million Optimum Voice customers, and noted that the service has already reached penetration of one-third of the company's cable customers and more than one-half of its high-speed Internet customers.[10] Cablevision added 122,000 voice customers in the second quarter of 2006.[11] Analysts expect that Cablevision will be the voice provider for 27 percent of the homes it passes by the end of 2006.[12] There are already almost 6.7 million cable telephony subscribers,[13] and cable companies are expected to serve more than 8.5 million lines by the end of 2006 and more

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[8] Cox News Release, *Cox Digital Telephone To Be Available in All Cox Markets by End of Year* (July 13, 2006) http://phx.corporate-ir.net/phoenix.zhtml?c=76341&p=irol-newsArticle&t=Regular&id=881924&.

[9] Cablevision News Release, *Cablevision Completes Network Rebuild* (Dec. 3, 2003) http://www.cablevision.com/index.jhtml?id=2003_12_10.

[10] Cablevision News Release, *Cablevision's Optimum Voice Surpasses One Million Customers* (July 18, 2006) http://www.cablevision.com/index.jhtml?id=2006_07_18.

[11] Cablevision News Release, *Cablevision Systems Corporation Reports Second Quarter 2006 Selected Operating and Financial Measures* (Aug. 8, 2006) http://www.cablevision.com/index.jhtml?id=2006_08_08.

[12] Craig Moffett, *et al.*, Bernstein Research, *Cable 2Q06 Preview: The Ideal Defensive? Raising Target Prices for Comcast and Cablevision* at Exhibit 46 (2006).

[13] *See* NCTA, *Broadband Deployment*, http://www.ncta.com/ContentView.aspx?contentId=57 (last visited Aug. 22, 2006) (6.7 million cable telephony subscribers as of March 2006).

than 13 million lines by the end of 2007.[14] In fact, some analysts expect cable telephony to enjoy a share of more than 30 percent of all U.S. households by the end of 2010.[15]

Further, any customer with a broadband connection – which is now available to more than 90 percent of U.S. households from a provider other than the incumbent LEC[16] – can obtain local and long distance phone service from an "over-the-top" VoIP provider such as Vonage, Skype, or 8x8. Millions of customers are in fact availing themselves of this option, and customers do view VoIP service as a replacement for their traditional phone line.[17] Vonage, Packet 8, and Lingo together serve more than two million subscribers.[18] Some 60 to 70 percent of Vonage customers bring their old wireline phone number with them when they subscribe to Vonage's VoIP service.[19]

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[14] Jeffrey Halpern *et al.*, Bernstein Research Call, *Quarterly VoIP Monitor: Six Million and Counting*, at Exhibit 18 (2006).

[15] Frank G. Louthan IV, Raymond James Equity Research, *Reassessment of Access Lines and Wireline Carriers* at 3 (2006) ("*Reassessment of Access Lines*").

[16] *See, e.g.*, NCTA, *Industry Overview: Statistics & Resources*, http://www.ncta.com/Docs/PageContent.cfm?pageID=86 (last visited Aug. 22, 2006) (estimating 117.8 million homes passed by cable modem service in 2006); Leichtman Research Group, Inc., Research Notes 1Q06 at 7 (Mar. 15, 2006) (estimating 107.5 million homes passed by cable modem service provided by the top 10 MSOs).

[17] *See, e.g.*, Ken Belson, *Customer Loss to Internet Continues to Hurt Phone Carriers*, New York Times at C3 (Aug. 2, 2006) (Vonage added 256,000 subscribers in the second quarter of 2006 "and now has 1.85 million customers, more than twice what it had a year before. The company indicated it expects to have as many as 2.45 million subscribers by the end of 2006.").

[18] *See* Aryeh B. Bourkoff, *et al.*, UBS, *2Q06 HSD/VoIP Review & Outlook: Triple-play Tilting the Scales in HSD* at Table 5 (2006).

[19] *See* Doug Shapiro *et al.*, Banc of America Securities, *Battle for the Bundle* at 30 (2005).

