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

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

REPLY COMMENTS OF THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES, THE NEW JERSEY DIVISION OF RATE COUNSEL, AND THE MAINE OFFICE OF THE PUBLIC ADVOCATE

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TABLE OF CONTENTS

PAGE

I. INTRODUCTION. 1

II. SEPARATIONS STILL MATTERS. 4

A. Despite assertions to the contrary, separations rules continue to be an important tool for regulators. 4

B. The incumbents overstate the extent of competition in telecommunications markets, and fail to demonstrate that emerging competition eliminates regulators' need to have access to separations data. 5

C. Commenters acknowledge that multiple states still utilize the separations process for rate-of-return regulation and that rate-of-return carriers must still conduct separations studies. 10

D. Contrary to the incumbents' assertion, incentive regulation does not render the separations rules invalid or irrelevant; the initial comments lack any persuasive support for BellSouth's Forbearance Petition. 11

E. Industry comments fail to address the need for stakeholder access to separations data in order to detect anticompetitive pricing of bundled regulated and non-regulated services. 15

F. Initial comments provide ample evidence regarding the numerous and various ways in which separations is still necessary. 16

G. The Supreme Court's holding in *Smith v. Illinois* still applies. 24

III. SEPARATIONS REFORM 26

A. The Commission's application of separations accounting has not kept pace with new technologies: as a result, consumers of intrastate regulated services are bearing unfair cost burdens. 26

B. Continuing growth in DSL demand corroborates concerns about DSL's free ride over the common network. 28

TABLE OF CONTENTS CONT'D

PAGE

C. Developments in the special access and private line markets render the separations freeze unsustainable. 34

D. The Commission should ignore the Bells' broadband "scare tactics." 38

E. Other parties also recommend that the separations process exclude costs for non-regulated services such as wireline broadband services. 41

F. There is little support for any one of the *Glide Path II* proposals. 45

G. The Commission should reduce rates for interstate regulated services and state regulators should reduce rates for intrastate regulated services to correspond with the re-assignment and re-allocation of billions of dollars of investment to unregulated services and to interstate special access services. 47

H. As a matter of law and sound policy, the Commission should reject carriers' attempt to preclude states from assigning and allocating costs to the interstate and to unregulated categories. 49

IV. THE STATUS QUO HARMS CONSUMERS AND IS UNSUSTAINABLE. 54

A. The Commission should reject proposals to hold the separations process hostage to other ongoing proceedings. 54

B. Contrary to industry assertions, the benefits of the separations rules far outweigh the costs. 56

C. The Commission should reject calls to continue the separations freeze; doing so unfairly requires consumers of intrastate regulated services to subsidize unregulated services and/or interstate services. 58

D. The Commission should issue a detailed data request in a timely manner. 59

V. CONCLUSION. 62

TABLES AND FIGURES

PAGE

Table 1 The incumbents own or control more than 94% of the end-user switched access lines as of December 31, 2005 7

Table 2 Major Carriers Average Traffic Sensitive Interstate Access Rate 21

Table 3 An Analysis of Industry Loop Costs 23

Table 4 Impact of Direct Assignment of Special Access Investment by Price Cap Carriers 24

Table 5 Demand for Bells' DSL Continues to Increase Dramatically 30

Table 6 DSL "Free-Rides" on Local Loop Investment 32

Table 7 Correcting Separations: Based on Demand 33

Table 8 Correcting Separations: Based on Cost Causation 34

Figure 1 Growth in Demand For DSL Service (2000 to 2006) 31

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I. INTRODUCTION

The National Association of State Utility Consumer Advocates ("NASUCA") as an organization,[1] and its members the New Jersey Division of Rate Counsel ("NJ Rate Counsel") and the Maine Office of the Public Advocate ("Maine OPA") (collectively, "State Consumer Advocates") hereby respond to the initial comments submitted on August 22, 2006, in response to the Federal Communications Commission's ("FCC" or "Commission") Order and FNPRM in this proceeding.[2] These reply comments were

[1] NASUCA is a voluntary national association of more than forty consumer advocates in 41 states and the District of Columbia, organized in 1979. NASUCA's members are designated by the laws of their respective states to represent the interests of utility consumers before state and federal regulators and in the courts. *See, e.g.*, Ohio Rev. Code Chapter 4911; 71 Pa. Cons. Stat. Ann. § 309-4(a); Md. Pub. Util. Code Ann. § 2-205(b); Minn. Stat. Ann. Subdiv. 6; D.C. Code Ann. § 34-804(d). Members operate independently from state utility commissions, as advocates primarily for residential ratepayers. Some NASUCA member offices are separately established advocate organizations while others are divisions of larger state agencies (*e.g.*, the state Attorney General's office). Associate and affiliate NASUCA members also serve utility consumers, but have not been created by state law or do not have statewide authority.

[2] *In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, Order and Further Notice of Proposed Rulemaking, (rel. May 16, 2006)("Order" and "FNPRM").

prepared, as were NASUCA's initial comments, with the assistance of Susan M. Baldwin and Dr. Robert E. Loube.

Several themes emerge from the initial comments:

- *Separations matters even under price cap regulation:* Contrary to the views espoused by various incumbent local exchange carriers ("ILEC"), the presence of incentive regulation does not make the separations process irrelevant. Among other reasons (which these reply comments and State Consumer Advocates' initial comments discuss in detail), interstate and intrastate rates -- including those that prevail under alternative regulation -- require re-initialization to incorporate correct separations accounting.

- *Take the money and run:* The regional Bell operating companies' ("RBOCs'" or "Bells'") position on separations reform is inherently unfair – now that they are reaping substantial (and increasing) unregulated revenues from services that depend on the common network, the RBOCs claim that separations is obsolete and irrelevant. If the RBOCs will not "take" the costs that are associated with offering unregulated services, they should not be allowed to "run" with the revenues. Many comments echo State Consumer Advocates' concern about the unfair mismatch of costs and revenues.

- *The "fail-safe" proposal:* Based on a pretense of competition, the RBOCs claim that separating costs is an irrelevant exercise. However, the Bells are not offering to forgo the option of any future request to regulators to raise consumers' rates should they discover that they have spent excessive costs and earned inadequate returns on fiber-based and other new services.

- *The status quo penalizes consumers:* Before the Commission and states abandon the separations process, and before they consider any increases to subscriber line charges ("SLCs") or universal service support, they should first re-initialize regulated interstate and intrastate rates. Indeed, in any event, regulators should re-initialize rates.

- *The Commission should discount the ILECs' broadband scare tactics:* Contrary to the ILECs' rhetoric, correcting the flawed separations process will not deter economically efficient broadband investment.

- *States should not await the outcome of this proceeding to fix intrastate regulated rates:* States should apply the existing separations rules to assign and allocate costs away from intrastate regulated services to unregulated services and to the interstate jurisdiction. Disproportionate growth in demand for digital subscriber lines ("DSL"), interstate special access, and other services means that consumers of intrastate regulated offerings are bearing unfairly billions of dollars of costs associated with a common network.

- *Asymmetric information benefits the ILECs and harms consumers*: Not surprisingly, the industry opposes the Commission's issuance of a data request in this proceeding. However, timely information would assist the Commission in completing separations reform. Therefore, the Commission should issue a data request according to its original intention and consistent with State Consumer Advocates' recommendations discussed in initial comments and in these reply comments.

