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BEFORE THE ARIZONA CORPORATION COMMISSION

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JEFF HATCH-MILLER
Chairman

WILLIAM A. MUNDELL
Commissioner

MIKE GLEASON
Commissioner

KRISTEN K. MAYES
Commissioner

BARRY WONG
Commissioner

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

This notice is filed pursuant to Decision No. 68348, which required the filing of "all petitions and/or comments filed at the FCC or with Congress which seek preemption of state regulation." On November 20, 2006, Verizon filed reply 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. On October 25, 2006, Verizon field Comments on the Missoula Plan at the Federal Communications Commission in the Matter of Developing a Unified Intercarrier Corporation Regime, CC Docket No. 01-92. Copies of both filings are attached.

RESPECTFULLY SUBMITTED this 29th day of December, 2006.

By: Thomas H. Campbell
Michael Hallam
Lewis and Roca LLP
40 N. Central Avenue
Phoenix, Arizona 85004-4429
(602) 262-5723 (phone)
(602) 734-8341 (fax)

Attorneys for Verizon

ORIGINAL and thirteen (13) copies of the foregoing filed this 29th day of December, 2006, with:

Arizona Corporation Commission
Docket Control – Utilities Division
1200 W. Washington Street
Phoenix, Arizona 85007

COPY of the foregoing hand-delivered this 29th day of December, 2006, to:

Lyn Farmer, Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Christopher C. Kempley, Chief Counsel
Legal Division
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Maureen A. Scott
Legal Division
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Ernest G. Johnson, Director
Utilities Division
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

COPY of the foregoing mailed this
29th day of December, 2006 to:

Charles H. Carrathers, III
General Counsel, South Central Region
Verizon Inc.
HQE03H52
600 Hidden Ridge
Irving, TX 75015-2092

Deborah R. Scott
Snell & Wilmer, L.L.P.
One Arizona Center
400 E. Van Buren
Phoenix, Arizona 85004

Sherry F. Bellamy
Vice President and Associate General Counsel
Verizon Corporate Services Corp.
1515 North Courthouse Road, Suite 500
Arlington, VA 22201

Robert P. Slevin, Associate General Counsel
Verizon Corporate Services, Corp.
1095 Avenue of the Americas
Room 3824
New York, NY 10036

Mary L. Coyne
Verizon, Washington DC Inc.
2055 L Street, N.W., 5th Floor
Washington, D.C. 20036

Andrew B. Clubok
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Suite 1200
Washington, DC 2005

Jayne Williams

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20544

In the Matter of Developing a Unified Intercarrier Compensation Regime	CC Docket No. 01-92

COMMENTS OF VERIZON ON THE MISSOULA PLAN

Of Counsel:

Michael E. Glover

Karen Zacharia
Amy P. Rosenthal
VERIZON
1515 North Courthouse Road, Suite 500
Arlington, VA 22201-2909
(703) 351-3175

Counsel for Verizon

October 25, 2006

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20544

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COMMENTS OF VERIZON[1] ON THE MISSOULA PLAN

INTRODUCTION AND SUMMARY

The world has changed dramatically since the Commission issued the first Notice of Proposed Rulemaking in this docket, in which it sought comment on whether a broad restructuring of intercarrier compensation rules could meet the Commission's goals of promoting economic efficiency, enhancing competition, reducing the need for regulatory intervention, and mitigating arbitrage. Today, carriers are investing in new, next-generation platforms based on Internet protocol ("IP") — platforms that make possible vast new opportunities for consumers, for the economy, and for society. Competition among these IP-based platforms, including wireline telephone, cable, wireless, and others, is giving users choices they have never had before. As a result of these and other developments in new products and services, demand for traditional, circuit-switched voice services has declined and the amount of traffic exchanged on a circuit-switched basis is shrinking.

For these reasons, any solution to reforming existing intercarrier compensation rules the Commission adopts will necessarily be transitional in nature. Such a transitional plan must not, by rearranging the prices of legacy networks and services, interfere with the benefits that will

[1] The Verizon companies participating in this filing ("Verizon") are the regulated, wholly owned subsidiaries of Verizon Communications Inc.

flow to customers in the future through the dynamic process of developing new networks and services. Nor should any "plan" regulate the exchange of IP traffic, because that market is already working well today, without regulation. The Missoula Plan, however, is not focused on this future, but on the past. A plan focused on reforming the exchange of traffic among circuit-switched networks will not improve efficiency or facilitate the market's transition from the old world to the new one. Moreover, the rapid development of new competitive products and services is constraining service prices, calling into question the ability to sustain the price increases the Plan mandates.

As Verizon explained in prior filings in this docket, none of the previously submitted plans satisfied that forward-looking standard. On the contrary, all of them would have both failed to remedy existing arbitrage problems and disrupted the market-based efficiencies that are possible in a regime founded on negotiated, commercial arrangements between carriers. At a time when the market is changing so rapidly, the Commission should proceed with great caution, as the market has yet to adapt to the specific services customers want and at what cost those services should be provided. Sweeping and arbitrary changes that impose costs or affect carriers' revenue expectations may disrupt the development of the new networks and services that are the real keys to consumer benefits in the future. The Missoula Plan, like the previously submitted plans, falls far short of conformity with the Commission's stated goals for intercarrier compensation reform. It certainly fails to meet the key test of any transitional regime: doing no harm to investment in next-generation technologies.

As we have explained, to fulfill the Commission's goals for intercarrier compensation reform, any plan the Commission adopts should comply with six key principles.

First, interconnection does not always result in an equal exchange of value to the interconnecting networks. When interconnection benefits the connecting networks disproportionately, one normally compensates the other so that the transaction provides equal value to each. A default rule that does not recognize this principle provides disincentives for investment in network improvements, because network operators will be unable to recoup those investments and other providers will have strong incentives to free ride on the investments of the network operators.[2]

Second, any default rules should preserve existing negotiated arrangements — in particular, negotiated agreements for the exchange of packetized traffic — and facilitate new arrangements. Because the goal of any new regime should be to encourage carriers exchanging circuit-switched traffic to adopt negotiated arrangements, the Commission must ensure that any default rule does not become a mandatory rule in practice. This will occur if the default rule so favors one class of carriers that those carriers have no incentive (and their negotiating partners have no ability) to reach any alternative, even where a socially-optimal, wealth-maximizing alternative may exist.[3]

Third, any default rules should provide for positive rates and a more uniform rate structure for the various types of traffic than exists today. Positive rates reflect the market outcome that one network is compensated when interconnection does not result in an equal exchange of value and also provide appropriate investment incentives, while more uniformity

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[2] *See* Comments of Verizon in Response to Further Notice of Proposed Rulemaking at 3 (May 23, 2005) ("2005 Verizon Comments"); Reply Comments of Verizon In Response to Further Notice of Proposed Rulemaking at 2 (July 20, 2005) ("2005 Verizon Reply Comments").

[3] *See* 2005 Verizon Comments at 3-4; 2005 Verizon Reply Comments at 2-3.

among various types of traffic reduces opportunities for carriers to engage in arbitrage, including through non-compliance with the rules.[4]

Fourth, the system should be flexible enough to ensure recovery of costs currently recovered through intercarrier compensation. The purpose of the reform effort is to promote competition and eliminate arbitrage, not to reduce carrier revenues or end-user rates.[5]

Fifth, any default rules should avoid disruptive changes to existing interconnection architectures and legal precedent. Years of litigation have settled the requirements of the Telecommunications Act of 1996 ("1996 Act") and the Commission's regulations thereunder, and those requirements have been internalized by market participants. Upsetting these settled expectations will impose significant costs on carriers that will significantly reduce, if not outweigh, any benefits provided by new intercarrier compensation rules, while inevitably creating new arbitrage opportunities to be exploited.[6] Moreover, the costs of rearranging network architectures to comply with new rules will come at the expense of network improvements that further the transition to IP-based networks.

Sixth, the Commission should ensure that any new rules apply to both interstate and intrastate traffic, and the Commission should seek additional authority from Congress if necessary. The failure to do so will perpetuate existing arbitrage opportunities by allowing carriers to continue to exploit the disparity between inter- and intra-state rates. Although the Commission likely has the necessary authority to regulate intercarrier compensation for all traffic, the legal question is not a trivial one. Proponents of the plans submitted to the Commission, including the Missoula Plan, have overstated the certainty of the Commission's

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[4] *See* 2005 Verizon Comments at 4; 2005 Verizon Reply Comments at 3.

[5] *See* 2005 Verizon Comments at 4-5; 2005 Verizon Reply Comments at 3.

[6] *See* 2005 Verizon Comments at 5; 2005 Verizon Reply Comments at 3.

existing authority. If the Commission is not confident of its authority to regulate intrastate rates it should be cautious in adopting any new rules that apply to that traffic.[7]

The Missoula Plan does not satisfy many of these key principles. The Plan's significant defects, alone and together, should lead the Commission to reject it.

First, the Plan fails to remedy — and, in fact, exacerbates — the disparately high rates that mid-sized and rural incumbent local exchange carriers ("LECs") charge, which create arbitrage opportunities and inflate long-distance rates in urban areas. Any intercarrier compensation reform the Commission adopts should meaningfully reduce those rates by requiring all carriers to set their interstate access rates equal to those charged by carriers currently subject to the CALLS plan. The Plan also disproportionately benefits mid-sized and rural LECs to the detriment of both consumers and other carriers, including other carriers serving rural consumers. These benefits not only create new arbitrage opportunities, but also insulate mid-sized and rural carriers from competition, thereby harming consumers.

Second, the Plan is incredibly complex, necessarily creating opportunities for arbitrage, both obvious and hidden. Contrary to the Commission's directive that "any new plan should be simple to administer," FNPRM ¶ 61, the Plan creates an intricate web of rules, tracks, and exceptions. It is admittedly a difficult task to bring clarity, simplicity, and uniformity to intercarrier compensation, but the Plan does not come close on this score.

Third, despite all this complexity, the Plan fails to address a number of issues that are fundamental to intercarrier compensation reform. The Plan's rules regarding Voice over Internet Protocol ("VoIP") traffic are vague and incomplete, and also fail to ensure that VoIP providers will be able to enter markets, particularly rural markets. The Plan also presumes the continued

[7] *See* 2005 Verizon Comments at 33-42; 2005 Verizon Reply Comments at 28-29.

need for large subsidies for mid-sized and rural carriers, failing to account for the increased competition — particularly from intermodal competitors — that renders such subsidies unnecessary. And the Plan also fails to explain how the Restructure Mechanism will be funded and administered. The Plan also does little to induce states to participate or to compensate for their absence if they do not. The Plan also leaves open whether the Commission will preempt most state authority over intrastate rates, and has no provisions to account for the non-trivial possibility that the Commission will be found two or more years into the Plan to lack such authority. Intercarrier compensation reform will not be effective unless it applies to both inter- and intra-state rates.

Fourth, the Plan imposes massive — and unrecoverable — implementation costs due to the Plan's unnecessary overhaul of existing interconnection rules and its effort to trump, and thereby require the renegotiation of, the vast majority of existing interconnection agreements. By requiring carriers to devote financial and technological resources, as well as personnel, to comply with the Plan's new interconnection rules, the Plan diverts such resources away from investments in networks as carriers move to more efficient, less expensive, and feature-rich IP-based networks. The network restructuring the Plan compels bears no relationship to sound economic or technological network architecture, and therefore will contribute to network inefficiencies driven by regulation instead of market factors.