In addition, wireless phone subscribers now outnumber wireline subscribers by an ever-widening margin,[20] and consumer surveys reveal that wireless service has displaced 64 percent of long distance and 42 percent of local calling from landlines in households with wireless phones.[21] Moreover, an estimated six percent of residential customers have replaced their landline phone with wireless service,[22] and one-quarter of all households are expected to be wireless-only by 2010.[23]

The net result of all this competition, not surprisingly, is that traditional local phone companies are losing many millions of lines each year. Verizon alone has lost approximately 11 million lines since the end of 2002 – a decrease of 18 percent – and its local subscriber base continues to shrink.[24] In light of this vigorous competition,

[20] *See* CTIA, *Wireless Quick Facts* (Apr. 2006), http://files.ctia.org/pdf/Wireless_Quick_Facts_April_06.pdf ("*Wireless Quick Facts*") (As of the end of 2005, there were 207.9 million U.S. wireless subscribers); FCC Industry Analysis Division, *Local Telephone Competition: Status as of December 31, 2005* (July 2006) at Table 1 (there were 175.4 million wireline subscribers as of the end of 2005).

[21] Kate Griffin, Yankee Group Report, *Pervasive Substitution Precedes Displacement and Fixed-Mobile Convergence in Latest Wireless Trends*, at 5 & Exhibit 3 (Dec. 2005).

[22] *Wireless Quick Facts*. At least one analyst puts the number even higher: "Between 10% and 15% of the total market is now using wireless exclusively." Jack Dierdorff, *Dialing into Wireless Stocks*, Business Week Online, Mar. 7, 2005, http://www.businessweek.com/bwdaily/dnflash/mar2005/nf2005037_6375_db006.htm. Analysts also estimate that, by 2009, between 23 and 37 percent of wireless subscribers will use a cell phone as their primary telephone. *See* Dinesh C. Sharma, *Consumers Ready To Ditch Landlines*, CNET News.com, Oct. 25, 2005, http://news.com.com/Consumers+ready+to+ditch+landlines/2100-1039_3-5913185.html.

[23] *See Reassessment of Access Lines* at 2.

[24] *Compare Verizon Investor Quarterly, Q4 2002* at 13, http://investor.verizon.com/financial/quarterly/vz/4Q2002/4Q02Bulletin.pdf (Jan. 29, 2003); *with Verizon Investor Quarterly, Q2 2006* at 14, http://investor.verizon.com/financial/quarterly/VZ/2Q2006/2Q06Bulletin.pdf (Aug. 1, 2006).

traditional phone companies are under tremendous pricing pressure.[25] With customers already leaving at an increasingly rapid pace, any effort to charge excessive rates would be economically irrational. This marketplace reality renders historical rate regulation regimes, and the burdensome cost allocation rules that accompany them, such as separations, a harmful anachronism. And that is especially true when unfairly applied only to one of many providers in a given market.

Separations indeed imposes considerable costs on carriers, costs ultimately absorbed by consumers, either directly in the form of higher prices or indirectly through reduced investment. In fact, under the pre-freeze separations process, carriers had to perform more than 475 separate studies. Verizon alone devoted at least 60 employees and 11 major computer systems to maintaining the separations databases and performing separations calculations. As the Commission recognized in instituting the separations freeze in 2001, costly separations studies needed to be discontinued in order to "reduce regulatory burdens on carriers during the transition from a regulated monopoly to a deregulated, competitive environment in the local telecommunications marketplace." *Jurisdictional Separations and Referral to the Federal-State Joint Board*, Report and Order, 16 FCC Rcd 11382, ¶ 13 (2001) ("*Separations Freeze Order*"). The burden of separations is even more significant today given the tremendous growth in competition from entities – such as cable companies, VoIP providers, and wireless service providers – that are not saddled with regulatory cost allocation and accounting obligations.

[25] *See, e.g.*, Marguerite Reardon, *Verizon Plays Hardball on Pricing*, News.com, Nov. 9, 2005, http://news.com.com/Verizon+plays+hardball+on+pricing/2100-1037_3-5942158.html ("Verizon Communications has reduced rates on its traditional telephony service to new lows as it tries to compete with cable companies who are now offering telephony as part of their own packages.").