Based on a review of others' filings, State Consumer Advocates reiterate the concerns raised in their initial comments. Carriers' efforts to discourage regulators from examining and enforcing proper cost assignment and cost allocation are thinly disguised efforts to protect carriers' unregulated operations from bearing a fair share of the cost of common network facilities and resources. Carriers' economic incentive is to maximize the percentage of the cost of the common network that they recover from regulated, non-competitive services, and to minimize the percentage that they assign and allocate to their unregulated services. Therefore, since carriers lack any compelling reason to comply with existing separations requirements and to contribute to separations reform, Commission and state review and reform of ILECs' cost accounting is essential to protect consumers from anticompetitive and excessive rates.

II. SEPARATIONS STILL MATTERS.

A. Despite assertions to the contrary, separations rules continue to be an important tool for regulators.

Comments submitted by state regulators in this proceeding accurately describe the theoretical underpinnings of separations and the consequences of jurisdictional mismatches and cost-revenue mismatches. State Consumer Advocates echo the sentiments of the Idaho Public Utilities Commission ("PUC") and the Vermont Public Service Board ("PSB"), Vermont Department of Public Service ("DPS") and Nebraska Public Service Commission (collectively, "Vermont/Nebraska PSC")[3] that "[m]atching revenues with costs is a paramount principle" of regulation.[4] The Idaho PUC succinctly and correctly suggests that the following "undesirable consequences" will result from a cost-revenue mismatch:

- There will be an incentive to reduce rates for the jurisdiction receiving the revenues, and "[t]he temptation will be strongest when the service is competitive or one for which public policy seeks greater deployment."[5]

- The jurisdiction "receiving the costs" might be required to raise rates for other services, thus violating the cost causality principle: "It would also be likely to harm consumers who purchase inelastic service and consumers in areas with minimal or no competition, normally rural areas."[6]

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[3] The Vermont Public Service Board, Vermont Department of Public Service and Nebraska Public Service Commission filed joint comments. The Idaho Public Utilities Commission ("Idaho PUC") and the Iowa Utilities Board ("Iowa Board") each filed separate comments. The comments filed by Vermont/Nebraska PSC, Idaho PUC, and Iowa Board are substantially similar and often include identical language. The Iowa Board comments do not address the cost-revenue mismatch, but do, however, discuss matching jurisdiction with both revenue and cost.

[4] Idaho PUC, at 9; see also, Vermont/Nebraska PSC, at 10.

[5] Id.

[6] Idaho PUC, at 9; see, also, Vermont/Nebraska PSC, at 11.

A mismatch between jurisdiction and the revenues and costs of a service also creates problems. For example, as the Idaho PUC, the Iowa Board, and Vermont/Nebraska PSC correctly observe, if a regulator sets rates for a service but does not have responsibility for the cost recovery, the incentive is to deregulate the price and "leave the consequences to the other regulator."[7] The Idaho PUC, Iowa Board and Vermont/Nebraska PSC explain, "[s]uch arrangements will not be stable in the long run, and it will be highly unlikely for prices to reflect actual costs, because those costs have been moved to the other jurisdiction."[8] State Consumer Advocates concur with these views.

B. The incumbents overstate the extent of competition in telecommunications markets, and fail to demonstrate that emerging competition eliminates regulators' need to have access to separations data.

Contrary to the industry's assertions, intermodal alternatives and new technologies do not render the separations process irrelevant, but rather underscore the need to revisit the way in which carriers assign and allocate costs. Verizon asserts that "extensive intermodal competition and new technologies" have "rendered artificial regulatory distinctions between local and long distance services -- as well as interstate and intrastate services -- unsustainable anachronisms."[9] AT&T characterizes itself and other ILECs as "price takers forced to set their rates to meet increasingly robust

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[7] Idaho PUC, at 10; Iowa Board, at 5; Vermont/Nebraska PSC, at 12.

[8] Id.

[9] Verizon, at 1; see also AT&T, at 4.

competition, rather than based on separated costs" and as unable to "increase rates without suffering severe consequences in the market."[10]

The ILECs' comments fail to counter State Consumer Advocates' demonstration that the level of competition in telecommunications markets remains insufficient to constrain ILEC market power.[11] Therefore, the separations process is essential to prevent anticompetitive practices and to ensure that rates reflect underlying costs.

A large portion of the competitive local exchange carriers' ("CLECs'") nationwide market share, 68% of the CLECs' access lines. depends on incumbent carrier facilities.[12] Even when viewed on a retail basis, and based on the Commission's most recent statistics (which do not yet incorporate Verizon's acquisition of MCI and its market share), the incumbents dominate more than 82 percent of the nation's local service market.[13] Furthermore, when viewed on a retail and wholesale basis, as Table 1 shows, as of year-end 2005 the incumbents own or control at least 94% of the end user switched access lines in service nationwide either directly through their own retail services or

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[10] Id., at 5.

[11] State Consumer Advocates, at 3, 10. See, also, Affidavit of Susan M. Baldwin attached to State Consumer Advocates Comments ("Baldwin Affidavit"), at paras. 54-59.

[12] Federal Communications Commission, Wireline Competition Bureau, Industry Analysis and Technology Division, *Local Telephone Competition: Status as of December 31, 2005*, (July 2006), at Table 3.

[13] Id., at Table 7.

indirectly by leasing wholesale facilities to their competitors, through resale, the unbundled network element platform ("UNE-P"), other similar commercial arrangements, and UNE loops.[14] The estimated share of 94% understates ILECs' actual market share because it does not yet include the Verizon-acquired MCI lines.

Table 1

The incumbents own or control more than 94% of end-user switched access lines as of December 31, 2005	
Total incumbent end-user lines	143,766,000
Total CLEC end-user lines	31,584,000
Total end-user switched access lines	175,350,000
CLEC share of end-user switched access lines	**18%**
CLEC resold lines	6,648,000
CLEC UNE lines	14,836,000
CLEC-owned lines	10,100,000
Total CLEC lines	**31,584,000**
CLEC-owned lines as a percent of all lines	**6%**
Percent of all lines owned or controlled by incumbents	**94%**

Furthermore, competition from providers using UNE-type arrangements is diminishing in the wake of the FCC's *Triennial Review Remand Order*.[15] According to the Commission's *Local Telephone Competition Report*, as of December 31, 2005, the

[14] Id., at Tables 10 and 11.

[15] *Unbundled Access to Network Elements; Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, FCC WC Docket No. 04-313; CC Docket No. 01-338, *Order On Remand*, rel. February 4, 2005 ("Triennial Review Remand Order"); Federal Communications Commission, Wireline Competition Bureau, Industry Analysis and Technology Division, *Local Telephone Competition: Status as of December 31, 2005*, (July 2006), at Table 3. For further discussion of this point, see *In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer of Control*, FCC WC Docket No. 06-74, sponsored declaration of Susan M. Baldwin and Sarah M. Bosley on behalf of the New Jersey Division of the Ratepayer Advocate, filed June 5, 2006 ("Baldwin/Bosley Declaration WC Docket No. 06-74"), at paras. 67 - 69.

number of end-user switched access lines served by CLECs through UNEs was 14,836,000, a reduction of approximately 24% from a high of 19,624,000 in June 2004.[16]

The decisions of MCI and AT&T (the nation's two largest CLECs) to merge with RBOCs provide further evidence of the declining prospect for local competition. During the FCC's review of the Verizon/MCI merger, the applicants repeatedly suggested that MCI's business was declining and that MCI was not a competitor for Verizon's mass-market voice services.[17] SBC and AT&T made similar representations for their merger.[18] Yet AT&T and MCI were the largest CLECs competing with the RBOCs for mass market customers. Therefore, their exit from the local market casts serious doubt on the likelihood of smaller CLECs' inroads into the mass market.