DISCUSSION

I. THE PLAN UNREASONABLY INSULATES MID-SIZED AND RURAL CARRIERS FROM COMPETITION BY MAINTAINING HIGH RURAL ACCESS RATES AND CREATING UNNECESSARY BENEFITS AND IMPLICIT SUBSIDIES FOR SUCH CARRIERS

A. The Plan Perpetuates Excessively High Rural Access Rates

Mid-sized and rural incumbent carriers' interstate and intrastate access charges are typically the highest such rates of all telecommunications carriers. As even the Plan's supporters recognize, such carriers currently charge interstate access rates that, on average, are *three times* larger than the interstate access rates of other incumbent LECs and of competing LECs. *See* Plan Ex Parte from The Missoula Plan Supporters, to Marlene H. Dortch, Secretary, FCC Attach. A (Aug. 22, 2006) ("Plan Ex Parte"). Mid-sized and rural carriers' average intrastate access rates are similarly out of proportion, on average doubling the intrastate access rates charged by other incumbent carriers. *See id.* The ranges of inter- and intra-state access rates charged by mid-sized and rural carriers are even more extreme, with the highest rates reaching nearly 10 and 35 cents per minute, respectively. *See id.*

Any sensible plan for intercarrier compensation reform would, at a minimum, dramatically reduce these rates, both in absolute and relative terms. The Commission can plainly do this, with respect to interstate rates, by requiring all carriers to reduce their interstate access rates to the levels currently maintained by the carriers subject to the CALLS plan.[8] CALLS brought about substantial reductions in the interstate access charge rates of the carriers subject to that plan, and it would be appropriate to create a more level playing field by extending that plan

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[8] *See* Sixth Report and Order in CC Docket Nos. 96-262 and 94-1 Report and Order in CC Docket No. 99-249 Eleventh Report and Order in CC Docket No. 96-45, *Access Charge Reform*, 15 FCC Rcd 12962, ¶ 1 n.1 (2000), *aff'd in part and remanded in part*, *Texas Office of Pub. Util. Counsel v. FCC*, 265 F.3d 313 (5th Cir. 2001).

to all carriers' interstate access rates. Such a reduction would have the added benefit of solving, to some degree, the competitive harms caused by the rate averaging rule and reducing, if not eliminating, subsidies that have no place in today's competitive marketplace.[9]

The Missoula Plan purports to confront the problem of the extremely high access charge rates of mid-sized and rural carriers. But the Plan does not meaningfully reduce those rates. In relative terms, the Plan actually exacerbates the disparity between mid-sized and rural incumbent carriers' access rates, and the access rates charged by other incumbent and competitive carriers. Indeed, under what the Plan's sponsors call their "solution," the Plan's target for Track 2 terminating intercarrier compensation is *sixteen times* larger than the target for Track 1, and the target for Track 3 terminating intercarrier compensation is *thirty-four times* larger than the Track 1 target.[10] And the Plan retains these high rates without any explanation for the disparity between rates for different Tracks.

Moreover, these relative differences are the *best* that the Plan's proponents can hope for, because the reductions in intrastate originating and terminating access rates for Track 3 carriers are voluntary for the first three years of the Plan, with preemption only a possibility from the fourth year onward. *See* Plan at 3. Therefore, there is no guarantee that Track 3 rates will not remain at their current levels, even as Track 1 rates are reduced significantly. The Plan's few incentives to encourage state participation — the Early Adopter Fund and access to the Restructure Mechanism, *see id.* at 3-4 — are unlikely to be sufficient to entice them. Those incentives pale in comparison to the structured, annual review found by the Tenth Circuit to be sufficient to induce state reform. *See Qwest Communications Int'l Inc. v. FCC*, 398 F.3d 1222, 1238 (10th Cir. 2005).

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[9] *See infra* Part I.C.

[10] *See* Plan Ex Parte Attach. B.

In addition, there are a number of respects in which the Plan permits rate *increases* for Track 3 carriers, even in states that voluntarily adopt the Plan. First, the Plan permits Track 3 carriers to remain under rate-of-return regulation — and, thereby, to avoid the "powerful profit incentive to reduce costs" that comes with price cap and other incentive-based regulation[11] — and also to remain in the NECA pool, which has been unable to provide the Commission with reliable cost information or earnings reports.[12] *See* Plan at 7, 18. NECA increased its switched access rates by 6 percent in the most recent annual access filing, and there is nothing in the plan to prevent further rate increases by NECA LECs or other Track 3 carriers. Second, the Plan allows a Track 3 carrier to increase intrastate access rates when they are below the carrier's interstate rates. *See id.* at 18 & n.5. Third, the Plan similarly allows some Track 3 carriers to increase reciprocal compensation rates. The Plan permits those Track 3 carriers with interconnection agreements that had provided for exchange of traffic subject to 47 U.S.C. § 251(b)(5) on a bill-and-keep basis to begin charging for that traffic, despite those interconnection agreements. *See id.* at 19.

Finally, even where the Plan appears to propose a meaningful reduction in rates for mid-sized and rural carriers — as with the proposed cap on tandem transit rates, *see id.* at 51 (proposing a cap of $0.0025 per MOU) — that appearance is deceiving. First, as a practical matter, only a nominal amount of transit traffic traverses mid-sized and rural carriers' switches; instead, those carriers primarily handle and derive revenue from originating and terminating traffic. Therefore, the rate cap will only marginally affect those carriers, if at all. Second, even as to the limited tandem transit traffic that such carriers handle, the cap has features and

[11] *See National Rural Telecom Ass'n v. FCC*, 988 F.2d 174, 178 (D.C. Cir. 1993).

[12] NECA's failure to comply with the Commission's tariff rules has prevented the Commission from fully investigating the NECA pool tariffs. *See* Memorandum Opinion and Order, *July 1, 2004 Annual Access Charge Tariff Filings*, 19 FCC Rcd 23877 (2004).

exemptions that limit its applicability. Indeed, some mid-sized and rural carriers' transit services are not subject to the cap, because the Plan exempts "[t]andem owners in Track 3" that offer "jointly provided tandem switched transport for access traffic." *Id.* at 54. In addition, the cap will increase with inflation, permitting increases "capped" rates charged by mid-sized and rural carriers, perhaps returning to the levels they are at today. *See id.* at 51. The plan also doubles the cap — to \$0.0050 — on *all* traffic that triggers the Plan's "Traffic Volume Limitation," not merely the traffic above the volume limitation. *Id.* at 52.

B. The Plan's Provisions Provide Disparate and Unjustified Windfalls to Track 2 and 3 Carriers

In addition to failing to lower mid-sized and rural access rates sufficiently, the Plan has numerous provisions that create new implicit subsidies and generate uneconomic wealth transfers for Track 2 and 3 carriers. These subsidies and windfalls disrupt the market, harm consumers and competition, and in some instances simply do not make sense. Below, we catalog some of the more obvious examples of preferential treatment for rural carriers in the Plan.

First, the proposed transport regime includes unwarranted exceptions that unreasonably advantage Track 2 and 3 carriers over Track 1 carriers. The Plan proposes, as a general matter, to require an originating carrier to deliver local traffic to the terminating carrier's "Edge." *Id.* at 41-42.[13] But Track 1 carriers are required to subsidize the transport costs of Track 2 and 3 carriers through the so-called "full" and "modified" Rural Transport Rules. Under the "full" Rural Transport Rule, a Track 1 carrier bears all of the cost of transporting traffic to a Track 2 carrier's Edge, as well as all of the cost of transporting the Track 2 carrier's traffic from a meet point to the Track 1 carrier's Edge. *See id.* at 34-35. As a result, the Track 1 carrier could bear

[13] The Plan defines an "Edge" as "the location on a carrier's network where it receives traffic for routing within its network and where it performs the termination function for traffic received from other carriers." Plan at 42.

three-quarters or more of the transport costs involved in the exchange of traffic between the two carriers. The "modified" Rural Transport Rule differs in only one respect, as it requires a Track 2 or 3 carrier to bear half the cost for the facilities used to transport their traffic from the meet point to the Track 1 carrier's Edge, instead of foisting all of those costs onto the Track 1 carrier, as under the "full" rule. *See id.* at 34. Thus, under the modified rule, the Track 1 carrier will bear well over half of the transport costs incurred in exchanging traffic with a Track 2 or 3 carrier. Further, under either scenario, the Track 1 carrier must bear all third-party transit costs for traffic in both directions when traffic is exchanged indirectly. *See id.* at 33-35. Other than a preference for shifting costs to other carriers, the Plan offers no rationale for these exceptions to the general rule for assigning transport costs.

The Plan's designation of permissible Edges also is a boon to Track 2 and 3 carriers. For example, a Track 1 carrier "*cannot* designate one of its End Offices as an Edge if that End Office subtends the carrier's own access tandem," *id.* at 45, while Track 2 and 3 carriers "may declare *any* eligible End Office to be an Edge, even if the End Office subtends the carrier's own access tandem," *id.* at 46. And while Track 2 and Track 3 carriers "may designate an eligible Trunking Media Gateway location that performs end office functionality, or a POP location that extends this trunking media gateway functionality, to be an Edge," *id.*, Track 1 carriers may do so only "for traffic terminating to its end offices that subtend its access tandem, in lieu of that access tandem itself," *id.* at 45. As a result, Track 2 and 3 carriers have far more choices about which points in their networks to designate as their Edges, which are the places to which other carriers must transport traffic. Therefore, Track 2 and 3 carriers can select Edges that increase the extent to which Track 1 carriers must bear the cost of transporting all the traffic they exchange with Track 2 and 3 carriers. Track 1 carriers, in contrast, have a more limited selection of Edges and, moreover, are precluded from using their local tandems as Edges, even though many carriers currently interconnect at local (rather than access) tandems. *See id.* at 43-44.

Third, the Plan favors mid-sized and rural carriers over Track 1 carriers through its rules for the federal Subscriber Line Charge ("SLC") rates and the "Restructure Mechanism," both of which address the recovery of costs currently recovered through intercarrier compensation. The Plan presumes that carriers will recover such costs first by increasing SLCs to the SLC cap, and only then through the Restructure Mechanism. But the Plan increases the SLC caps for Track 1 carriers to a higher level ($10) than for Track 3 carriers ($8.75), and further increases the SLC cap for Track 1 carriers to adjust for inflation. *See id.* at 20-21. This ignores the competitive reality of non-rural markets. If Track 1 carriers do not increase their SLCs to the cap — for example, because of the competitive markets that Track 1 carriers generally face — the Track 1 carriers cannot recover those amounts from the Restructure Mechanism.[14] Thus, the SLC cap serves as an artificial mechanism to reduce equal access to the Restructure Mechanism and the overall recovery of costs currently recovered through intercarrier compensation. Track 3 carriers, with their lower SLC cap that does not increase with inflation, are insulated from these aspects of the Plan. Indeed, because the Track 1 SLC cap rises with inflation, the gap between Track 1 and Track 3 eligibility for the Restructure Mechanism will grow over time.

The Restructure Mechanism's rules for addressing the so-called "access shift" also disparately favor Track 2 and 3 carriers. When a Track 1 carrier calculates its "access shift," it must — from the Plan's inception — determine that amount based on the number of access lines it currently has, as opposed to the number of access lines at the time the Plan took effect. That means that every access line lost to competition reduces a Track 1 carrier's recovery from the

[14] *See* FNPRM ¶ 101 (questioning "whether it is realistic to institute a regulated SLC for years to come, when market conditions may not allow carriers to charge such a SLC").