B. **Separations Should Be Preemptively Discontinued on a Per-Carrier, State-by-State Basis Where Regulation No Longer Relies on Separated Costs.**

Even before the 1996 Act, the Commission and many state regulators started to move away from tying rates to regulated accounting costs. In adopting price cap regulation for larger local phone companies in the early 1990s, for example, the Commission explained that an incentive-based form of rate regulation, which regulates prices directly, would be more effective and efficient than traditional rate-of-return regulation. *See, e.g.*, *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, ¶ 21 (1990) ("a properly-designed system of incentive regulation will be an improved form of regulation, generating greater consumer benefits"). And subsequent changes to the price cap rules – the elimination of sharing obligations and (for carriers that obtain pricing flexibility) of the low-end adjustment – have eliminated the nexus between interstate access rates and costs. *See Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, 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, ¶¶ 147-155 (1997) (eliminating sharing); 47 C.F.R. § 69.731 (prohibiting carriers with pricing flexibility from seeking a low-end adjustment).

Many states have followed the Commission's lead, and the move away from cost-based regulation has only accelerated in recent years as competition has intensified. A large majority of states no longer employ cost-based regulation, although some states do continue to utilize separations less directly. Most states that have moved from return-based regulation have adopted cost-independent price cap mechanisms or social contracts that freeze certain rates for a period of time, and an increasing number have deregulated major categories of rates altogether. In the states that do not rely on separations, separations is irrelevant.

Separations also is not needed to advance other legitimate regulatory ends. Notwithstanding the suggestion of some state regulators, *see* FNPRM, ¶ 35, Section 254(k) does not require jurisdictional separations. Section 254(k) states only that the Commission shall "establish any *necessary* cost allocation rules ... to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services." 47 U.S.C. § 254(k) (emphasis added). As an initial matter, that section says nothing at all about the allocation of costs between regulatory jurisdictions, nor does it require an arbitrary and artificial allocation of costs between the interstate and intrastate jurisdictions in any instances where rates are not regulated based on costs. Moreover, because competition effectively disciplines telephone rates, and in any event the Commission and many state regulators have largely moved away from cost-based rate regulation, cost allocation rules of any kind – whether among services or between regulatory jurisdictions – are unnecessary in those states.

Further, separations reform would not help the Commission to evaluate the reasonableness of special access rates. *See* FNPRM, ¶ 36. Special access rates are competitively disciplined and have been declining in real terms in both price cap and price flex areas. In fact, in an analysis submitted in June 2005, Verizon showed that its overall special access revenues per line had dropped by 16.6 percent per year in real terms since 2001, and that between 2002 and 2004, DS1 and DS3 prices paid by customers fell by 5.7 and 7.6 percent, respectively, in real terms. *See* Taylor Decl., ¶¶ 14, 16, 26 & Table 3. And, while the category-specific rates of return calculated under the Part 69 rules are economically meaningless, as noted above, revising the separations process will not produce a more accurate picture of special access earnings. This is so because any effort to allocate costs among services or regulatory jurisdictions is inherently arbitrary, and has become even more so with the introduction of new services and technologies.

1. A Carrier-Initiated, Optional Mechanism for Seeking Relief from Separations Will Promote Deregulation While Accommodating Variations in State Regulation.

States use a variety of mechanisms to regulate local rates. While the majority of states have moved away from cost-based regulation, a distinct minority do still utilize separations-derived costs as a basis for certain intrastate regulation. Therefore, the Commission should establish a glide path toward discontinuing separations requirements in jurisdictions that no longer utilize separations and adopt a mechanism now that permits carriers to eliminate separations in those jurisdictions that no longer rely on separated costs.

In particular, to ensure a smooth transition with minimal burdens on both carriers and states, the Commission should adopt a streamlined process to remove separations requirements on a per-carrier, state-by-state basis. This process should allow any carrier no longer subject to regulation that relies on costs in a particular state to petition this Commission to eliminate separations requirements for that state. The separations requirements should automatically end for that carrier in that state if the state does not object within a set period and demonstrate that separations-derived costs actually are used in regulating telephone rates. Such a process will benefit consumers by reducing unnecessary costs and promoting regulatory certainty, which fosters additional investment.

Once the Commission has eliminated separations requirements for a particular carrier in a particular state, it must then prospectively preempt any state rules requiring allocation of costs between the federal and state jurisdictions. Without such preemption, the benefits of deregulation would be lost, as carriers still would be required to incur the costs of complying with separations procedures despite their irrelevance. Further, carriers could be subject to many different state separations regimes, with far greater regulatory burden and costs than the current, unitary system. Compliance with such a patchwork quilt of inconsistent cost allocation obligations could not help but impede competition and create an uncertain investment environment.