The intermodal competition to which the RBOCs refer[19] is irrelevant to competition for mass market consumers in the basic local exchange service market. The Commission should give little weight to the ability of intermodal competition to

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[16] Federal Communications Commission, Wireline Competition Bureau, Industry Analysis and Technology Division, *Local Telephone Competition: Status as of December 31, 2005*, (July 2006), at Table 3. This data still includes any lines that MCI was providing in December 2005 as part of the CLEC data. MCI and Verizon merged in January 2006. *Id*., at 2, footnote 5.

[17] *Verizon Communications, Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, FCC WC Docket No. 05-75, Application for Transfer of Control, March 11, 2005, Appendix 1: Public Interest Statement, at 49 and Declaration of Robert W. Crandall and Hal J. Singer, at para. 33.

[18] Merger of SBC Communications Inc. and AT&T Corp., *Description of the Transaction, Public Interest Showing, and Related Demonstrations*, filed with the Federal Communications Commission, dated February 21, 2005,Declaration of Dennis W. Carlton and Hal S. Sider, at paras. 5-52 and Declaration of John Polumbo, at paras. 22-23. AT&T explained in a New Jersey proceeding, "AT&T announced in the summer of 2004 that it would no longer actively market traditional wireline services to consumer and small-business customers as a result of FCC decisions that hinder AT&T's ability to compete for the customers using unbundled network elements." In the Matter of Verizon New Jersey, Inc., Revision of Tariff BPU NJ No. 2, Providing for a Revenue Neutral Rate Restructure Including a Restructure of Residence and Business Basic Exchange Service and Elimination of $.65 Monthly Credit BPU Docket No. TT04060442, AT&T Response RPA-ATT-2.

discipline the actions of the RBOCs. Competition is largely at the margin and/or for the high-value customer subscribing to multiple services. Such competition does little to protect the consumer of plain old telephone service ("POTS") without the bells and whistles.[20] Contrary to the ILECs' assertions, the RBOCs are on track to re-monopolize the market at worst or participate in a cable-telco duopoly at best. The FCC estimates discussed above show that half of the facilities-based lines served by CLECs and reported in the *Local Competition Report* are provided over coaxial cable connections, evidence of the emerging cable-telco duopoly.[21]

Furthermore, the incumbent carriers' own use of new technologies, such as VoIP, provides compelling evidence that regulatory scrutiny of cost assignment is more important than ever. It is precisely the increase in bundling of the Bells' regulated basic service with new, unregulated lines of business that prompts consumer advocate calls for reform and raises regulatory concerns with regard to cross-subsidization.[22] In any case, current intrastate rates were not independently set in a competitive market. As stated in

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[19] See, e.g., AT&T, at 4-5; Verizon, at 1.

[20] In its order approving the merger of SBC and AT&T the Commission appropriately excluded over-the-top VoIP services from the relevant market. *In the Matter of SBC Communications, Inc. and AT&T Corp. Applications for Approval of Transfer of Control*, WC Docket No. 05-65, Memorandum Opinion and Order, rel. November 17, 2005, at paras. 86-88. The Commission also found that wireless services do not have a "price constraining effect on all consumers' demand for primary line wireline services." Id., at footnote 277. See, also, *In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer of Control*, FCC WC Docket No. 06-74, sponsored declaration of Susan M. Baldwin and Sarah M. Bosley on behalf of the New Jersey Division of the Ratepayer Advocate, filed June 5, 2006 ("Baldwin/Bosley Declaration WC Docket No. 06-74"), at paras. 110-138.

[21] Federal Communications Commission, Wireline Competition Bureau, Industry Analysis and Technology Division, *Local Telephone Competition: Status as of December 31, 2005*, (July 2006), at Tables 10 and 11, at 2.

[22] State Consumer Advocates, at 10-11. See also Baldwin Affidavit, at paras. 135-154 and Appendix E.

initial comments:

> The ILEC position misses the fact that most of the current rates were not set in a competitive market. Rather, current rates were set under, or derived from, monopoly conditions, based on the outmoded separations and allocations percentages that have been frozen since 2001.[23]

Furthermore, as the Idaho PUC, Iowa Board, and Vermont/Nebraska PSC aptly state:

> In a competitive environment an unregulated carrier always has an incentive to subsidize its competitive services with revenues from it noncompetitive services. Also, many ILECs have some customers who have no competitive alternatives. An ILEC would have an incentive to collect more than a reasonable contribution to common costs from these customers.[24]

These reply comments discuss in more detail below the relationship of the RBOCs' bundling of competitive and noncompetitive services to separations accounting.

C. Commenters acknowledge that multiple states still utilize the separations process for rate-of-return regulation and that rate-of-return carriers must still conduct separations studies.

There is little argument that the separations process is still required for rate of return regulation. Even among the ILECs, there is a recognition that state regulators still rely upon separations in some situations. According to the Independent Telephone and Telecommunications Alliance; National Exchange Carrier Association, Inc.; National Telecommunications Cooperative Association; Organization for the Promotion and Advancement of Small Telecommunications Companies; and the Eastern Rural Telecom Association ("Associations"), "[t]he separations process does remain important, however,

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[23] State Consumer Advocates, at 3.

[24] Idaho PUC, at 10; Iowa Board, at 5; Vermont/Nebraska PSC, at 12.

for carriers subject to ROR regulation in one or both jurisdictions."[25] Verizon concedes, in addition, that "some states do continue to utilize separations less directly."[26] John Staurulakis, Inc. ("JSI") argues that the best approach is a tiered-approach, whereby large price cap carriers are relieved of their separations obligations, while the freeze on allocation factors remains in effect for rate-of-return carriers.[27] The Commission should not indefinitely maintain the current separations freeze nor should it adopt an "exit ramp" without specifically addressing the fact that carriers in many states are still operating under rate-of-return regulation (or may, in the future, either be required to or opt to return to rate of return regulation).

D. Contrary to the incumbents' assertion, incentive regulation does not render the separations rules invalid or irrelevant; the initial comments lack any persuasive support for BellSouth's Forbearance Petition.

State Consumer Advocates discussed in detail the continuing relevance of separations, even where carriers are subject to price cap regulation, in initial comments, and this discussion refutes comprehensively the industry's argument that separations is extraneous and unnecessary under price cap regulation.[28] BellSouth asserts that the original justification for the separations process, to prevent rate-of-return regulated companies from recovering the same costs twice, is no longer valid;[29] that "[p]rice

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[25] Associations, at 6.

[26] Verizon, at 9.

[27] JSI, at 2. JSI prepares jurisdictional cost studies and Universal Service Fund data for ILECs in addition to "offering regulatory, financial and business development services." JSI, at 1.

[28] State Consumer Advocates, at 10; Baldwin Affidavit, at 43-53.

[29] BellSouth, at 3.

regulation breaks the connection between regulatory revenue requirements and costs that are determined through the application of regulatory accounting and jurisdictional separations processes and the rates actually charged to customers;" and that, therefore, "the role for jurisdictional separations ceases to exist."[30] USTelecom similarly claims that incentive regulation obviates the need for jurisdictional separations because incentive regulation "removes the link between jurisdictional separations and consumer prices."[31]

BellSouth contends that granting its request for forbearance on separations is "the natural first step toward fulfillment of comprehensive separations reform."[32] BellSouth also states that by extending the forbearance to companies similarly situated to BellSouth, the Commission will "(1) clear out a large swatch of out-dated rules that do nothing but hinder carrier efficiency and competitiveness; and (2) narrow the separations reform exercise to only those carriers for whom it continues to be relevant."[33]

Contrary to these views, the presence of price cap regulation does not eliminate the need for regulators to apply the separations accounting processes to carriers' costs. As the State Consumer Advocates' initial comments discussed in detail, the presence of a price cap system is not sufficient evidence of just and reasonable rates.[34] In many instances, the price cap rate levels and permissible rate increases in a state's alternative

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[30] Id., at 4.