Restructure Mechanism. But "[u]nlike Track 1 carriers, Track 2 price-cap carriers that lose lines will not lose Restructure Mechanism dollars" until the fourth year after the Plan's inception. *Id.* at 73. Meanwhile, it appears that rate-of-return carriers — the vast majority of which are Track 3 carriers — are fully insulated from access line loss in the calculation of their "access shift." Such carriers determine revenue recovery simply "by comparing the revenues . . . that the carrier has under the existing system with the revenues that the carrier will have under the Plan (including SLC increases permitted under the Plan)." *Id.*

Finally, the Plan gives a windfall to mid-sized and rural carriers by re-indexing the existing rural High-Cost-Loop Fund ("HCLF") "based on the current nationwide average cost per loop for rural telephone companies." *Id.* at 77. After this re-indexing occurs, "the total amount of HCLF support will be increased in three equal steps over 24 months and recapped. Thereafter, the size of the fund will be subject to annual adjustments based on the rural growth factor." *Id.* Only mid-sized and rural carriers will benefit from this modification to the existing mechanism. Moreover, because there is no connection between this proposed modification to the HCLF and intercarrier compensation reform, this proposal appears designed simply to ensure such carriers' support for the Plan. Even assuming there is merit to the proposal to re-index the HCLF, such a proposal should be considered by the Commission in a separate proceeding that focuses on the HCLF and is not intertwined with numerous, unrelated intercarrier compensation issues.

C. The Plan's Preferential Treatment of Mid-Sized and Rural Carriers Insulates Those Carriers from Competition and Harms Rural and Non-Rural Consumers

The net effect of the Plan is both to insulate mid-sized and rural carriers from competition in their historic service territories and to provide them with advantages as they seek to expand beyond those territories. The Plan thus turns on its head the mandate of 1996 Act: "[t]o promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies."[15]

The Plan insulates mid-sized and rural carriers from competition by narrowly defining those carriers that qualify for Tracks 2 and 3 and, therefore, limiting the set of carriers that may take advantage of the preferential treatment that the Plan bestows on carriers outside Track 1. The Plan's definition of a "Covered Rural Telephone Company" — which is used to determine the carriers eligible for Tracks 2 and 3 — excludes a number of carriers that nonetheless serve the same rural consumers as those that qualify for Track 2 or 3 status. For example, but for the exclusion of affiliates of a Bell Operating Company ("BOC"), *see* Plan at 5, a number of Verizon's rural affiliates would qualify as Covered Rural Telephone Companies and as Track 2 carriers under the Plan, *see id.* at 5 n.4. Indeed, "[a]ll non-ILECs fall into Track 1," even those that serve rural areas predominantly (or even exclusively). *Id.* at 5. The Plan provides no rational reason why all carriers serving a defined high cost area are not eligible for the same treatment and the same opportunity to set rates that reflect the higher costs of serving those areas. And treating all such carriers as Track 1 carriers provides a clear competitive advantage to those incumbent mid-sized and rural LECs that qualify for Track 2 or 3 status, and an equally clear disadvantage to the rural customers of other carriers, who differ from other rural customers only in their choice of provider. Track 1 entrants have to charge lower rates, bear a greater proportion of transport costs, and can recover less from the Restructure Mechanism than incumbent Track 2 and 3 carriers under the Plan, which thus forces them to subsidize competitors.

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[15] Pub. L. No. 104-104, 110 Stat. 56, 56 (1996).

The Plan not only provides Track 2 and 3 carriers with these competitive advantages to shield themselves from competition in their traditional service territories, but also allows them to use those advantages as a sword when they compete outside those traditional territories. First, the Plan permits Track 2 and 3 carriers — but only such carriers — to purchase other Track 2 and 3 carriers without losing the benefits afforded to non-Track 1 carriers. *See id.* at 6. This gives Track 2 and 3 carriers an advantage over Track 1 carriers that seek to expand in (or into) rural areas. Second, the Plan permits Track 2 and 3 carriers to expand into Track 1 areas without limits, while still maintaining their Track 2 or 3 status in their historical regions. *See id.* The Plan has no mechanisms to prevent Track 2 or 3 carriers from using the beneficial rates, terms, and conditions in effect in their traditional region to fund their out-of-region competition. This is yet another way in which the Plan requires Track 1 carriers to subsidize other carriers. Such subsidization harms consumers because, as the Commission has recognized in another context, "payments from other carriers may enable a carrier to offer service to its customers at rates that bear little relationship to its actual costs, thereby gaining an advantage over its competitors." *ISP Remand Order*[16] ¶ 68.

The Plan's failure to reduce mid-sized and rural access rates meaningfully also prevents the Plan from addressing the effects of those access charges on long-distance carriers' retail rates, harming consumers in areas otherwise suited to even more aggressive competition in the provision of long-distance service and bundles including such service. The Commission's geographic rate averaging rules require long-distance carriers to pass on to their urban customers

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[16] Order on Remand and Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 16 FCC Rcd 9151 (2001) ("*ISP Remand Order*").

the high access rates of mid-sized and rural carriers.[17] As the Commission has recognized, the geographic rate averaging rule is "an implicit subsidy flowing from customers in low-cost areas . . . to customers in high-cost services areas." FNPRM ¶ 85. Moreover, that rule has tended to "drive increasing specialization of companies serving rural" areas to avoid the geographic rate averaging rule, "ultimately leading to higher costs and fewer competitive choices for rural consumers." *Id.* ¶ 86. Consumers in highly competitive urban areas are also harmed, because national long-distance carriers are unable to compete on a level playing field with regional long-distance carriers that serve only urban customers and do not have to include the mid-sized and rural carriers' high access rates in their average retail rates.

Finally, the overall result of preserving the disparately high rates for rural access is to perpetuate inefficiency. Through a combination of high access rates and rate averaging among long-distance carriers, mid-sized and rural LECs are implicitly subsidized by all non-rural consumers, and by rural consumers who choose alternative technologies such as wireless or IP-based telephony. As with all subsidies, this one encourages overconsumption of the subsidized service (traditional wireline telephony in rural areas), and underconsumption of other services, even if they are technologically superior. Similarly, the access subsidy to mid-sized and rural LECs may tend to discourage investment in non-subsidized but more efficient alternatives. Thus, by creating disincentives for investment in IP, wireless, and other alternatives, high mid-sized and rural access rates paradoxically hinder competition, reduce choices, and harm the very consumers they are intended to benefit.

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[17] *See* 47 C.F.R. § 64.1801.

II. THE PLAN'S COMPLEXITY WILL CREATE, RATHER THAN ELIMINATE, ARBITRAGE OPPORTUNITIES

Since the passage of the 1996 Act, the Commission, state commissions, and carriers of every stripe have spent vast amounts of time and money litigating about the existing intercarrier compensation regime and the arbitrage schemes that arose as carriers sought to find and exploit loopholes. There is no certainty that any new regime will avoid such uneconomic results and arbitrage opportunities. But the complexity of the Missoula Plan — with 111 pages of new rules, conditions, and classifications — is necessarily vulnerable to arbitrage, simply by virtue of its complexity and the law of unintended consequences. In addition, there are numerous arbitrage opportunities apparent on the face of the Plan.

A. Experience Shows that a Complex Intercarrier Compensation Regime Breeds Inefficiencies and Arbitrage Opportunities

The Commission's directive regarding intercarrier compensation reform proposals was clear: "any new plan should be *simple* to administer." FNPRM ¶ 61 (emphasis added). There are many reasons to prefer simplicity to complexity in intercarrier compensation rules. A plan that is simple to administer, for example, will be easy to understand and implement, thereby reducing transaction costs for carriers and administrative costs for regulators. A complex plan, by contrast, creates those transaction and administrative costs and, moreover, is open to the possibility of arbitrage arising from the interaction of its complex parts.

The Commission's experience with the existing intercarrier compensation rules has demonstrated that even the most well-intentioned regulatory compensation regime can be manipulated in unforeseeable ways by carriers seeking arbitrage opportunities. Sometimes, the arbitrage may arise from an unforeseen change in technology, markets, or consumer preferences — the growth of VoIP services and the attendant arbitrage opportunities they present is one example. Other times the arbitrage may apply existing technology in some unforeseen way.

And sometimes the arbitrage may involve both — as demonstrated by the massive impact of applying reciprocal compensation to dial-up Internet traffic. But in each case, clever arbitrageurs found loopholes in complex systems that had been thought, at their inception, to be fair and immune from arbitrage.

Furthermore, the principal source of arbitrage problems under the existing rules is that their complexity induces strategic profit-seeking behavior by parties willing to revise or rearrange transactions just to exploit regulatory differences. This often occurs through rule evasion (or violation) designed to charge higher rates or pay lower ones. The Missoula Plan is not an improvement in this regard. Central to the Plan are "distinctions based on artificial regulatory classifications" — such as the distinction between all the rural carriers in Track 3 and the rural carriers that are in Track 1 because they are BOC-affiliated — that the Commission has said "create both opportunities for regulatory arbitrage and incentives for inefficient investment and deployment decisions." *Id.* ¶ 3. The Plan's complexity also gives rise to opportunities for rule evasion and violation that will require substantial enforcement efforts to detect and police, leading to the same kind of extensive litigation that has marked the ten-and-a-half years since the 1996 Act.

For all the talk of "rationalizing current regulatory distinctions" and creating "a far more efficient and stable" intercarrier compensation regime,[18] the Plan is far more complex than the Commission's current rules. Coming in at 111 pages, the Plan is longer and contains more rules than all the diverse current regulations combined. Those pages are filled with new default rules and interconnection terms and conditions that would create a system of multiple varying rates for different classes of carriers. For example, the Plan not only establishes different rules for three

[18] Plan Ex Parte Introduction at 2 (July 24, 2006).

separate categories (or Tracks) of carriers, but also allows different carriers in different Tracks — and sometimes in the same Track — to make elections between and among regulatory options that drive further disparities among carriers ostensibly within the same Track. This complexity and its concomitant indeterminacy will, at a minimum, impose on all carriers substantial administrative costs that will inevitably be borne by consumers. This complexity also will likely induce strategic behavior by carriers (and potentially by consumers) that produces no real benefits.

Finally, notably absent from the Plan is any meaningful role for privately negotiated agreements between carriers. Although the Plan is set up as a "default" regime — meaning that parties are free to negotiate different arrangements — the Plan so heavily favors mid-sized and rural carriers that there is no room to arrive at an optimal solution. That is, even if all parties would, in the aggregate, be better off under an alternative arrangement, the heavily skewed default rules may render them unable to reach that result. This is telling because the Commission has explained that "proposals that rely on negotiated agreements between carriers might be preferable to regimes requiring detailed rules and regulations," as intercarrier agreements are more "consistent with the pro-competitive de-regulatory environment envisioned by the 1996 Act." *Id.* ¶ 33. As Verizon has explained in prior submissions,[19] a market-based approach, based on negotiated, commercial agreements, is the best long-term solution to ensuring the efficiency of the telecommunications markets in the face of substantial technological change.[20]

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[19] *See* 2005 Verizon Comments at 6-15; 2005 Verizon Reply Comments at 20-21.

[20] *See* Report and Order, *Cellular Service and Other Commercial Mobile Radio Services in the Gulf of Mexico*, 17 FCC Rcd 1209, ¶ 27 (2002) ("[T]he best way to achieve reliable, ubiquitous service . . . is to encourage further reliance on negotiation and market-based solutions to the fullest extent possible.").

B. A Number of Arbitrage Opportunities Are Apparent on the Face of the Plan

First, and foremost, the Plan creates arbitrage opportunities through its failure meaningfully to reduce mid-sized and rural carriers' interstate access charge rates — such as to the level that CALLS carriers currently charge — as well as its failure to make meaningful reductions in intrastate access and reciprocal compensation rates, along with its further failure to guarantee that those limited rate reductions it proposes will actually take effect. The Plan's target for Track 2 terminating intercarrier compensation is sixteen times larger than the target for Track 1, and the target for Track 3 terminating intercarrier compensation is thirty-four times larger than the Track 1 target.[21] The Plan magnifies these relative differences by making Track 3 intrastate rate reductions voluntary for at least the first three years of the Plan. *See* Plan at 3. As the Commission has recognized, arbitrage can result when there are "different rates that different types of providers must pay for essentially the same functions." FNPRM ¶ 15. Thus, the non-trivial access rate differences create arbitrage opportunities by generating traffic subject to the Track 3 carriers' high access charges. This might occur by inducing customers to locate — either actually or nominally — in a Track 3 carrier's territory by offering to share the high access charges with those customers. Or carriers might find ways to route traffic through a Track 3 carrier to make it appear to be subject to the Track 3 carrier's access charges when it is not. In general, the non-trivial rate differences are likely to perpetuate the existing arbitrage opportunities to be had by misclassifying traffic as subject to higher (or lower) intercarrier rates depending on whether a carrier is trying to take advantage of those high rates (or avoid them).