The Commission has authority to adopt binding separations rules (including a federal policy that eliminates separations requirements in certain circumstances) and to preempt inconsistent state requirements. *See* 47 U.S.C. §§ 221(c), 410(c); *Crockett Tel. Co. v. FCC*, 963 F.2d 1564, 1567 (D.C. Cir. 1992) ("Although each state has great freedom to regulate intrastate rates, once the FCC has applied its jurisdictional separation, that part of the cost base deemed to be interstate is outside the jurisdictional reach of the state regulatory agency."), *Id.* at 1573 ("when the Commission has prescribed an applicable separation methodology, states are not free to ignore it"); *see also Hawaiian Tel. Co. v. Pub. Utils. Comm'n of Haw.*, 827 F.2d 1264, 1275-76 (9^{th} Cir. 1987), *cert. denied*, 487 U.S. 1218 (1988) (finding a state ratemaking methodology to be inconsistent with and thus "necessarily preempted" by federal separations methodology). Once the Commission has determined that elimination of these requirements serves the public interest, any state cost allocation rules would be preempted as inconsistent with the policy balance wrought by the Commission. *See Buckman Co. v. Plaintiffs' Legal Comm.*, 531 U.S. 341, 348 (2001) (finding obstacle preemption where "somewhat delicate balance of statutory objectives" could "be skewed by allowing" state-law claims); *Geier v. Amer. Honda Motor Co.*, 529 U.S. 861, 881 (2000) (a rule of state tort law that imposed a duty contrary to the "mix" of options permitted by federal regulations is conflict-preempted); *Edgar v. MITE Corp.*, 457 U.S. 624, 634 (1982) (finding obstacle preemption where state law "upset the careful balance struck by Congress"). State regulation of separations would impermissibly negate the Commission's determination that such rules are no longer necessary nor beneficial and create a competitive disadvantage.

2. **<u>Transitioning Away from Separations Where It Is No Longer Used in Ratemaking Is Consistent with *Smith*.</u>**

Discontinuing use of separations procedures where separations-derived costs are no longer used in ratemaking is consistent with *Smith v. Ill. Bell Tel. Co.*, 282 U.S. 133 (1930). In *Smith*, Illinois Bell contended that an order of the Illinois Commerce Commission prescribing rates for telephone service in the city of Chicago was confiscatory. *Id.* at 136. The Illinois Commerce Commission had established those rates based on Illinois Bell's costs, but without making any distinction between the intrastate and interstate property and business of the company. *Id.* at 146-47. In striking down the state's decision, the Court held that, under the circumstances presented, the separation of intrastate and interstate property, revenues, and expenses was "essential to the appropriate recognition of the competent governmental authority in each field of regulation." *Id.* at 148.

The *Smith* decision does not mandate separations regardless of the regulatory environment. *Smith* stands only for the proposition that, where rates are regulated based on costs, each jurisdiction must look only to the costs that fall within its "competent governmental authority." *Id.* Where rates no longer are tied to costs – a situation that the *Smith* Court did not consider – the failure to separate costs has no impact on a state's authority to "regulate the transactions within its own domain according to its own perception of public policy." *Id.* at 151.[26] Put another way, eliminating separations requirements where neither the state nor the Commission utilizes regulation that relies on cost respects both the states' and the Commission's rights to determine the appropriate method of regulation in their respective jurisdictions, which is all that *Smith* requires. *See also United States v. RCA Alaska Comm'ns, Inc.*, 597 P.2d 489 (Alaska 1979) ("[S]eparation of intrastate and interstate business is not compelled by the . . . jurisdictional limits expressed in *Smith*."), *overruled on other grounds*, *Owsichek v. State*, 627 P.2d 616 (Alaska 1981).

III. PENDING THE ULTIMATE ELIMINATION OF SEPARATIONS, THE COMMISSION SHOULD EXTEND THE CURRENT FREEZE AND REEMPHASIZE ITS BINDING NATURE.