[31] USTelecom, at 5.

[32] BellSouth, at 4.

[33] Id., at 5. See also AT&T, at 11; Qwest, at 23; JSI, at 5.

regulation framework simply freeze in place a grossly outdated and unfair assignment and allocation of common network costs. ILECs, in their initial comments, also neglect to address the asymmetric incentives that they have for bringing exogenous costs (such as the mis-assignment and under-allocation of common network plant) to regulators' attention. As State Consumer Advocates explained:

> Another limitation of price cap plans is that ILECs have an economic incentive to bring exogenous events that *raise* their costs to the attention of regulators but lack a corresponding incentive to alert regulators to exogenous events that *lower* their regulated costs. This is evidenced by the recent order approving AT&T's request for exogenous treatment of local number portability ("LNP") costs. If price cap regulation worked efficiently, major exogenous events such as jurisdictional and regulatory shifts in the treatment of VoIP, ISP-bound traffic, and DSL should lead to a decline in rates under price caps. Federal and state rates, set by price caps, require re-initialization to address these major exogenous events.[35]

The ILECs also fail to acknowledge their contradictory positions espoused in regulatory proceedings. As shown in the State Consumer Advocates' initial comments, in filings to the Commission regarding the review of the proposed merger of AT&T and BellSouth, AT&T and BellSouth blame the frozen level of separations for the seemingly exorbitant returns from special access.[36] A reply declaration submitted by AT&T and BellSouth in their merger proceeding observed that the "FCC's cost allocation rules relating to these services are based on cost studies from the late 1990s and have been

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[34] State Consumer Advocates, at 9-10; Baldwin Affidavit, at paras. 43-53.

[35] Baldwin Affidavit, at para. 46, citing *In the Matter of Petition of AT&T Inc. for Waiver of the Commission's Rules to Treat Certain Local Number Portability Costs as Exogenous Costs Under Section 61.45(d)*, FCC CC Docket No. 95-116, *Order*, July 10, 2006.

[36] See Baldwin Affidavit, at paras. 24-25.

frozen since 2001. Since that time, however, there has been a substantial divergence in demand for special access and switched access revenues."[37] The declaration also quotes comments filed by legacy SBC in a different proceeding stating,

> ARMIS results . . . understate the costs an ILEC incurs to provide any service that has experienced significant growth in volumes. The costs for interstate special access services are particularly susceptible to this understatement because demand has increased dramatically over the past several years with the explosive growth in data services. The result is a mismatch between costs which do not properly reflect current utilization and volumes and revenues which do. This mismatch, of course, will overstate the calculated rate of return.[38]

In their merger proceeding, AT&T and BellSouth blame exorbitant profits on the separations freeze. In this separations proceeding, they claim that separations are irrelevant.

The initial comments in support of BellSouth's Petition for Forbearance are unpersuasive. The Commission should reject BellSouth's Petition and should reject the carriers' argument that incentive regulation renders the separations process irrelevant. In fact, price cap regulation has failed to yield just and reasonable rates. State Consumer Advocates continue to support immediate action by state regulators to re-initialize intrastate rates to correspond with the substantial exogenous change in costs associated

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[37] *In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer of Control*, WC Docket No. 06-74, Reply Declaration of Dennis W. Carlton and Hal S. Sider, June 19, 2006, at para. 30.

[38] Id., at para. 32, quoting comments of David Toti, then the Executive Director – Regulatory Accounting for SBC.

with the shifting use of common plant for interstate and unregulated services.[39]

E. Industry comments fail to address the need for stakeholder access to separations data in order to detect anticompetitive pricing of bundled regulated and non-regulated services.

Industry commenters fail to address adequately the importance of separations to prevent anticompetitive pricing of bundled services which mingle intrastate, interstate, regulated and unregulated products and services. The Commission should reject Verizon's assertion that there is no economically meaningful way to divide revenues from service bundles among jurisdiction and that there is no particular reason to engage in such a process.[40] The State Consumer Advocates' initial filing provides compelling justifications for the development of cost accounting tools to detect cross-subsidization and anti-competitive pricing behavior.[41] The State Consumer Advocates continue to support the issuance of the proposed data request in order for the Commission to adequately address and analyze whether the RBOCs are compensating their state operations adequately for the use of their networks'; whether POTS customers are receiving the same quality of service as bundle customers; and whether the RBOCs are

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[39] State Consumer Advocates, at 6-7.

[40] Verizon, at 18, stating "any data collection would presume that the extent to which a particular portion of the network is used by a particular service is relevant to the ratemaking process. Again, this is not consistent with the reality of a marketplace that demands service bundles and carrier networks that support multiple, disparate services."

[41] State Consumer Advocates, at 10-11; Baldwin Affidavit, at 135-154 and Appendix E. RBOC investor reports for the third quarter 2006 (not available for the initial round of comments) indicate that bundle penetration continues to grow. For example, BellSouth reported a 5.7% increase in its package subscription from September 30, 2005 to September 30, 2006. Almost 44% of its BellSouth Answers customers have two or more affiliate services (*i.e.* long distance, wireless, DSL or dial-up Internet). BellSouth, *BLS Investor News*, October 24, 2006, at 7. Verizon added 2.5 million Verizon Freedom packages from September 30, 2005 to September 30, 2006 and now serves approximately 7.5 million customers via bundles. Verizon Communications, Inc., *Investor Quarterly: Q3 2006*, October 30, 2006, at 6.

utilizing discriminatory tying arrangements, among other concerns.[42] As noted in the State Consumer Advocates' initial filing. "Without access to comprehensive data about consumers' usage patterns (e.g., local and toll usage), and interaffiliate transactions between the parent companies and the state operations, (e.g., cost and revenue information), one cannot assess whether anti-competitive behavior is occurring."[43]

F. Initial comments provide ample evidence regarding the numerous and various ways in which separations is still necessary.

Contrary to industry contentions, separations data is critically important for diverse regulatory purposes. For example, Verizon asserts that "Section 254(k) does not require jurisdictional separations."[44] However, Verizon utterly fails to substantiate this claim, and to the contrary, the Joint Board has recognized that the states and the FCC have a *duty* to ensure that, as Section 254(k) requires, "the services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."[45] As stated in the Baldwin

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[42] Baldwin Affidavit, at paras. 147-151.

[43] Id., at para. 146.

[44] Verizon, at 10.

[45] Baldwin Affidavit, at para. 19, citing *Glide Path II Paper*, at 8.

Affidavit, "[s]tates must analyze incumbent's cost accounting to fulfill their responsibility as set forth in the 1996 Act."[46]

The Idaho PUC correctly suggests that a "cost-revenue mismatch" violates section 254(k) in two ways. First, if the service is competitive, it will receive contribution from less competitive services and thus violate 254(k) by using non-competitive services to subsidize competitive services.[47] Second, to the extent the service provides revenue for the interstate jurisdiction but directs costs to the state jurisdiction, and the state covers the shortfall by raising local rates, more than a reasonable share of joint and common costs are directed to the local exchange service, thus violating the second sentence of 254(k).[48]

Along those lines, Alexicon comments that "usage and function are still the underlying principles of identifying jurisdiction," and states further that "[s]ince those principles are still applicable in any given telecom-related circumstance (as there will always be issue surrounding authority and jurisdiction), separations rules are very relevant."[49] Contrary to other carrier representatives, Alexicon[50] suggests that states continue to rely on separations rules:

> In our experience many states currently rely upon the use of

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[46] Id., at para 19.

[47] Idaho PUC, at 9; Vermont/Nebraska PSC, at 11.