A second arbitrage opportunity arises from the Plan's treatment of "out-of-balance" traffic. Under the Plan, when a carrier receives more than three times the traffic that it sends to

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[21] *See* Plan Ex Parte Attach. B.

another carrier, the receiving carrier becomes responsible to pay 100 percent of the transport costs involved in exchanging traffic between the two carriers. *See* Plan at 39-41. In so doing, the Plan creates the incentive for carriers to focus on outbound only customers, so as to shift those transport costs. For example a carrier might focus on outbound call centers, such as those that engage in telemarketing or polling. Some might seek to employ separate subsidiaries to handle originating and terminating traffic, or might even tailor calling plans to attract customers with disproportionate quantities of outbound calling. Still others might try to re-route third-party traffic so that the balance of traffic can be manipulated to appear as if more traffic is being originated than is in fact the case. These are essentially the mirror opposites of the arbitrage opportunity created by early state commission decisions holding that ISP-bound calls are subject to reciprocal compensation. As with the rule favoring ISP traffic, a rule favoring outbound traffic would similarly induce skewed and uneconomic behavior.[22]

Third, the Plan's rules for reductions to originating access charges create opportunities for regulatory arbitrage. The Plan establishes a schedule for the reduction of total access charges, which gives Track 1 carriers flexibility to decide how to reduce originating and terminating access charges to generate a twenty-five percent total reduction in access charges each year for three years. *See id.* at 11. Indeed, while the Plan does not require reductions in Track 1 carriers' originating access rates for the first three years of the Plan, it gives those carriers the option of immediately reducing originating access rates to zero. *See id.* at 12. This flexibility creates incentives for certain carriers to game the system by lowering originating access rates and thereby slowing the decline of their terminating access rates. This would likely be attractive to a carrier with relatively low originating access minutes. Such a carrier generates

[22] *See ISP Remand Order* ¶¶ 67-73.

almost all of its access revenue from terminating access charges. This carrier could reduce originating access charges to zero, without losing much revenue at all. At the same time, this carrier can limit (or perhaps eliminate) reductions in its terminating access rates for one or more years, while still complying with the twenty-five percent total reduction in access charges. As a result, the carrier can comply with the Plan while charging the highest possible rates on the only traffic that generates significant revenues.

Fourth, although the Plan establishes Edge rules for all Track 1 carriers, differences in the network architecture employed by incumbent LECs and competitive LECs creates opportunities for the competitive LECs to engage in arbitrage. Because incumbent LECs have typically employed a hub-and-spoke or spider-web network, with end office switches connected to each other and subtending tandems, the Edge rules proposed in the Plan substantially limit the locations that an incumbent LEC can select as an Edge. *See id.* at 45-46 (providing, for example, that a Track 1 carrier cannot select an end office as an Edge if that end office subtends the carrier's own tandem). But competitive LECs do not normally utilize that same architecture, and therefore have much more freedom in selecting the facilities they will designate as Edges. *See id.* at 46 (permitting a Track 1 carrier to designate a Trunking Media Gateway as an Edge if it subtends a different carrier's tandem). The definitions of some of the facilities that could qualify as an Edge for a competitive LEC appear sufficiently broad that a competitive LEC could likely arrange its network to locate "Edges" inside the premises of some of its large enterprise customers. *See id.* at 42-45. Incumbent LECs and other carriers would then be forced to transport traffic all the way to that competitive LEC's end-user customers, thereby enabling the competitive LEC to shift some of the costs of serving those customers on to other carriers.

Fifth, the Plan creates arbitrage opportunities by mandating a telephone-number based methodology "that will rely on the calling and called telephone numbers to determine" whether a call is access or non-access traffic. *Id.* at 25. Although the industry has historically used telephone numbers for this purpose, that was because those numbers correlated extremely well with customers' geographic locations, providing a cheap and reliable means of jurisdictionalizing calls. But the industry has not blindly relied on telephone numbers. In some cases, telephone numbers are consistently *inaccurate* in determining jurisdiction. For example, when a wireless customer roams into a neighboring MTA, the call between a landline customer in the neighboring market and the wireless customer will always appear to be interMTA, even when the calling and called parties are on the same street. In situations such as this, where telephone numbers have proven to be a demonstrably poor proxy for customers' geographic locations, and where the amount at stake was significant — such as leaky PBXs, Feature Group A traffic, and wireless roaming — the industry has turned to billing factors and other proxies instead of telephone numbers.[23] Today, telephone numbers are an increasingly poor proxy for geographic location, with explosion of wireless traffic, VoIP, and other services that provide consumers with non-geographic numbers. Yet the Plan proposes to switch to a pure telephone-number based system. Because the Plan also maintains distinctions between inter- and intra-state access charges, and between access charges and reciprocal compensation — particularly for Track 3

[23] *See, e.g.*, Memorandum Opinion and Order, *MTS and WATS Market Structure*, 97 F.C.C.2d 834, ¶ 108 (1984); Report and Order and Order on Further Reconsideration and Supplemental Notice of Proposed Rulemaking, *Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture Policy and Rules Concerning Rates for Dominant Carriers*, 6 FCC Rcd 4524, ¶ 66 (1991); First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 15499, ¶ 1044 (1996) ("*Local Competition Order*") (subsequent history omitted).

carriers — the exclusive reliance on telephone numbers will encourage manipulation of those numbers to obtain more favorable rate treatment.

The Plan's reliance on telephone numbers is problematic for another reason. The Plan adopts a presumption that traffic received without the telephone number of the calling party is subject to access charges or reciprocal compensation in the same proportion as traffic that is received with the telephone number. *See, e.g., id.* at 28. This default rule may not hold true for all carries — in some cases, the traffic received without telephone numbers is actually subject to lower charges overall than traffic with numbers; in other cases, the opposite is true. In all events, carriers normally address their specific circumstances in the context of negotiations to arrive at agreements that make sense for those carriers. Imposition of this one-size-fits-all rule, however, would grant windfalls to those carriers that (by happenstance or design) owe less (or receive more) from application of the Plan's default rule. These carriers no longer will have reason to negotiate a rule that accurately reflects their particular traffic characteristics, unless they can extract an equally valuable concession from the other party.

III. THE PLAN LEAVES UNRESOLVED A NUMBER OF CRITICAL ISSUES WITHOUT WHICH ANY REFORM TO INTERCARRIER COMPENSATION CANNOT HOPE TO BE EFFECTIVE

Despite the length and complexity of the Plan, it leaves significant issues unresolved. These unresolved issues, moreover, relate to key regulatory policy issues, such as the treatment of VoIP, and to central aspects of the Plan, such as the Restructure Mechanism and Commission preemption of state regulation.

A. The Plan Does Not Fully Address VoIP Traffic

In the Further Notice of Proposed Rulemaking, the Commission observed that "[t]he current intercarrier compensation system . . . does not take into account recent developments in service offerings, including . . . voice over Internet Protocol (VoIP) services." FNPRM ¶ 148.

The Plan does not fill this existing void. The Plan provides that "VoIP-originated traffic terminating to the PSTN [public switched telephone network]" is subject to "[t]erminating reciprocal compensation charges." Plan at 28. VoIP-to-PSTN calls also "will be designated as access traffic and subject to applicable terminating access charges when the telephone number of the calling party and the telephone number of the called party are associated with rate centers that are not in the same reciprocal compensation local calling area." *Id.* And when "VoIP-originated traffic . . . terminates on the PSTN and qualifies as access traffic," it will be subject to "[i]nterstate terminating switched access charges." *Id.* at 30.[24] But despite all of this, the Plan contains no rules for traffic in the other direction — that is, a call that originates on the PSTN but is delivered to a VoIP customer. This is not some minor oversight, as PSTN-to-VoIP calls are significant today and can only be expected to grow more in the future.

The Plan also does not address VoIP-to-VoIP calls. Some VoIP-to-VoIP traffic never transits the PSTN, because the two VoIP providers involved have entered into commercial arrangements pursuant to which they hand off the traffic to each other in IP format. Compensation for traffic so exchanged on an IP-to-IP basis is left to the VoIP providers' private negotiations, which is consistent with the deregulatory framework that applies today to the Internet.[25] The Plan, however, does not explicitly ensure that such successful commercial arrangements — negotiated in the absence of any regulatory compulsion — will be preserved. Moreover, the Plan also does not address VoIP-to-VoIP traffic that transits the PSTN because the

[24] However, the Plan does not explain how carriers would apply this rule. Today carriers that receive calls cannot independently differentiate VoIP-to-PSTN calls from non-VoIP-to-PSTN calls. As a practical matter, carriers likely would not be able to exempt those calls from the Plan's general mandate that carriers apply intrastate or interstate access rates apply to a particular call based on a comparison of the telephone numbers. The Plan provides no guidance as to how carriers should implement its rule in light of these limitations.

[25] *See* 2005 Verizon Comments at 19.

two VoIP providers have not yet entered into a direct exchange arrangement, likely because such an arrangement is not commercially warranted given the volume of traffic exchanged between their respective customers. Such calls, however, are handled by one or more wireline carriers en route from one VoIP provider to the other and at least some of these carriers will have no contractual relationship with either VoIP provider. These wireline carriers perform necessary work and incur various costs in handling this traffic, but the Plan does not contain any rules to govern the amounts the various carriers and VoIP providers involved in such a call will owe to each other.

Another significant gap regarding VoIP service under the Plan concerns the rights of VoIP providers to use third-party carriers to enter markets — particularly rural markets — to exchange traffic, to obtain number portability, and to arrange for billing and receipt of intercarrier payments. Recent state commission decisions threaten to prevent consumers in rural areas from sharing in the benefits enjoyed by the millions of consumers who already use VoIP technology.[26] The existence of these state commission decisions makes clear that any intercarrier compensation reform must establish clear rules regarding the provision of VoIP service, particularly to rural customers. This issue currently is pending before the Commission,[27] yet the Plan is silent on this issue.

[26] *See, e.g.*, Order Ruling on Arbitration, *Petition of MCImetro Access Transmission Services, LLC for Arbitration of Certain Terms and Conditions of Proposed Agreement with Farmers Telephone Cooperative, Inc., et al.*, Docket No. 2005-67-C, Order No. 2005-544, 2005 S.C. PUC LEXIS 241 (S.C. P.S.C. Oct. 7, 2005), *reh'g denied*, Order No. 2005-678 (Mar. 3, 2006); Order Ruling on Arbitration, *Petition of MCImetro Access Transmission Services, LLC for Arbitration of Certain Terms and Conditions of Proposed Agreement with Horry Telephone Cooperative, Inc. Concerning Interconnection and Resale Under the Telecommunications Act of 1996*, Docket No. 2005-188-C, Order No. 2006-2, 2006 S.C. PUC LEXIS 2 (S.C. P.S.C. Jan. 11, 2006), *reh'g denied*, Order No. 2006-111 (Mar. 3, 2006).

[27] *Petition of Time Warner Cable*, WC Docket No. 06-55.