Retooling current separations mechanisms would be futile – and quite possibly harmful to newly competitive markets. The problems endemic to separations cannot be fixed. The deployment of new technologies and services and consumer demand for any distance and bundled service offerings have fundamentally transformed the marketplace. In today's environment, historical efforts to artificially divide services into local and long

[26] Because separations procedures would be eliminated only where a state no longer relies on separated costs, state jurisdiction over intrastate rates would be unaffected. Therefore, transitioning away from separations on a per-carrier, state-by-state basis is consistent with Section 2(b) of the Act.

distance components, or between interstate and intrastate jurisdictions, have been overtaken by the marketplace, make little economic sense, and are increasingly unworkable. Any efforts to modify rather than displace the current fundamentally broken process will only make things worse. At this interim stage, stability is required. Accordingly, in any instances where separations is maintained, the Commission should retain the current freeze indefinitely (until continued deregulation eliminates the use of separations-derived costs in all jurisdictions) and preempt any state efforts to impose different jurisdictional cost allocations.

A. The Commission Should Continue the Separations Freeze Rather than Seeking To Reform an Outdated and Arbitrary Mechanism.

The Commission should extend the current freeze indefinitely rather than attempting to develop a new "separations lite" approach. It would not be productive to expend scarce resources trying to fine-tune a separations methodology that (1) is supposed to provide only a rough justice allocation,[27] and (2) was frozen in order to "reduce regulatory burdens on carriers during the transition from a regulated monopoly to a deregulated, competitive environment in the local telecommunications marketplace," *Separations Freeze Order*, ¶ 13, a transition which is largely complete.

[27] *See Smith v. Ill. Bell Tel. Co.*, 282 U.S. 133, 148 (1930) ("the difficulty in making an exact apportionment of the property is apparent, and extreme nicety is not required, only reasonable measure being essential"); *see also La. Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 360 (1986) ("[T]he realities of technology and economics belie such a clean parceling of [inter- versus intrastate] parceling."); *General Communication, Inc.*, Memorandum Opinion and Order, 16 FCC Rcd 2834, ¶ 31 (2001) ("*Smith* recognizes that it is inherently difficult, if not impossible, to apportion with mathematical precision the uses of exchange plant equipment."); *MCI v. FCC*, 750 F.2d 135, 141 (D.C. Cir. 1984) ("*Smith* compels only reasonable measures, because the allocation of costs is not a matter for the slide-rule, but involves judgment on a myriad of facts.") (internal quotations omitted).

In adopting the freeze in 2001, the Commission recognized that the separations process cannot be reconciled with "rapid changes in the telecommunications infrastructure, such as the growth in Internet usage and the increased usage of packet switching" as well as "other new technologies, such as digital subscriber line (DSL) services," *Id,* ¶¶ 12 & n.32; *see also id.* ¶ 1. In the intervening five years, there has been an explosion of distance- and usage-insensitive services that defy jurisdictional classification and further exacerbate the arbitrary nature of jurisdictional cost allocations. As the Commission recently observed, "as more services are offered over a single loop, cost allocations are likely to become more arbitrary and thus less reasonable." *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities*, Report and Order and Notice of Proposed Rulemaking, 20 FCC Rcd 14853, ¶ 142 n.434 (2005) ("*Wireline Broadband Order*").[28]

In addition, any effort to resurrect some form of separations studies could have a deleterious effect on investment in new broadband networks, potentially limiting the reach and increasing the cost to consumers of valuable new services. Some parties already have wrongly suggested that recent deregulatory actions merit a substantial reallocation of investment from the state to the federal jurisdiction. *See, e.g.*, Comments of N.J. Division of the Ratepayer Advocate, WC Docket No. 05-342, at 10-11 (Jan. 23, 2006). If these views were reflected in new separations rules, network owners would

[28] Similarly, the Commission noted the futility of trying to devise "cost causality and usage measures" applicable to nonregulated broadband Internet access services: "These measures ... would have to reflect the evolution of the incumbent LECs' networks from traditional circuit-switched networks into IP-based networks. The proceedings to set these measures would be both resource-intensive and, given the changes in network technology from the time when the part 64 cost allocation rules were developed, likely to lead to arbitrary cost allocation results." *Wireline Broadband Order,* ¶ 134. The same holds true in the separations context.

face arbitrary, non-market-based limits on cost recovery, which would undermine incentives to make the massive investments that are required to deploy new, next-generation networks. Such an outcome would be inimical to the public interest and directly contrary to Congress's and the Commission's core goal of promoting the availability of broadband services.