[48] Idaho PUC, at 9-10; Vermont/Nebraska PSC, at 11.

[49] Alexicon, at 5.

[50] Alexicon Telecommunications Consulting "provides financial, regulatory, and managerial consulting services to a variety of small, rural/insular, independent, and tribal rate-return regulated telecommunications providers in twelve (12) states." Id., at 1.

> existing FCC Part 32, 36, and 64 rules to help establish intrastate apportionment of rate base and expense recovery calculations in a variety of intrastate revenue, earnings, and rate-of-return proceedings. We also note that the existence of the NECA pooling process can only be accomplished utilizing some type of jurisdictional separation process (for both average schedule and cost companies).[51]
>
> Without these rules it would be generally impossible to accurately assess the 'regulated' earnings, or allowable cost and investment base of rate-of-return companies, on a consistent basis. The application of jurisdictional separations rules provides a uniformly accepted method for various regulatory bodies to accurately determine regulated jurisdictional earnings.[52]

The Idaho PUC recognizes that "[e]ven where carriers have been 'deregulated' or placed on price caps, separations data may still be needed, either by the company or by a regulator," and states further that "[i]n addition, some universal service programs depend upon separations data."[53] The Iowa Board and Vermont/Nebraska PSC echo this concern.[54] The Iowa Board, the Idaho PUC, and Vermont/Nebraska PSC provide examples of the continuing need for separations data:

- Although switched access rates do not themselves rely upon separations data, a request for exogenous treatment of costs to be included in those rates would need to be evaluated by using separated costs.[55]

- Smaller rate of return carriers use separations data to calculate interstate access rates.[56]

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[51] Id., at 4.

[52] Id., at 5.

[53] Idaho PUC, at 6.

[54] Iowa Board, at 2; Vermont/Nebraska PUC, at 6.

[55] Idaho PUC, at 6; Iowa Board, at 2-3; Vermont/Nebraska PUC, at 7.

[56] Idaho PUC, at 6. As noted by the Idaho PUC: "NECA operates two different pools, a common line pool

- At the state level, although carriers may operate under price caps, the state commission may still have statutory obligation to evaluate intrastate earnings.[57]

- Carriers under price caps "may appeal from the state commission's decision on the grounds that its rates are confiscatory in violation of the Fifth Amendment to the United Stated Constitution."[58]

With regard to universal service, initial comments state:

- High Cost Loop ("HCL") support "depends on 'study area average unseparated loop cost per working loop.' This in turn depends upon separations rules (but not the allocation rules) used to categorize outside plant and central office facilities)."[59]

- "The 'Local Switching Support' ["LCS"] program depends upon each company's 'projected annual unseparated local switching revenue requirement.' This number, in turn, depends upon the separations rules to categorize plant within central office plant accounts."[60]

- "The 'Interstate Common Line Support' ["ICLS"] program depends on each carrier's interstate 'Common Line Revenue Requirement.' This in turn depends on the costs assigned to the interstate jurisdiction by separations rules."[61]

Contrary to assertions in the industry's initial comments, and as the Idaho PUC aptly explains, separations continues to be relevant and important to enable regulators to

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and a traffic sensitive pool. Each has separately identified costs, and each produces separate rates. The allocation of a carrier's overall costs in the two pools also relies on separations categories defined in 47 C.F.R. Part 36." *Id.*, at fn 6. See, also, Iowa Board, at 3; Vermont/Nebraska PUC, at 7.

[57] Idaho PUC, at 7; Vermont/Nebraska PUC, at 7-8. For instance, the Vermont PSB allowed Verizon Vermont to continue its incentive regulation plan in 2005 only after the financial results of the plan were compared with the results expected from rate-of-return regulation. Id., at 8 and footnote 7.

[58] Idaho PUC, at 7; see also, Vermont/Nebraska PSC, at 8.

[59] Idaho PUC, at 7 (footnote omitted); see also Iowa Board, at 3; Vermont/Nebraska PSC, at 8.

[60] Idaho PUC, at 7 (footnote omitted); see also Iowa Board, at 4; Vermont/Nebraska PSC, at 8.

[61] Idaho PUC, at 8 (footnote omitted); see also Iowa Board, at 4; Vermont/Nebraska PSC, at 9.

achieve various important goals, such as universal service, just and reasonable rates, assessing requests for exogenous treatment, and evaluating price cap plans.

For example, the large ILECs have used the exogenous change process to significantly increase their interstate access rates. The CALLS Order reduced the average traffic sensitive rate for the large carriers to $0.0055.[62] Currently only Qwest has a rate that has remained at the level required by the CALLS Order. The other large ILECs' current rates are substantially above the CALLS $0.0055 average traffic sensitive rate. These rate increases, shown below, have been initiated through the exogenous change process.

Table 2

Major Carriers Average Traffic Sensitive Interstate Access Rate	
Carrier	**Avg. Traffic Sensitive Rate**
AT&T-Ameritech	$0.006591
AT&T-PACBell	$0.006149
AT&T-SWB	$0.006538
BellSouth	$0.006407
Qwest	$0.005429
Verizon	$0.006719
Source: Carriers' 2006 TRP filings	

Further, the HCL support mechanism provides support to carriers with loop costs that exceed the national average loop cost. The national average loop cost is the average of the individual carriers' loop costs. While a carrier's loop cost is determined on an unseparated basis, it is necessary to categorize cable and wire investment and circuit

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[62] *In the Matter of Access Charge Reform*, Sixth Report and Order, CC Docket No. 96-262, FCC 00-193,

equipment investment in order to determine the carrier's loop cost. In particular, the algorithm that determines the loop cost is based on a carrier's circuit equipment Category 4.13 investment and cable and wire facility Category 1 investment.[63]

Due to the large carriers' interpretation of the Separation Freeze Order, they have failed to directly assign investment to special access categories. The result of this failure is that reported special access investment is too low and reported Category 1 loop investment is too high. The distorted high Category 1 investment increases the national average loop cost and could reduce support for high cost study areas. As shown below, the Non-Rural Carrier Per-Line Loop cost increased 9.2 percent in 2006 over 2005 while the Rural Carrier Per-Line Loop cost increased by only 3.9 percent. This difference is only partially explained by the larger line losses suffered by the non-rural carriers. An additional cause of the different loop cost increases is that the non-rural carriers' unseparated revenue requirement increased faster than the rural carriers' unseparated revenue requirement. Increases in the non-rural carrier loop revenue requirement are directly linked to those carriers' failure to directly assign special access investment and to their failure to exclude non-regulated investments from their Part 32 recorded cost.

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released May 31, 2000, ("CALLS Order"), ¶¶140-159; See Also 47 C.F.R. §61.3(e) and (qq).

[63] Universal Service Fund 2006 Submission of 2005 Study Results by the National Exchange Carrier Association, September 29, 2006, Appendix A1, Appendix A2, and Appendix B; see also, 47 C.F.R. §36.621.

Table 3

An Analysis of Industry Loop Costs[64]

Unseparated Revenue Requirement			
Industry Group	**2005**	**2006**	**Percent Change**
Total	45,755.7	46,933.5	2.6%
Rural	8,107.6	8,191.4	1.0%
Non-Rural	37,648.2	38,742.0	2.9%
Loops			
	2005	**2006**	**Percent Change**
Total	166.0	157.0	-5.4%
Rural	20.5	19.9	-2.7%
Non-Rural	145.5	137.1	-5.8%
Cost Per Loop			
	2005	**2006**	**Percent Change**
Total	275.67	298.86	8.4%
Rural	395.80	411.17	3.9%
Non-Rural	258.76	282.54	9.2%

[64] Universal Service Fund 2006 Submission of 2005 Study Results by the National Exchange Carrier Association, September 29, 2006.