B. The Restructure Mechanism Is Insufficiently Justified and Defined

The Plan presumes that mid-sized and rural carriers should continue to receive massive subsidies, through both disparately higher access charges rates and through the Restructure Mechanism. But that presumption is not valid in today's competitive market, where even consumers in the most rural areas have access to telephone services from cable companies, non-facilities-based VoIP providers, and/or wireless carriers. As Verizon has argued elsewhere, the Commission should question the need for such subsidies when consumers have access to quality services provided at affordable rates by a number of competing providers.[28]

Two consequences flow from today's increased competition, both of which undercut the purported need for a Restructure Mechanism that perpetuates today's subsidies. First, new intermodal service providers can, and in many cases do, operate without the help of *any* such support.[29] In areas where carriers are willing and able to offer service without such subsidies, those subsidies should be eliminated or vastly reduced as part of market-oriented reforms. Second, because telephone services are far more affordable than they were when the 1996 Act was adopted,[30] the need for such subsidies is proportionately diminished. By ignoring these competitive gains and creating yet another fund for the distribution of subsidies, the Plan inhibits consumers from fully realizing all of the benefits of new competition in telecommunications markets.[31]

Even aside from these facts, the Plan fails to define the Restructure Mechanism in a meaningful way. While the Plan details, at length, the manner in which money is to be paid *out*

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[28] *See* Comments of Verizon and Verizon Wireless, WC Docket No. 05-337, at 3-13 (Oct. 10, 2006).

[29] *See id.* at 7 & n.19.

[30] *See id.* at 7-9.

[31] *See id.* at 9-10.

of the Restructure Mechanism, the Plan says nothing about how the Restructure Mechanism is to be administered or how money is to be paid *in* to the fund. Both omissions are significant. In the eleven pages devoted to discussing how to calculate the access shift and the corresponding recovery from the Restructure Mechanism for various Tracks of carriers, there is not a word about who will conduct these calculations, whether they will be audited, whether there is an appeals process, or any other operational details of the mechanism. *See* Plan at 64-74. And, although the Plan sponsors estimate that the size of the Restructure Mechanism will be about $1.5 billion at the end of the Plan's transition period,[32] they fail to explain where this money will come from. This failure is not only a massive oversight, but also it is troubling to Track 1 carriers who have a reasonable concern that they will find themselves forced to fund yet another regulatory subsidy.

C. The Plan Deals Inadequately with the Challenges to Reforming Intrastate Access Rates

Perhaps most important among the unanswered questions, the Plan leaves open whether the Commission will exercise preemptive authority regarding certain intrastate access rates, while assuming that the Commission can preempt state regulation of other intrastate access rates whenever necessary.[33] To be effective, however, new intercarrier compensation rules must apply at both the interstate and intrastate levels. Many of the concerns regarding the current regulatory scheme — and some of the primary opportunities for arbitrage — are rooted in the efforts by some carriers to exploit the disparity between the interstate rates regulated by the Commission and the intrastate rates currently regulated by state commissions. A plan with voluntary state participation invites a continuation of such disparities and the arbitrage they foster. It is

[32] Plan Ex Parte Executive Summary at 1.

[33] *See id.* at 3.

impossible to analyze the Plan's operation completely without more definitive information regarding how many states are likely to opt out. Meaningful reform cannot exist if the regulation of compensation for intrastate traffic is left in the hands of more than fifty states and territories.

As Verizon has explained previously, the Commission has express authority to regulate intercarrier compensation for interstate and wireless traffic. *See* 47 U.S.C. §§ 201(b) (interstate), 332(c)(1) (wireless).[34] With respect to the intraexchange (local) traffic subject to § 251(b)(5), however, Congress gave the Commission express authority only to establish general rules governing the compensation for such traffic, with the various state commissions authorized to apply those general rules and set the actual rates. And Congress gave the Commission no express authority over wireline interexchange, intrastate traffic. Nonetheless, courts have repeatedly recognized that the Commission can regulate intrastate traffic in certain circumstances, when separate intrastate regulation would frustrate the federal regime and federal policy objectives.[35] Although the exercise of this authority to regulate intercarrier compensation for all traffic raises a non-trivial legal issue, there are reasonable arguments that would support the Commission's exercise of such authority under its established preemption authority.[36] Namely, as telephone numbers become increasingly detached from their historical, geographic affiliations it becomes increasingly difficult to separate traffic into intrastate and interstate components. In today's market, separate intrastate regulation would frustrate the federal regime and federal policy objectives.

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[34] Because Congress has expressly preempted state "regulat[ion] [of] . . . the rates charged by any commercial mobile service," "[n]otwithstanding section[] 2(b)," the Commission also has sole authority to regulate intercarrier compensation for intrastate wireless traffic. *See Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 800 n.21 (8th Cir. 1997) (subsequent history omitted).

[35] *See, e.g., id.* at 375-76 n.4; *Public Serv. Comm'n of Md. v. FCC*, 909 F.2d 1510, 1515 (D.C. Cir. 1990).

[36] *See* 2005 Verizon Comments at 36-38.

Despite the foregoing, the Commission's authority to preempt state regulation of intrastate access rates is not ironclad. For this reason, Verizon has urged the Commission, if it concludes that it lacks authority to regulate intercarrier compensation for wireline intrastate traffic or that the question is uncertain, to seek express authority from Congress *before* embarking on a plan that requires reductions in those intrastate rates in order to succeed. The Plan, however, encourages the Commission to act first, and figure out its preemption authority later. Following this advice will require the Commission to address its authority to regulate intrastate access rates in a piecemeal fashion. First, because the Plan calls for immediate reduction in terminating intrastate access rates for Track 1 and 2 carriers, *see*, *e.g.*, Plan at 8-9, 15, the Commission may face challenges from the Plan's inception. Then, because reductions to originating intrastate access rates are voluntary until at least the second year of the Plan for Tracks 1 and 2 and until at least the fourth year of the Plan for all intrastate access rates for Track 3 carriers, *see id.* at 3, it could be two to four years after the Plan's inception before the Commission faces challenges to its authority to regulate those intrastate access rates. As a result, the Commission and the industry could face a situation in which they are two or four years into the Plan, states are refusing to opt into the Plan, and the Commission finds (because the courts hold) that it is powerless to do anything about it. It would be irresponsible for the Commission to embark on so significant a regulatory matter without assurance that it can carry the project through to completion.

IV. THE PLAN'S NETWORK ARCHITECTURE RULES WILL IMPOSE SUBSTANTIAL AND UNNECESSARY IMPLEMENTATION COSTS

The Plan imposes network architecture and interconnection rules that differ substantially from the arrangements and rules in place today. Because the new rules disregard both present law and current technological advancements, carriers will face significant implementation costs if the Commission adopts the Plan. Moreover, those costs would divert resources from investment in IP technology, delaying the introduction of the networks of the future, with their increased efficiencies, lower costs, and greater array of services. Verizon estimates that its total implementation costs could be as much as roughly half a billion dollars.[37] And Verizon is not alone in this regard — all other carriers will have to incur these inefficient costs. These implementation costs are wholly unnecessary and not justified by the benefits purportedly attributable to the Plan.

A. The Plan Includes Rules of Questionable Legality, Compliance with Which Will Be Costly

Over the past ten years, carriers have engaged in extensive litigation before the courts, the Commission, and state commissions to resolve the interconnection issues created by the 1996 Act and the Commission's rules. Those disputes occur less frequently today, as the industry has largely internalized the existing rules. By rejecting that existing framework, however, the Plan threatens to undo much of the work of the past ten years. This is particularly wasteful because a number of the Plan's interconnection rules are legally questionable. Not only will such rules impose substantial implementation costs, but because they are legally questionable they may well be struck down after carriers have invested substantial resources to comply with them.

1. The Plan's direct interconnection rules, which would apply to all carriers, conflict with the "three-tiered hierarchy of escalating obligations based on the type of carrier involved" that Congress established in § 251.[38] The first tier, § 251(a), "imposes . . . duties on *all*

[37] This amount represents capital costs and expenses that would be sunk and unrecoverable.

[38] Declaratory Ruling and Notice of Proposed Rulemaking, *Guam Public Utilities Commission Petition for Declaratory Ruling Concerning Sections 3(37) and 251(h) of the Communications Act*, 12 FCC Rcd 6925, ¶ 19 (1997) ("*Guam Declaratory Ruling*").

telecommunications carriers,"[39] including the duty to "interconnect directly or indirectly with the facilities and equipment of other telecommunications carriers." 47 U.S.C. § 251(a)(1). This duty ensures "universal connectivity," so that calls can be completed between subscribers on different networks.[40] The third tier, § 251(c), "imposes the most extensive duties on [local exchange carriers] that are incumbent[s]."[41] As part of those duties, Congress imposed on incumbent LECs — and only incumbent LECs — the duty to permit interconnection at a point on the incumbent LECs' networks. *See id.* § 251(c)(2).[42] Yet the Plan expressly attempts to extend this duty to non-incumbent providers, by requiring *all carriers* to "permit other carriers with the financial obligation for interconnection to physically interconnect at its Edge for the purpose of *direct* interconnection." Plan at 41 (emphasis added).

Because the existing regime only requires carriers (other than incumbent LECs) to "interconnect directly *or* indirectly with the facilities and equipment of other telecommunications carriers," 47 U.S.C. § 251(a)(1) (emphasis added), carriers other than incumbent LECs have had no reason to build their networks with sufficient capacity to accommodate direct interconnection with every other carrier with which they exchange traffic. As a result, the Plan would require non-incumbent LECs to build into their networks the equipment necessary to permit direct

[39] *Id.* (emphasis added).

[40] Seventh Report and Order and Further Notice of Proposed Rulemaking, *Access Charge Reform*, 16 FCC Rcd 9923, ¶ 93 (2001).

[41] *Guam Declaratory Ruling* ¶ 19; *see* 47 U.S.C. § 251(h) (defining incumbent LEC).

[42] The Commission's regulations under § 251(c) indicate the limited nature of the current interconnection requirement. *See* 47 C.F.R. § 51.305(b) ("A carrier that requests interconnection solely for the purpose of originating or terminating its interexchange traffic on an incumbent LEC's network and not for the purpose of providing to others telephone exchange service, exchange access service, or both, is not entitled to receive interconnection pursuant to section 251(c)(2) of the [1996] Act.").

connection with untold numbers of carriers. This would come at substantial cost, yet would not improve the reliability of the network or the experience of consumers on the network.

2. Similarly, Congress imposed an obligation to enter interconnection agreements pursuant to the terms of § 252 on incumbent LECs only. *See* 47 U.S.C. §§ 251(c)(1), 252(a)(1). The Plan, however, requires all carriers to enter into interconnection agreements under § 252 of the 1996 Act. *See* Plan at 55. There is no basis in the language of the 1996 Act for the Commission to extend that § 252 process to all agreements between all carriers. Not only would it dramatically expand the role of state commissions under the 1996 Act, when Congress has expressly and purposefully assigned them a carefully circumscribed role, limited to agreements between incumbent LECs and requesting carriers that implement the § 251(b) and (c) duties. *See USTA v. FCC*, 359 F.3d 554, 568 (D.C. Cir. 2004). It also would require carriers to negotiate, arbitrate before state commissions, and litigate in federal court agreements with a multitude of other carriers with which they have never before had any obligation to enter into such agreements. This is not required by the 1996 Act and will generate massive implementation costs for all carriers.