Retaining the freeze also will avoid aggravating the regulatory disparity that already exists between incumbent LECs and their legions of intermodal competitors. Today, incumbent LECs are uniquely subject to rate regulation, regulatory cost accounting requirements, and detailed reporting obligations. The freeze initially was implemented in part to "reduce regulatory burdens" on incumbent LECs in the face of growing competition. *Separations Freeze Order,* ¶ 13. Allowing jurisdictional shifts in costs now, when competition has become so much more robust, would increase regulatory burdens at the very time regulation should be fading away. Accordingly, the Commission should continue the current freeze indefinitely, until all states have eliminated cost-based regulation for all carriers, and should preempt any inconsistent state cost allocation requirements for the reasons discussed above.

Against this background, it is noteworthy that some of the options discussed in the Glide Path papers prepared by the State members of the Separations Joint Board consider means of eventually eliminating separations altogether. *See* FNPRM at Appendix A, Glide Path Paper I, Option 7; *id.* at Appendix B, Glide Path Paper II Option 6. Under appropriate circumstances, these options have merit, and the mechanism outlined above provides a workable means of transitioning to a regulatory regime without separations at the appropriate time. That mechanism also is preferable to some of the other options set out in the papers, which propose to explore alternative means for allocating costs between the interstate and intrastate jurisdictions. *See id.* at Appendix A, Glide Path Paper I, Options 2-6; *id.* at Appendix B, Glide Path Paper II, Options 1, 3-5. Given the marketplace and regulatory changes discussed above – as well as the unavoidably arbitrary nature of any jurisdictional cost allocation – the Commission should minimize disruption and maximize certainty by continuing the freeze until separations is eliminated altogether.

Finally, the Commission should not require carriers to complete the Draft Data Request in Appendix C to the FNPRM. *See* FNPRM, ¶ 31. Any data collection, no matter how carefully crafted, would be burdensome and pointless. Likewise, any data collection would assume that there is some economically meaningful way to divide revenues in service bundles between federal and state jurisdictions and between regulated and non-regulated services, which is not the case. Further, any data collection would presume that the extent to which a particular portion of the network is used by a particular service is relevant to the ratemaking process. Again, this is not consistent with the reality of a marketplace that demands service bundles and carrier networks that support multiple, disparate services.[29]

B. <u>Carriers Cannot Be Compelled To Alter the Frozen Category Allocations while the Freeze Remains in Effect.</u>

In conjunction with continuing the existing freeze indefinitely, the Commission should make clear that states are not free to compel carriers to alter the frozen category

[29] Even if there were some reason to collect the type of data contemplated by the draft request, which there is not, imposing a data collection requirement now would be premature. The current freeze will extend until July 2009, and given dramatic changes in network usage and technology, any data collected in 2006 or 2007 likely would be stale by the time regulators sought to use them to craft a post-freeze separations process.

allocations. In this regard, the Commission should reject NARUC's request for a ruling that "all carriers must continue to directly assign all private lines and special access circuits based on existing line counts."[30] *See* FNPRM, ¶ 38. While NARUC seeks to characterize its position as seeking an "update" of the category allocations, in reality it would have the Commission adopt a whole new allocation mechanism, which is inconsistent with the *Separations Freeze Order* and the Commission's desire to "provide stability for carriers" by extending the freeze, FNPRM, ¶ 1.

Contrary to what NARUC implies, directly assigned amounts were not allocated between jurisdictions based on line counts prior to the freeze. Revising directly assigned amounts from one year to the next required a carrier to perform complex studies. In particular, directly assigned amounts were determined prior to the freeze by conducting the same investment studies as were used for any other category of cable and wire facilities or central office equipment investment. In the case of cable and wire facilities, the carrier had to perform a detailed examination of engineering records to obtain mileages, circuit types, and materials used and their relative costs. Burdensome examinations were also required to determine average book cost per mile and to develop average loop costs in order to calculate the directly assigned amounts. Similarly, for circuit equipment a detailed examination of engineering records was required to determine which pieces of circuit equipment (and their relative costs) were put on each

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[30] Likewise, some state regulators or regulatory staff have taken the position that Verizon must reallocate major portions of its network investment to the interstate private line category. *See Investigation into a Successor Incentive Regulation Plan for Verizon New England, Inc., d/b/a Verizon Vermont*, Dkt No. 6959, Order (Vt. Pub. Serv. Bd. Sept. 26, 2005). Similar arguments have been presented in an ongoing docket of the Maine Public Utilities Commission. *See* Direct Testimony of Robert Loube, Ph. D., on behalf of the Office of Public Advocate, Dkt No. 2005-155 (Maine Pub. Util. Comm'n Sept. 26, 2005).

circuit and what type of circuit was involved.[31] NARUC's proposal would resurrect this burdensome process.