It is possible to estimate the impact of the failure to directly assign special access investment on the HCL support mechanism by reducing the reported Cable and Wire Facility Category 1 Investment and Circuit Equipment Category 4.13 for Price Cap carriers. Once the investment is reduced, the national average loop cost can be recalculated and carrier support can be re-estimated. The table below shows the impact of reducing those investments by 10, 20 and 30 percent. A 10 percent investment reduction decreases the National Average Loop Cost by 8.77 percent and increases support to rural carriers by 12.52 percent.

Currently, because of the fund cap, the full impact of special access direct assignment will not be passed through to the rural carriers.[65] However, if the fund cap is removed temporarily, as proposed by the Missoula Plan[66], or permanently, then special access direct assignment will have a significant impact on the support rural carriers receive.

[65] 47 C.F.R. §36.603.

[66] See July 24, 2006 letter from Tony Clark, Commissioner, North Dakota Public Service Commission, Chair, Committee on Telecommunications, Ray Baum, Commissioner, Oregon Public Utility Commissioner, Chair, Task Force on Intercarrier Compensation and Larry Landis, Commissioner, Indiana Utility Regulatory Commission, Vice-Chair, Task Force on Intercarrier Compensation to Kevin Martin, Chairman, Federal Communications Commission, CC Docket No. 01-92, *In the Matter of Developing a Unified Intercarrier Compensation Regime.*

Table 4

Impact of Direct Assignment of Special Access Investment by Price Cap Carriers		
Percentage Reduction in Price Cap Carrier HCL Investment	**National Average Cost Per Loop**	**Support for Rural Carriers**
10 Percent	-8.77%	12.52%
20 Percent	-17.54%	26.66%
30 Percent	-26.32%	42.00%

G. The Supreme Court's holding in *Smith v. Illinois* still applies.

Responding to the Commission's inquiry regarding whether discontinuing separations would be consistent with *Smith v. Illinois*, Verizon asserts that the "*Smith* decision does not mandate separations regardless of the regulatory environment," and states further "*Smith* stands only for the proposition that, where rates are regulated based on costs, each jurisdiction must look only to the costs that fall with its 'competent government authority.'"[67] AT&T concurs with Verizon.[68]

Qwest, however, contends that *Smith v. Illinois* is still applicable, but asserts that the Commission has "broad latitude in modifying existing separations rules" and "wide latitude as to how it satisfies" *Smith v. Illinois* as long as it uses "reasoned decision-making."[69] Qwest acknowledges that:

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[67] Verizon, at 14.

[68] AT&T, at 9, citing *National Ass'n of Regulatory Utility Commr's v. FCC*, 737 F.2d 1095, 1112 (D.C. Cir. 1984).

[69] Qwest, at 15.

> Until ILECs are adequately relieved of common carrier regulation at both state and interstate levels and as long as they use common facilities to provide services in these jurisdictions, there will likely be a need for some sort of cost separation methodology.[70]

As the State Consumer Advocates have shown, the level of competition in the market has yet to render rate regulation moot, whether rates are regulated by price cap or traditional rate of return regulation. In order to assess whether rates are just and reasonable, cost data are essential. Therefore, as required by *Smith v. Illinois*, the Commission continues to be obligated to enforce compliance with separations rules, and, more generally, to ensure that the separations rules achieve the intended objective of apportioning costs properly between the federal and state jurisdictions. Furthermore, the Commission's apparent goal of not disrupting carriers' expectations about cost recovery should take a back seat to the more important goal of correcting a system of separations that is flawed not only by carriers' non-compliance, but also by outdated factors. The Commission stated in the recent Order,

> We find, as did the Commission in the *2001 Separations Freeze Order*, that avoiding a sudden cost shift will provide regulatory certainty that offsets the concern that there may be a temporary misallocation of costs between the jurisdictions. Maintaining the stability and regulatory certainty of the freeze will allow carriers to make investment decisions without fear that a reversion to the earlier rules would create radically different cost recovery requirements than they would currently expect.[71]

State Consumer Advocates respectfully disagree with the Commission's reasoning because carriers *should* have different cost recovery expectations than they now do. The

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[70] Id., citing 2001 Glide Path paper.

[71] *Order*, at para. 22, citing *Smith v. Illinois.*

longer that the FCC allows the frozen *status quo* to prevail, the longer carriers will consider themselves entitled to cross-subsidize their competitive offerings by allowing them to dodge any share of the cost burden. Carriers lack any economic incentive to step up to the plate and correct the flawed separations systems, and, therefore, it is critically important for the Commission to alert the industry to the need to require compliance with existing separations rules and to reform separations rules. Furthermore, as State Consumer Advocates stated in initial comments, although the Commission may determine that *Smith vs. Illinois* may not require "extreme precision," the current freeze "institutionalizes a gross imprecision."[72] Therefore, the Commission should take steps to reform separations in a timely manner to satisfy *Smith vs. Illinois*.

III. SEPARATIONS REFORM

A. The Commission's application of separations accounting has not kept pace with new technologies; as a result, consumers of intrastate regulated services are bearing unfair cost burdens.

If, contrary to State Consumer Advocates' and others' recommendation, the Commission decides to abandon the separations process, it is essential that federal and state regulators *first* re-initialize rates. Otherwise, the present interstate and intrastate rate levels and rate structures will perpetuate unfair cost recovery and cross-subsidization by regulated services of competitive offerings.

Rather than making separations moot, as the industry contends, the emergence of new technologies and consumers' evolving use of services make separations -- between

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[72] Baldwin Affidavit, at 64, citing *FNPRM*, at footnote 52 wherein the Commission stated: "We stress that,

regulated and unregulated services, and between interstate and intrastate jurisdictions -- more relevant than ever. AT&T proposes that the separations process should not be extended to unbundled network elements ("UNEs"), DSL, private line services, Internet traffic or Internet protocol ("IP")-based services even if the separations process is not discontinued, because the process is "wholly unnecessary in competitive markets because suppliers are price takers, forced to price services according to market forces rather than based on costs, and thus have no opportunity to double-recover."[73] Alexicon suggests, on the other hand, that the "current Voice over Internet Protocol ('VoIP') technology for interexchange calling has certainly added a previously unexpected complication to the determination of interexchange and interstate/intrastate jurisdiction, but this does not necessarily affect either competitive neutrality or cost causation issues in the long term."[74]

The Commission should heed regulators' concerns in this regard. For example, the Wisconsin Public Service Commission ("PSC") observes that the current separations system does not assign costs correctly for products and services such as UNEs, fiber-to-the-home and unregulated wholesale services, and private line/special access. The Wisconsin PSC observes further that these inaccurate cost allocations adversely affect customers of rate-of-return regulated companies.[75] As discussed earlier in these comments, inaccurate cost allocations *also* harm customers of companies regulated by

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under the principles of *Smith v. Illinois*, extreme precision is not required in the separations process."

[73] AT&T, at 7.

[74] Alexicon, at 4.

price cap systems.

Accurate cost accounting is critical to protect today's and tomorrow's consumers from the risks associated with ILECs' new lines of business. Based on a pretense of competition, the RBOCs claim that separating costs is an irrelevant exercise. However, separating costs properly is essential not only to protect today's consumers, but also to protect future consumers. Improper cost accounting today, means that *existing* rates are excessive and should be re-initialized based on an exclusion of mis-assigned and mis-allocated costs.