3. The Plan would require Track 1 carriers "to transport their originating traffic to . . . [an] Edge" on the network of the carrier receiving the traffic. Plan at 33. But the 1996 Act and the Commission's regulations expressly limit incumbent LECs' interconnection obligations to providing a point of interconnection that is "*within* the incumbent LEC's network." 47 C.F.R. § 51.305(a)(2) (emphasis added); *see* 47 U.S.C. § 251(c)(2). An Edge on another carrier's network is plainly not "within" the incumbent LEC's network. Therefore, these other carriers will have a new right to insist that a Track 1 incumbent LEC spend whatever funds necessary to "(i) [c]onstruct[] its own facilities, (ii) [o]btain[] facilities from a third-party carrier, or (iii)

[p]urchas[e] transport services from the terminating carrier" in order to comply with this new obligation to interconnect at a point *not* on the incumbent LEC's network. Plan at 31.

4. The Plan also would compel "[a]ll ILECs that are providing Tandem Transit Service" at the Plan's inception to "continue providing that service during the term of the Plan." *Id.* at 50. This requirement significantly departs from the current regime, under which parties negotiate tandem transit service through private agreements or offer it through tariffs. The Commission has repeatedly recognized that its "rules have not required incumbent LECs to provide transiting."[43] This is for good reason. Verizon provides transiting service to competitors voluntarily and at reasonable rates pursuant to negotiated commercial agreements or tariffs. *See, e.g.*, FNPRM ¶ 129 ("recogniz[ing] that many incumbent LECs, mostly BOCs, voluntarily provide transit service"). These voluntary arrangements have proven successful, and, as Verizon has previously explained, there is no statutory basis for imposing new federal rules to regulate transit service.[44] In so doing, the Plan limits the flexibility in the existing regime, where such service is offered through negotiated agreements or by tariff.

This requirement could impose significant and potentially unrecoverable costs on incumbent LECs. For example, tandem transiting service could become more costly or administratively burdensome in light of the Plan's proposed requirements for signaling and the exchange of call detail records. The Plan clearly attempts to change the economics of the direct

[43] Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, 18 FCC Rcd 16978, ¶ 534 n.1640 (2003), *vacated in part and remanded*, *USTA v. FCC*, 359 F.3d 554 (D.C. Cir. 2004), *cert. denied*, 543 U.S. 925 (2004); *see, e.g.*, Memorandum Opinion and Order, *Application by BellSouth Corporation, et al., for Authorization To Provide In-Region, InterLATA Services in Florida and Tennessee*, 17 FCC Rcd 25828, ¶ 155 (2002); Memorandum Opinion and Order, *Joint Application by BellSouth Corporation, et al., for Provision of In-Region, InterLATA Services in Alabama, Kentucky, Mississippi, North Carolina, and South Carolina*, 17 FCC Rcd 17595, ¶ 222 n.849 (2002).

[44] *See* 2005 Verizon Reply Comments at 7-8.

versus indirect interconnection decision in a way that would encourage establishment of significantly more direct interconnections, when such direct interconnections may not provide the most efficient interconnection approach.

B. The Plan Includes Additional Rules that Impose Substantial and Unnecessary Implementation Costs

The implementation costs that the Plan imposes do not result solely from rules that, as shown above, are plainly inconsistent with the 1996 Act and the current legal regime. They also result from the changes the Plan makes to existing interconnection agreements, the Plan's unnecessarily complicated "solution" to so-called "phantom" traffic, and additional changes to network architecture that improve neither service nor efficiency.

First, the Plan imposes significant implementation costs on all carriers because it overrides the rates in the vast majority of existing interconnection agreements, all but requiring time-consuming and costly renegotiation of those agreements. The Plan provides that its rates will apply if: (i) the party's "agreement is silent [about rates] or permits alteration in relevant part in accordance with changes in law," (ii) "if there is no agreement," or (iii) "if an agreement is in an evergreen period." Plan at 4. Thus, the only rates that will not be superseded by the Plan's rates are those in a limited set of agreements that explicitly provide for no changes in rates as a result of a change in law *and* that are still in their initial term and, therefore, not in an evergreen period.

The Plan's reasons for excepting this narrow set of agreements is unclear, but apparently proceeds from the correct view that negotiated bargains are preferable to regulatory fiat. Recognizing that principle, however, makes clear that the exception is far too narrow. The fact that an agreement containing a provision barring changes to rates as a result of a change in law is in evergreen provides no basis on which to undo the parties' bargain. After all, the evergreen provision was also part of that bargain, and the parties plainly expected that *all* of the provisions of the agreement — including the rates — would persist during the evergreen period. This point is true more broadly. Even when parties did not insist on a "no-changes-to-rates" clause — likely because of the Commission's strong preference for change-of-law clauses[45] — rates were likely a central focus of the negotiations over the agreement. Trumping rates while leaving the rest of the agreement intact would subject the parties to an agreement to which they would not necessarily have agreed voluntarily. In any event, because evergreen periods typically are subject to termination, and agreements that permit changes to rates normally have clearly specified change-of-law processes, there is no reason for the Plan to trump virtually all existing agreements. Such a result is particularly unfair when carriers have spent large sums of money negotiating and, in some cases, arbitrating disputes to reach agreements. Instead, preserving existing agreements will ensure that carriers change those agreements only when they find the new rules to be more advantageous than their existing voluntary agreements.

Second, the Plan unnecessarily attempts to remedy supposed problems associated with "phantom" traffic. As Verizon has previously explained, "phantom" traffic can occur in two different scenarios: (1) failure to identify the carrier that delivered the traffic to the transiting tandem and therefore owes intercarrier compensation, and (2) failure to identify the jurisdiction of a call and, therefore, the proper rate to apply.[46] Difficulties in identifying the necessary information for a call can typically be corrected through carrier education on how to read and interpret the information contained in the terminating access records. The problem, therefore, is normally not a lack of information, but an inability to interpret the information that is provided. And, to the extent that information is missing altogether, it is the terminating carrier's

[45] *See Local Competition Order* ¶ 152.

[46] *See* 2005 Verizon Reply Comments at 15-17.

responsibility to enter into billing arrangements with the carriers that owe it intercarrier compensation. The Plan, however, proposes a three-part "comprehensive solution" that would impose unnecessary costs on all carriers to solve an issue that could be much more easily and cheaply corrected by enabling and encouraging carriers to make better use of the information they currently receive and by enforcing existing rules against those that manipulate call detail information. In no event should the Commission, as some urge, move ahead with the Plan's proposed "solution" as a priority matter. Verizon estimates that the phantom traffic provisions, alone, will cost Verizon at least a few hundred million dollars to implement. Other carriers would presumably face similarly significant costs as well.

Third, the Plan prohibits Track 1 incumbent LECs from designating their local tandems as Edges interconnection, which will disrupt existing network architecture. Like most such carriers, Verizon has both access and local tandems. While these tandems serve different purposes in Verizon's internal network — with local tandems switching traffic between the switching centers that serve the exchanges in a particular area and access tandems generally switching traffic between long-distance carriers, competitive LECs, and CMRS providers and the switching centers that serve the exchanges in a particular area — many carriers currently interconnect at both types of tandems. Under the Plan, however, local tandems cannot serve as a Track 1 carrier's "Edge" for interconnection purposes; for some unspecified reason, only access tandems can serve as a Track 1 carrier's Edge. *See* Plan at 42-45. This means that carriers currently connecting with Verizon at a local tandem have the right to insist on interconnecting instead at an access tandem. If those carriers exercise that right, they would strand facilities Verizon has built to accommodate direct interconnection at its local tandems and require Verizon to build new facilities at its access tandems to accommodate the additional interconnections.

The Edge rules also have the potential to disrupt existing network architecture arrangements between incumbent LECs and long-distance carriers. Many long-distance carriers currently connect directly with a LEC's end office switch because the traffic volumes make such an arrangement more efficient and cheaper than connecting at the tandem switch that those end office switches subtend. The Plan, however, generally prohibits a Track 1 carrier from designating an end office as the carrier's Edge. *See id.* at 45. Long-distance carriers, therefore, could insist on limiting delivery of traffic to an incumbent LEC's access tandem, and force the incumbent LEC to bear the switching and transport costs associated with delivering that call to the end office. As above, long-distance carriers that exercise this new right would strand existing facilities that were used for end office interconnection and would likely require the building of new facilities at the access tandems to accommodate the additional interconnections.

Finally, long-distance carriers that currently have to comply with the geographic rate averaging rule will face significantly more complex calculations under the Plan. Recall that long-distance carriers are required to average the rates they charge customers across geographic areas so that rural customers are not charged substantially more than urban customers. Because the Plan will actually increase the disparity between rural and urban interstate switched access rates, long-distance carriers face added complexity in creating rate plans.

CONCLUSION

For the foregoing reasons, the Commission should resolve the issues in this proceeding in accordance with these comments, and Verizon's previously filed comments in this docket.

Respectfully submitted,

Karen Zacharia

Of Counsel:

Michael E. Glover

Karen Zacharia
Amy P. Rosenthal
VERIZON
1515 North Courthouse Road, Suite 500
Arlington, VA 22201-2909
(703) 351-3175

Counsel for Verizon

October 25, 2006

Federal Communications Commission

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Verizon

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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
	)	

Reply of Verizon

Michael E. Glover, *Of Counsel*

Jeffrey S. Linder
Suzanne Yelen
WILEY REIN & FIELDING LLP
1776 K Street, N.W.
Washington, D.C. 20006
(202) 719-7000
Fax: (202) 719-7049

Edward Shakin
Christopher M. Miller
VERIZON
1515 North Courthouse Road
Suite 500
Arlington, VA 22201-2909
(703) 351-3071

November 20, 2006

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In the Matter of	)	
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Reply of Verizon[1]

I. SUMMARY

The communications marketplace has been transformed by robust, intermodal competition, the introduction of powerful new technologies, and consumer demands for the greater efficiency and lower prices associated with bundled service offerings. These changes compel the elimination of regimes that regulate the rates and service of just one among many providers, particularly where such regimes are based on archaic notions of cost and artificial distinctions between interstate and intrastate and regulated and nonregulated services.

The Commission and many states have eliminated archaic price regulation, and in these jurisdictions separations should be preemptively eliminated. Where states still utilize separations, the Commission should maintain the freeze and reemphasize that it is binding on the states. Letting the states adopt their own jurisdictional cost allocation requirements is not only unnecessary, but would create great uncertainty in the industry and undermine investment. Likewise, parties advocating modifications to the separations

[1] The Verizon companies participating in this filing are the regulated, wholly-owned subsidiaries of Verizon Communications Inc.

rules ignore both the efficacy of competition in constraining local telephone rates and the highly burdensome and counter-productive nature of their proposals.

Proceeding in this manner will preserve the stability that the freeze has brought to the industry, promote continued investment in next-generation networks and services, and enable ILECs to compete more effectively with the multitude of rivals that are not subject to onerous cost allocation requirements.

II. THE RECORD SUPPORTS ADOPTION OF A PROCESS FOR PREEMPTIVELY ELIMINATING SEPARATIONS WHERE REGULATION NO LONGER RELIES ON SEPARATED COSTS.

A. Separations Should Be Discontinued in States That No Longer Rely on Separated Costs.

There is robust competition in the communications marketplace. *See* Verizon at 4-8. Moreover, developments since the opening comments were filed confirm that this competition continues to expand and intensify. For example, Cox, which in July 2006 stated that it would be offering voice service in all of its markets by year-end, announced on October 30, 2006 that it had already met this goal.[2] Concomitantly, Verizon has continued to lose access lines, reporting a loss of 7.5 percent of total access lines between the third quarter of 2005 and the third quarter of 2006 and a loss of 9.8 percent of residential access lines in the same period.[3]

This competition prevents any carrier from pricing its services unreasonably. Not surprisingly, therefore, the record shows that many states have followed the

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[2] Cox News Release, *Cox Digital Telephone Now Offered in All Cox Markets* (Oct. 30, 2006) http://phx.corporate-ir.net/phoenix.zhtml?c=76341&p=irol-newsArticle&t=Regular&id=923325&.