Notably, there is no basis in the Commission's decisions for concluding that directly assigned amounts are somehow exempted from the freeze. The opposite is true: The *Separations Freeze Order* states that price cap carriers "will not have to perform the analyses necessary to categorize annual investment changes for interstate purposes" and further explains that, "[b]ecause a goal of the freeze is to reduce administrative burdens on carriers . . . any Part 36 requirement to segregate costs recorded in Part 32 accounts into categories, subcategories, or further sub-classifications shall be frozen at their percentage relationship for the calendar year 2000." *Separations Freeze Order*, ¶¶ 14, 22.[32]

Although the *Separations Freeze Order* notes that categories or portions of categories that had been directly assigned prior to the freeze should continue to be directly assigned, it makes clear that no investment studies are required: "[F]acilities that are utilized *exclusively* for services within the state or interstate jurisdiction are readily identifiable, [so] the continuation of direct assignment of costs [for those categories] will not be a burden." *Id.* ¶ 23 (emphasis added). In contrast, if a facility is used for both

[31] Moreover, revising a single category percentage results in changes to all category percentages in order to balance to 100 percent. Thus, altering any category percentage is inconsistent with the entire point of a separations category freeze.

[32] Similarly, the Joint Board's *Recommended Decision* regarding the freeze explained that "carriers will not have to perform the analyses necessary to categorize annual investment changes for interstate purposes. The major divisions of separations, such as central office equipment (COE) and [cable and wire facilities (C&WF)] investment will be allocated to the categories and, where appropriate, subcategories for the given year based on the frozen category relationships." *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, Recommended Decision, 15 FCC Rcd 13160, ¶ 19 (2000) (emphasis added).

interstate and intrastate purposes, the categories, sub-categories, and subclassifications pertaining to that facility, and the allocation of those categories, subcategories, and subclassifications, remain frozen at their 2000 levels.[33]

The Commission should reaffirm the broad scope of the freeze in order to prevent states from demanding the reclassification of investment from intrastate to interstate. Not only would such reallocation compel the same burdensome studies that the freeze was intended to eliminate, it would also result in a state's ability to reclassify as "interstate" investment that, under the Commission's rules, must be considered intrastate. Permitting states to mandate such reallocation would undermine the freeze as well as the overall concept of a unified, national approach to jurisdictional separations, and thus would be preempted. *See Crockett Tel. Co*, 963 F.2d at 1567, 1573; *see also Hawaiian Tel. Co.*, 827 F.2d at 1275-76.

[33] On June 28, 2001, representatives from Verizon, BellSouth, and (former) SBC met with Commission staff to discuss whether carriers had to continue to perform investment studies in order to revise directly assigned amounts. At that meeting, staff stated that it was not the Commission's intent that carriers should continue to do studies to determine directly assigned amounts. Staff suggested, however, that if there were some types of directly assigned equipment that could be readily identified from a company's accounting records, then that equipment could be directly assigned to a particular jurisdiction in accordance with paragraph 23 of the *Separations Freeze Order*. As a result of that discussion, Verizon began to directly assign DSLAM investment to COE Cat 4.13. Since investment dollars were being directly assigned to one particular category, it naturally changed the category percentages for the remaining categories as discussed above. On April 30, 2004, the Industry Analysis & Technology Division issued IATD letter 2004-14 questioning why Verizon's category percentages changed from the freeze base year percentages. When Verizon explained that the change was due to the direct assignment of DSLAM investment, the staff directed Verizon to "comply with the Commission's mandatory categories and factors freeze and not make any adjustments until the freeze expires" and to allocate "investment ... to the appropriate Part 36 separations categories and subcategories consistent with the percentage relationship for Verizon's calendar year 2000 results."

IV. CONCLUSION.

The Commission should establish a glide path toward the ultimate elimination of jurisdictional separations, retain the current freeze in the interim, and preempt the states from imposing any separations requirements that are inconsistent with the federal framework.

Respectfully submitted,

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August 22, 2006

Federal Communications Commission

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