Failure to establish proper cost accounting also jeopardizes *future* rates. Should ILECs discover in the future that they have spent excessive costs and earned inadequate returns on fiber-based and video services, they could attempt to seek rate increases for regulated services.[76] Proper cost accounting systems are essential to provide a foundation for any future investigations of carriers' requests to raise rates.

B. Continuing growth in DSL demand corroborates concerns about DSL's free ride over the common network.

The RBOCs' quarterly investor reports released in October 2006 show that DSL demand continues to increase significantly, further entrenching the RBOCs' dominance

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[75] Wisconsin PSC, at 3.

[76] Experience in the electric industry may be instructive. Federal and state regulators, anticipating that competition would yield lower prices, eliminated many forms of rate protection for consumers of electricity. A decade later, consumers are seeing rate increases, and the anticipated competition has failed to materialize, in part due to resistance from incumbents. "Competitive Era Fails to Shrink Electric Bills: More Increases Are Seen – Some States Are Seeking to Return to a System of Regulated Prices," *The New York Times,* October 15, 2006, at 1. Also, while consumers confront rate increases, investors that purchased power plants are reaping vast profits. "In Deregulation, Power Plants Turn Into Blue Chips," *The New York Times*, October 23, 2006, at 1. Absent adequate regulatory protection and proper cost accounting, consumers of intrastate telecommunications regulated services will be at risk of future rate increases.

of the “triple-play” market. Table 5 and Figure 1, which incorporate the recent data, show the increasing demand for DSL.[77] Demand for the RBOCs’ DSL services increased approximately ten-fold during a six-year period, from approximately 1.8 million lines in 2000 to approximately 20.1 million at the end of the third quarter of 2006. This trend corroborates the concerns and the recommendations discussed in detail in State Consumer Advocates’ initial comments and supporting affidavits.

Table 5

Demand for Bells' DSL Continues to Increase Dramatically
(DSL connections in thousands)

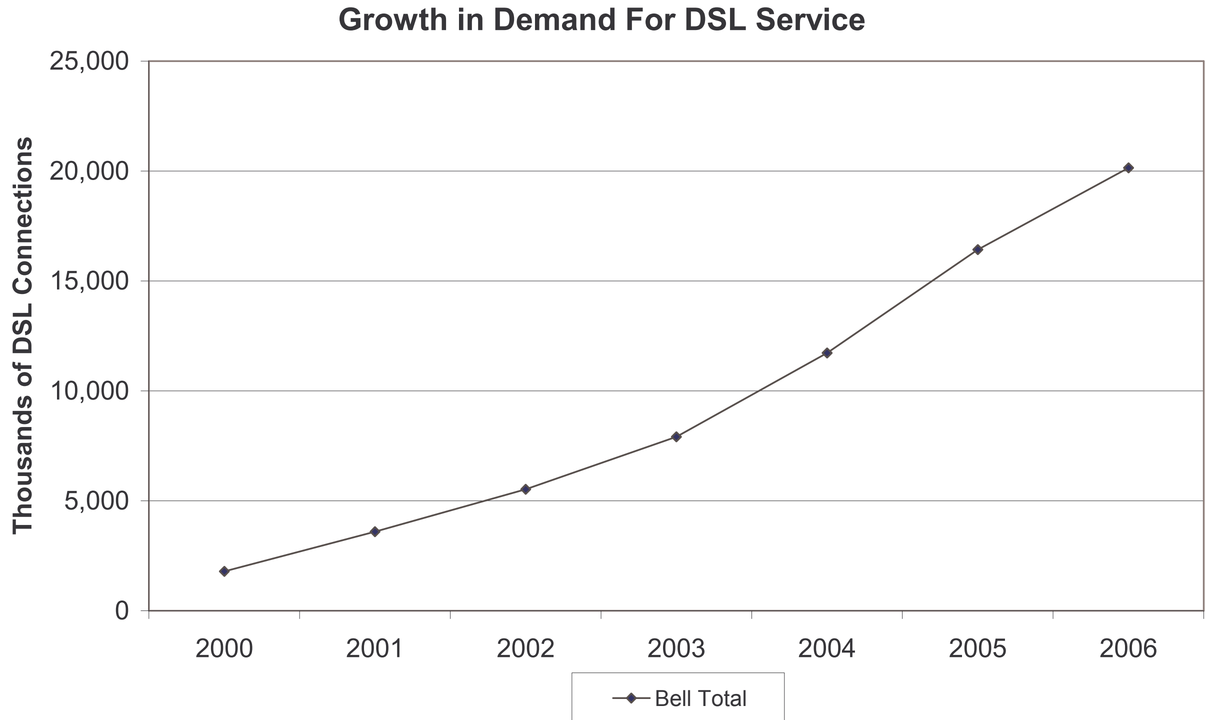
	2000	2001	2002	2003	2004	2005	2006
AT&T	767	1,333	2,199	3,515	5,104	6,921	8,148
BellSouth	215	621	1,021	1,462	2,096	2,882	3,449
Qwest	271	448	510	638	1,037	1,480	1,973
Verizon	540	1,200	1,800	2,300	3,485	5,144	6,573
Bell Total	1,793	3,602	5,530	7,915	11,722	16,427	20,143
Annual Growth Rate		101%	54%	43%	48%	40%	31%

Notes: 2006 numbers are as of the end of the third quarter of 2006. This table updates Table 3 in the Baldwin Affidavit.

Sources: SBC 2004 Annual Report, page 5; AT&T 2005 Annual Report, page 18; AT&T Q3 2006 Investor Briefing, page 16; BellSouth 2003 Annual Report; page 30; BellSouth 2004 Annual Report, page 26; BellSouth 2005 Annual Report, page 34; BellSouth Q3 2006 Investor News, page 7; Qwest 2001 Annual Report, page 45; Qwest 2002 Annual Report, page 37; Qwest Historical Financial Information, As of December 31, 2005, tab "Wireline" (QstatisticalProfile4Q05.xls, available at www.qwest.com); Qwest Third Quarter Financials, tab "Attachment D" (3Q2006_Attachments.xls, available at www.qwest.com); Verizon Q4 2000 Investor Quarterly, page 5; Verizon Q4 2002 Investor Quarterly, page 5; Verizon 2005 Annual Report, page 13; Verizon Q3 2006 Investor Quarterly, page 2.

[77] Table 5 and Figure 1 updates Table 3 and Figure 2 in the Baldwin Affidavit.

Figure 1



As stated by various parties, the Commission should direct carriers to assign and allocate plant based on DSL's use of the common network.[78] Table 6 quantifies the degree to which DSL presently gets a "free ride" over the public network.[79]

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[78] Idaho PUC, at 12-15; Vermont/Nebraska PSC, at 13-15, 18.

[79] Table 6 updates Table 5 in the Baldwin Affidavit.

Table 6

DSL "Free Rides" On Local Loop Investment

Year 2000	**Local Loop Investment**	**Switched Access Lines**	**DSL Connections**	**DSL Ratio**
AT&T	$38,002,020,000	58,041,420	767,000	1%
BellSouth	$21,795,268,000	25,087,026	215,000	1%
Qwest	$13,478,829,000	17,626,160	271,000	2%
Verizon	$44,274,219,000	63,016,104	540,000	1%
Bell Total	$117,550,336,000	163,770,710	1,793,000	1%
Year 2006				
AT&T	$45,197,899,000	44,062,251	8,148,000	16%
BellSouth	$25,462,175,000	18,808,132	3,449,000	15%
Qwest	$16,226,143,000	12,800,540	1,973,000	13%
Verizon	$49,215,330,000	48,636,292	6,573,000	12%
Bell Total	$136,101,547,000	124,307,215	20,143,000	14%
Bell Total % Change, 2000-2006	16%	-24%	1023%	

Notes: DSL Ratio is the ratio of DSL connections to the sum of DSL connections and switched access lines. Year 2006 Switched Access Lines are as reported at the end of 2005. Year 2006 DSL Connections are based on third quarter 2006 data. Because the actual 2006 Switched Access Lines figures are likely smaller than those shown above, the calculated DSL Ratio shown above underestimates the true DSL Ratio. This table revises Table 5 in the Baldwin Affidavit.