[3] *Verizon Investor Quarterly, Q3 2006* at 14, http://investor.verizon.com/financial/quarterly/vz/3Q2006/3Q06Bulletin.pdf (Oct. 30, 2006).

Commission's lead and moved away from cost-based regulation. For example, state commissions observe that "[m]any states have now passed laws that permanently remove carriers from classical rate of return regulation." Vermont/Nebraska PSC at 6; *see also* Idaho PUC at 5; Iowa Utilities Board at 1-2. Likewise, a recent study released by the National Regulatory Research Institute (which is affiliated with NARUC) found that, "incumbent local exchange carriers (ILECs) continue transitioning from rate-of-return regulation (ROR) to alternative forms of regulation, including price caps, flexible regulation, and particularly towards deregulation of competitive and non-basic services." NRRI, *State Retail Rate Regulation of Local Exchange Providers as of September 2005*, at 2 (April 2006).

In light of these marketplace and regulatory changes, carriers and state commissions uniformly urge that separations requirements be removed where a state no longer relies on separated costs in regulating rates. For example, several state commissions recommend that "[i]f separations results are not relevant for any regulatory purpose, no carrier should bear the cost of conducting separations studies and reporting separations data." Idaho PUC at 6; *see also* Iowa Utilities Board at 2; Vermont/Nebraska PSC at 6; Wisconsin PSC at 5 ("the industry is nearing a point where the separations process could be eliminated for some companies, especially larger companies….").[4]

Verizon has proposed that the Commission establish a streamlined glide path for removing separations on a carrier- and state-specific basis. Under such an approach, any

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[4] Similarly, AT&T, BellSouth, Qwest, Verizon, and the United States Telecom Association all showed that the separations process is burdensome and unnecessary, creates a competitive imbalance, and thus should not be applied in jurisdictions that no longer rely on separated costs. AT&T at 4-8; BellSouth at 4-6; Qwest at 11-16; Verizon at 11-13; United States Telecom Association at 3.

carrier no longer subject to cost-based regulation can petition the Commission to eliminate separations requirements for that carrier in that state. Removal of separations requirements would be automatic within a set time period if the state does not demonstrate that separations-derived costs actually are used in rate regulation. This process would put a minimal burden on regulators and carriers and would benefit consumers by discontinuing unnecessary and costly regulation.

Several state commissions propose an "exit ramp" option for incumbent carriers to terminate their separations obligations,[5] which is consistent in principle with the mechanism suggested by Verizon. However, certain aspects of the states' proposals are unnecessary. For example, there is no basis for freezing a company's universal service receipts on the date separations requirements are removed. Iowa Utilities Board at 4; Idaho PUC at 8. The states' implicit point is correct. Where competition assures reasonable rates in the absence of high-cost support, then such support is no longer necessary. There is a critical need to reform high cost support, but the issue of whether to eliminate the separations rules can and should be resolved independently from changes to the USF rules. Nor should the removal of separations requirements be conditioned on elimination of the subscriber line charge ("SLC"). *See* Wisconsin PSC at 6. If the Commission decides to adopt a means of cost recovery other than the SLC in the interstate jurisdiction, that is its prerogative. However, the elimination of separations rules where they are no longer used in ratemaking is not logically dependent on doing away with the SLC.

[5] *See, e.g.*, Vermont/Nebraska at 9; Iowa Utilities Board at 4; Idaho PUC at 8; *see also* Wisconsin PSC at 5

B. The Elimination of Separations by the Commission Is Binding on the States.

The Commission's separations decisions (including a determination that no separation of costs is required) are binding on the states and preempt any 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. Public Utilities Commission of Hawaii*, 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 eliminates separations requirements, states are not free to impose their own jurisdictional cost allocation rules. *See Buckman Co. v. Plaintiffs' Legal Comm.,* 531 U.S. 341, 348 (2001) (finding preemption where "somewhat delicate balance of statutory objectives" could "be skewed by allowing" state-law claims). A decision that separations requirements are no longer necessary is no less an assertion of federal authority than the imposition of separations rules. For example, the Commission's determination in *Computer II* to deregulate customer premise equipment on a preemptive basis was upheld on appeal,[6] as was the Commission's action in *Computer III* to preemptively eliminate structural separation requirements for enhanced

[6] Amendment of Section 64.702 of the Commission's Rules and Regulations, 77 F.C.C.2d 384 (1980), *aff'd*, *CCIA v. FCC*, 693 F.2d 198 (D.C. Cir. 1982).

services.[7] Accordingly, once the Commission finds that separations rules are no longer necessary, that determination forecloses the states from adopting their own requirements.

III. PENDING THE ELIMINATION OF SEPARATIONS, THE COMMISSION SHOULD MAINTAIN THE CURRENT FREEZE AND REEMPHASIZE THAT STATES CANNOT IMPOSE THEIR OWN JURISDICTIONAL COST ALLOCATION REQUIREMENTS.

A. The Freeze Has Promoted Stability and Has Been Consistent with the Interests of Consumers, and the Proponents of New Separations Rules Have Failed To Justify Such Requirements.

In adopting the initial separations freeze in 2001, the Commission sought to "reduce regulatory burdens" in light of growing competition and changing technology. *Separations Freeze Order*, ¶¶ 12, 13. Likewise, in deciding to extend the freeze for another three years, the Commission noted that its action "will provide stability" in a rapidly changing marketplace. *Jurisdictional Separations and Referral to the Federal-State Joint Board*, Order and Further Notice of Proposed Rulemaking, FCC 06-70, CC Docket No. 80-286 (rel. May 16, 2006), ¶ 1. The record confirms that the separations freeze has achieved its pro-competitive goals, promoted stability, and served the interests of consumers. For example, the Wisconsin PSC (at 1) stated that the original freeze and its extension "have been useful for the industry and have produced no evident, significant harms to the market or to consumers." *See also* Idaho PUC at 13-14.

The separations freeze, in short, has been a deregulatory success story, and the Commission should resist requests to adopt new separations rules in the pursuit of an assertedly more "accurate" jurisdictional cost allocation. Cost allocation in a multi-product, multi-jurisdictional firm is inherently arbitrary, and pursuing "accuracy" is

[7] *Amendment of Section 64.702 of the Commission's Rules and Regulations*, CC Docket No. 85-229, Phase I, 104 FCC 2d 958 (1986) (*Computer III Phase I Order*), *subsequent history omitted.*

inherently burdensome. As articulated even by the proponents of purportedly "streamlined" separations reform, any new separations rules would require legions of economists, accountants, and engineers to analyze the use (actual and prospective) of facilities, make predictions as to the future course of the technology and the market, and keep meticulous records (subject, of course, to audits). None of that activity, however, would produce any economic benefit: There would be no resulting increase in output or innovation, and no enhanced responsiveness to consumer demands. To the contrary, the resources of the regulated firm would be diverted to a pointless paper chase.

Notwithstanding the clear consumer benefits of the freeze and the arbitrary nature of any jurisdictional cost allocation rules, NASUCA and certain state regulators contend that new separations rules must be imposed in order to fix supposed flaws resulting from market changes since the current freeze was instituted. In particular, these parties point to growth in DSL and private line services, robust expansion of VoIP, increased use of the local loop for unregulated services, and the obligation to provide unbundled network elements. *See, e.g.*, Pennsylvania PUC at 2; Idaho PUC at 15; NASUCA, Baldwin Aff. at ¶ 12. The Commission should not accept any of these many and varied "reforms." All are premised on the mistaken notion that consumers of intrastate phone services are unfairly bearing billions of dollars of investment and expenses that purportedly should be reallocated to interstate services and unregulated lines of business. NASUCA, Baldwin Aff. at ¶ 12.

First, as explained in detail in Verizon's opening comments, robust competition assures that local phone rates are reasonable. Neither NASUCA nor any other proponent of detailed separations rules even tries to introduce contrary evidence. Indeed, NASUCA even acknowledges that Bell Company-served access lines have declined precipitously, *see* NASUCA, Baldwin Aff. at Table 5. Yet it nonetheless pronounces, without support, that "competition does not constrain market power." NASUCA, Baldwin Aff. at ¶ 56. Clearly, these lines are going somewhere – to cable telephony providers, wireless carriers, and VoIP providers – but NASUCA refuses to concede that this competition constrains prices.

NASUCA also is wrong in implying that basic phone subscribers are subsidizing rates for bundled services.[8] NASUCA, Baldwin Aff. at ¶ 140. As the Commission has long recognized, bundles are pro-consumer. *See Policy and Rules Concerning the Interstate, Interexchange Marketplace*, Report and Order, 16 FCC Rcd 7418 ¶ 14 (2001) ("[A]llowing all carriers to bundle products and services is generally procompetitive and beneficial to consumers."); *Bundling of Cellular Customer Premises Equipment and Cellular Service*, Report and Order, 7 FCC Rcd 4028, 4030-31, ¶ 19 (1992) ("[B]undling is an efficient promotional device which reduces barriers to new customers and which can provide new customers with … service more economically than if it were prohibited."). Indeed, NASUCA itself provides evidence of the consumer benefits of bundles, conceding that more than half of all former Bell company customers subscribe to bundles. NASUCA, Baldwin Aff. at ¶ 136. Clearly, where most telephone company subscribers already purchase bundles, and with that proportion growing, it makes no sense to suggest that the remaining minority of standalone local voice customers are

[8] NASUCA (at 5) goes so far as to suggest that pricing should be based on a service-by-service cost allocation. Yet no firm in a competitive market prices in this manner, and neither the FCC nor state commissions have ever sought to do so.

subsidizing bundled service rates, particularly where basic phone rates has been constrained by competition and by state regulation.[9]

B. The Specific Proposals Advanced by NASUCA and Some States Would Be Highly Burdensome and Would Deter Investment in Broadband Networks.

Not only are modified separations rules unnecessary and counter-productive, but the specific proposals put forth by NASUCA and others likely would harm consumers. It would be highly burdensome and inimical to local competition and continued investment in next-generation networks to implement the proposed changes.

First, adopting new separations reform with the goal of cutting local phone rates would be unlikely to yield appreciable consumer savings. As NASUCA acknowledges, most consumers purchase bundles of services, so forcing providers to recover more of their costs from jurisdictionally interstate or unregulated services would not produce an overall reduction in the price of the bundle. *See Wireline Broadband Order*, ¶ 143 (reallocating costs to particular services using the loop "would seem to produce only a shifting of charges from one part of the customer's bill to another"). And even the minority of customers who purchase local and long distance services on a standalone basis would see any decrease in local rates offset by an increase in long distance rates.

Second, the proposed rule changes would be highly burdensome, raising costs for both carriers and consumers. These proposals would require companies to perform

[9] NASUCA (Loube, ¶¶ 34-35) incorrectly asserts that Verizon has not been keeping its records in accordance with Part 64. Verizon's Part 64 compliance has been confirmed through periodic audits. Although Loube asserts that Verizon's reported results for Pennsylvania evidence non-compliance, in reality, the nonregulated investment reported in 2004 was related to FTTP broadband data service, which Verizon at that point treated as nonregulated pursuant to its Petition for Declaratory Ruling, which subsequently was mooted by the *Wireline Broadband Order*. Following that *Order*, FTTP broadband data service was reclassified as a regulated service for Part 64 purposes, so there was no shared investment to report.

complex allocation studies and predict future demand,[10] randomly reallocate a major portion of loop investment to unregulated services,[11] impute UNE revenues and expenses as a means of reducing common line costs,[12] and reinstate DEM studies for circuit switches,[13] among other things. As the Commission recognizes, however, incumbent LECs no longer retain the personnel and computer systems necessary to perform separations studies. *Notice*, ¶ 23. To accommodate these changes, Verizon and other carriers "would have to hire or reassign and train employees and redevelop systems for collecting and analyzing the data necessary to perform separations," which would be "unduly burdensome ... when there is a significant likelihood that there would be no lasting benefit to doing so." *Id.* While the Commission made this observation in the context of extending the freeze, the point is even more valid in the context of the post-extension marketplace, which will be even more competitive.

Third, the proposed rule changes would be antithetical to the Commission's and Congress's core goals of promoting local competition and fostering broadband deployment. Cutting local rates by fiat, which already are market-driven (or are set artificially low pursuant to regulatory mandate), would deter competitive entry by establishing an uneconomically low price ceiling. Competitors will not enter the market

[10] *See, e.g.,* Wisconsin PSC at 6-9 (adopt company-specific fixed factors based on the relative contribution that each group of services makes to the peak design capacity at the time of the purchase of a major investment in equipment; proposes multiple service groups and categories of equipment); Vermont/Nebraska at 18; Idaho PUC at 15.

[11] *See, e.g.*, NASUCA, Baldwin Aff. at 62-71; Loube Aff. at 17-19 (use current 25 percent interstate gross allocator for customers purchasing only telephone service, change allocator to 50 percent for customers purchasing ADSL and to 75 percent for customers purchasing ADSL and video)

[12] Wisconsin PSC, Appendix at 3-7.

[13] NASUCA, Loube Aff. at 22-23; Baldwin Aff. at 77; Vermont/Nebraska at 18.

or expand their existing offerings if they cannot earn a reasonable return on their investment.

Moreover, deterring competition in the provision of local voice service would undercut broadband investment by both competitors and incumbent LECs. Competitors such as cable companies market high-speed Internet access in conjunction with telephone service. If they cannot compete effectively in providing phone service because artificially low rates limit the potential return on capital, they will have fewer incentives to build out their high-speed networks, particularly in areas where the economic case for doing so already is marginal. And penalizing incumbent LECs for providing broadband services (by compelling them to reallocate even more investment and expenses away from local telephone service) would deter investments in next-generation networks – again, with economically marginal areas being hardest hit – which would deprive consumers of competition in the provision of high-speed Internet access and video services.

The detrimental impact on the provision of competitive video services is particularly anti-consumer. Local phone rates have declined in real terms,[14] while cable rates have increased markedly.[15] Thus, not only is there no need to cut phone rates further, but doing so could sacrifice the potential for much greater savings in the video

[14] Between December 2002 and December 2005, local phone rates declined by 1.4 percent in real terms. *See* FCC Industry Analysis and Technology Division, *Reference Book of Rates, Price Indices, and Household Expenditures for Telephone Service 2006*, at Table 3.1 ("FCC Reference Book").

[15] Between January 2002 and January 2004 (data for 2005 are not yet available), cable rates increased by 13.6 percent, while inflation during this period was only 5.1 percent. *See Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992*, Report on Cable Industry Prices, 20 FCC Rcd 2718, Attachment 2 (2005); FCC Reference Book, Table 3.1.

market, where wireline entry has triggered dramatic price reductions. *See Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Twelfth Annual Report, 21 FCC Rcd 2503, 2519, ¶ 41(2005) ("[C]ompetition to an incumbent cable operator from a wireline provider resulted in cable rates that were 'substantially lower (by 15 percent)' than in markets without this competition.") (citations omitted); Robert W. Crandall, J. Gregory Sidak, and Hal J. Singer, *Does Video Delivered Over a Telephone Network Require a Cable Franchise?* at 27, forthcoming at 59 Fed. Comm. L.J. (2007) (telephone entry into the video market can be expected to trigger a $7.15 decrease in the monthly price of cable television service) (available at http://papers.ssrn.com/so13/papers.cfm?abstract_id=932980).

IV. STATES MAY NOT TAKE ACTIONS THAT ARE INCONSISTENT WITH THE SEPARATIONS FREEZE.

As explained in Section II.B above, states have no authority to establish their own jurisdictional cost allocation rules. Perhaps recognizing the states' lack of latitude in this area, NASUCA claims that state regulators can compel incumbent LECs to directly assign private line investment notwithstanding the freeze. Some states also assert that they can preclude recovery of wireline broadband costs that are assigned to the intrastate jurisdiction through the separations process. Neither contention is correct.

A. States Cannot Compel "Direct Assignment" of Private Line Investment.

"Direct assignment" refers to the assignment of a particular cost category directly to the intrastate or interstate jurisdiction without employing a relative use factor or a fixed allocator. *See Notice,* ¶ 4. The *Separations Freeze Order* (at ¶ 23) makes it plain that *only* those facilities that are "readily identifiable" as being either exclusively intrastate or exclusively interstate would continue to be directly assigned following the freeze. That is not the case for private lines. To the contrary, determining directly assigned amounts prior to the freeze required carriers to conduct the same investment studies as were used for any other category of cable and wire facilities or central office equipment investment. For example, 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. Carriers also had to determine average book cost per mile and develop average loop costs in order to calculate the directly assigned amounts. Similarly, carriers had to undertake a detailed examination of engineering records to determine which pieces of circuit equipment (and their relative costs) were put on each circuit and what type of circuit was involved. Consequently, carriers cannot be forced to directly assign private line investment under the separations freeze.

Without acknowledging the "readily identifiable" language noted above, NASUCA nonetheless alleges that the *Separations Freeze Order* requires carriers to perform annual separations studies in order to update direct assignments. NASUCA, Loube Aff. at ¶¶ 9, 14; Baldwin Aff. at ¶¶ 20-26. NASUCA is wrong. The *Separations Freeze Order* provides precisely the opposite, stating that price cap carriers "will not have to perform the analyses necessary to categorize annual investment changes for interstate purposes." *Separations Freeze Order*, ¶ 14. The *Order* 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*, ¶¶ 22.

Moreover, shortly after the freeze was instituted, Commission staff instructed carriers *not* to perform studies to determine directly assigned amounts, and the staff subsequently told 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." IATD Letter 2004-14. *See* Verizon at 21 n.33 (discussing the 2001 meeting with the staff and the events leading up to the 2004 IATD letter). Accordingly, there is no merit to NASUCA's claim that separations studies are required.

For this reason, NASUCA (Loube Aff., ¶ 9; Baldwin Aff. ¶¶ 121-128) also is wrong in contending that Section 36.3(a) of the Commission's Rules compels carriers to perform updated investment studies for private line services each year. First, that Rule, which states that "[d]irect assignment of private line service costs between jurisdictions shall be updated annually," must be read in light of the language in the *Separations Freeze Order* limiting direct assignment only to those investments that are "readily identifiable" without the use of separations studies. Second, Section 36.3(b) of the Rules contains specific language governing carriers subject to federal price cap regulation (which must take precedence over the general language in subsection (a)), and that subsection states that price cap carriers *must* assign costs "based on the percentage relationships of the categorized/sub-categorized costs to their associated part 32 accounts for the twelve month period ending December 31, 2000." As Qwest (at 25-26) points out, it "is impossible both to annually update direct cost assignments and to use frozen factors." Updating direct assignments would change the amounts in the different separations categories and thereby alter the percentages assigned to the interstate and intrastate jurisdictions.[16]

Finally, even aside from the fact that separations studies to revise direct assignments are not permitted under the freeze, NASUCA is wrong in claiming that such studies would not be burdensome. NASUCA, Loube Aff. ¶ 24. 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. Compelling incumbent local exchange carriers once again to expend significant resources in this manner – when no competing provider is subject to such a burdensome obligation – would be inimical to fair competition and would serve no purpose. Accordingly, 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.

B. States Cannot Use the Part 64 Rules To Remove Wireline Broadband Costs from the Intrastate Rate Base.

A few state commissions (and NASUCA) contend that the Commission has afforded them flexibility, through the Part 64 process of allocating costs between regulated and non-regulated activities, to remove wireline broadband investment from the intrastate rate base. *See* Iowa Utilities Board at 7; Idaho PUC at 12; Vermont/Nebraska at 14; NASUCA at 7. They are wrong. States have authority to remove from the rate base *only* those costs that (1) have been allocated to the intrastate jurisdiction through the separations process, but (2) are associated with intrastate services that have been

[16] That is, revising a single category percentage results in changes to all category percentages in order to balance to 100 percent.

deregulated. States may not preclude recovery of jurisdictionally intrastate costs that they believe should have been assigned to the interstate jurisdiction but were not because of purported shortcomings in the separations process. Yet that is precisely what some seek to do here.

Under the Commission's rules, costs are first allocated between regulated and non-regulated services pursuant to the Part 64 rules. Costs associated with regulated services are then subject to the Part 36 jurisdictional separations process; costs associated with non-regulated services do not go through the separations process. In the *Wireline Broadband Order*, the Commission declared that wireline broadband Internet access should be treated as regulated under Part 64. *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities*, Report and Order and Notice of Proposed Rulemaking, 20 FCC Rcd 14853, ¶¶ 129-130 (2005) ("*Wireline Broadband Order*"). Indeed, in declining to reclassify these services as non-regulated for Part 64 purposes, the Commission noted that doing so would "impose significant burdens" while generating "at most marginal benefits." *Id.* ¶¶ 133-134.

Once costs have been assigned to the intrastate jurisdiction pursuant to the separations process, "state jurisdictions have the ability to remove the costs of *state non-regulated activities* so that those costs will not be recovered in regulated intrastate service rates." *Separations Freeze Order*, footnote 6 (emphasis added). This is so because, once costs that are considered regulated for Part 64 purposes have been through the separations process, "states can reallocate costs between the intrastate regulated and non-regulated spheres in order to reflect the scope of regulation in a particular state." *Joint Cost Order*, 2 FCC Rcd 1298, ¶ 91 (1987); *see also Wireline Broadband Order*, ¶ 129 & n.406.

However, they must "refrain from asserting any jurisdiction over activities that are identified as *interstate* regulated activities through the interaction of these [Part 64] rules and the Part [36] jurisdictional separations rules." *Joint Cost Order* at 1310 n.179 (emphasis added). That is precisely what some states seek to do here – essentially, to reallocate certain intrastate costs as interstate – and it is therefore prohibited.

V. <u>THE COMMISSION SHOULD NOT ISSUE A DATA REQUEST.</u>

The record demonstrates that any data collection would be burdensome and pointless. *See, e.g.*, US Telecom at 9; JSI at 9-10; ITTA *et al.* at 12-14; Qwest at 16-23. The information that the draft data request seeks unreasonably presumes that the extent to which a particular portion of the network is used by a particular service is relevant to the ratemaking process. Likewise, the draft data request assumes 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. And the draft further presumes that carriers retain the systems, personnel, and processes that would be needed to provide the requested information, much of which relates to the pre-freeze separations rules. Again, this is not the case. Consequently, the Commission should not issue the draft request attached to the *Notice*, let alone the even more detailed and burdensome version proposed by NASUCA. *See* NASUCA, Baldwin Aff. ¶¶ 98-100; Loube Aff. ¶ 53.[17]

[17] Finally, imposing a data collection requirement now would be premature in any event. In light of ongoing, dramatic changes in network usage and technology, any data collected in the next 12-18 months likely would be stale by the time regulators finalize a post-freeze separations process.

VI. 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,

By: /s/ *Jeffrey S. Linder*

Michael E. Glover, *Of Counsel*

Jeffrey S. Linder
Suzanne Yelen
WILEY REIN & FIELDING LLP
1776 K Street, N.W.
Washington, DC 20006
(202) 719-7000
Fax: (202) 719-7049

Edward Shakin
Christopher M. Miller
VERIZON
1515 North Courthouse Road
Suite 500
Arlington, VA 22201-2909
(703) 351-3071

November 20, 2006

Federal Communications Commission

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