Sources: Local Loop Investment: ARMIS Report 43-04, Table I. "Separations and Access Data," Row 1455 (C&WF Cat. 1 - Exch. Line - Joint Use). Switched Access Lines: ARMIS Report 43-08, Table III. "Access Lines in Service by Customer," Row 910. DSL Connections: SBC 2004 Annual Report, page 5; AT&T 2005 Annual Report, page 18; AT&T Q3 2006 Investor Briefing, page 16; BellSouth 2004 Annual Report, page 26; BellSouth 2005 Annual Report, page 34; BellSouth Q3 2006 Investor News, page 7; Qwest Historical Financial Information, As of December 31, 2005, tab "Wireline" (QstatisticalProfile4Q05.xls, available at www.qwest.com); Qwest Third Quarter Financials, tab "Attachment D" (3Q2006_Attachments.xls, available at www.qwest.com); Verizon Q4 2000 Investor Quarterly, page 5; Verizon Q4 2002 Investor Quarterly, page 5; Verizon 2005 Annual Report, page 13; Verizon Q3 2006 Investor Quarterly, page 2.

In initial comments, State Consumer Advocates provided a lower-bound estimate of $16 billion of common plant investment that should be assigned to DSL.[80] Table 7

[80] State Consumer Advocates, at 8, Baldwin Affidavit at para. 115 and Table 6.

revises that estimate based on the more recent demand data and shows that *at least* $19-billion in investment should be assigned to Bells' DSL line of business.[81]

Table 7

Correcting Separations: Based on Demand

Method 1: Demand-Based Correction - Loops

	Local Loop Investment	DSL ratio	2006 Demand-Based Correction
AT&T	$45,197,899,000	16%	$7,053,643,183
BellSouth	$25,462,175,000	15%	$3,945,658,478
Qwest	$16,226,143,000	13%	$2,166,994,514
Verizon	$49,215,330,000	12%	$5,859,382,585
Bell Total	$136,101,547,000		$19,025,678,761

Note: The 2006 Demand-Based Correction - Loops method matches investment with demand for DSL connections. For example, because DSL connections account for 16% of AT&T's total of switched access lines and DSL connections, 16% of the local loop investment is allocated to nonregulated services.

Sources: Local Loop Investment: ARMIS Report 43-04, Table I. "Separations and Access Data," Row 1455 (C&WF Cat. 1 - Exch. Line - Joint Use). Switched Access Lines: ARMIS Report 43-08, Table III. "Access Lines in Service by Customer," Row 910. DSL Connections: SBC 2004 Annual Report, page 5; AT&T 2005 Annual Report, page 18; AT&T Q3 2006 Investor Briefing, page 16; BellSouth 2004 Annual Report, page 26; BellSouth 2005 Annual Report, page 34; BellSouth Q3 2006 Investor News, page 7; Qwest Historical Financial Information, As of December 31, 2005, tab "Wireline" (QstatisticalProfile4Q05.xls, available at www.qwest.com); Qwest Third Quarter Financials, tab "Attachment D" (3Q2006_Attachments.xls, available at www.qwest.com); Verizon Q4 2000 Investor Quarterly, page 5; Verizon Q4 2002 Investor Quarterly, page 5; Verizon 2005 Annual Report, page 13; Verizon Q3 2006 Investor Quarterly, page 2.

Furthermore, as is explained in detail in the State Consumer Advocates' initial

[81] Table 7 updates Table 6 in the Baldwin Affidavit. See Baldwin Affidavit, at paras. 114-115 for detailed discussion.

comments, the Commission should consider assigning 50% of common plant to unregulated services, which would shift approximately $68 billion to the Bells' unregulated operations.[82]

Table 8

Correcting Separations: Based on Cost Causation

Method 3: Cost Causation

	Local Loop Investment	50% Cost Causation Correction
AT&T	$45,197,899,000	$22,598,949,500
BellSouth	$25,462,175,000	$12,731,087,500
Qwest	$16,226,143,000	$8,113,071,500
Verizon	$49,215,330,000	$24,607,665,000
Bell Total	$136,101,547,000	$68,050,773,500

Note: The Cost Causation method assumes that one half of the local loop investment should be allocated to nonregulated services.

Source: ARMIS Report 43-04, Table I. "Separations and Access Data," Row 1455 (C&WF Cat. 1 - Exch. Line - Joint Use).

The Bells' unique ability to leverage their ubiquitous network (financed through an historic stream of revenues from intrastate regulated noncompetitive services), enables them not only to offer DSL, but more importantly to attract and lock in triple-play

[82] Table 8 corresponds with Table 8 in Baldwin Affidavit. See Baldwin Affidavit, at para. 117.

customers with bundles of local, long distance, video and Internet access services.[83] Assigning costs solely based on DSL demand would represent movement in the right direction, but would still clearly understate the fair share of the network that should be assigned and allocated away from intrastate regulated services. ILECs should allocate at least half of the common local loop away from intrastate regulated services. As Table 8 shows, this would shift approximately $68 billion out of intrastate regulated rates.

C. Developments in the special access and private line markets render the separations freeze unsustainable.

Initial comments echo the State Consumer Advocates' concern about carriers' failure to assign the increasing quantities of interstate private lines to the interstate jurisdiction. The Wisconsin PSC states that, since the 2001 freeze, costs related to special access and private lines have been improperly intermingled with common line expenses. The Wisconsin PSC cites as evidence the supra-normal profits earned by numerous ILECs for their special access service: Out of 80 companies reporting, 55 had returns on investment in excess of 60%.[84] Describing this as "supra-normal" certainly strains the meaning of "normal." "Mind-boggling" would seem to fit more accurately, and it should take nothing more than this one fact to convince a disinterested observer that there is something seriously amiss in the separations regime, which needs fixed for

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[83]For example, in New Jersey, on August 4, 2006, Governor Corzine signed cable franchise legislation A-804/S-192. On November 2, 2006, Verizon filed the first application for a video franchise in New Jersey, seeking authorization to offer FiOS TV to consumers in 316 communities in New Jersey. http://newscenter.verion.com/press-releases/verizon/2006/verizon-to-file-first.html, site visited 11/6/2006.

[84] Wisconsin PSC Appendix A, at 5-6. The Vermont/Nebraska PSC and the Idaho PUC also cite ARMIS data to show that ILECs have earned extraordinarily high returns on special access.

the protection of consumers and competition.

The Idaho PUC and Vermont/Nebraska PSC note that the Commission and Joint Board recognized that interstate special access should be watched closely when it adopted the freeze in 2001. They state,

> Unfortunately, the Joint Board and the Commission have failed to take any meaningful action on this problem during the five years of the freeze, and the existing problems were exacerbated by a post-freeze decision from an FCC staffer. Now the problem has become so serious that the category freeze cannot be further extended.[85]

The Idaho PUC asserts that the Commission Staff decision to disallow any adjustment to any frozen categories in 2004 was contrary to FCC rules and exacerbated the mismatch.[86]

This misallocation has, of course, led to overstated costs for the intrastate jurisdiction. In describing why special access rates are a concern, the Idaho PUC states:

> A separations error that erroneously raises interstate earnings will also erroneously lower intrastate earnings, and this can provide a basis for a request to increase intrastate rates. Moreover, an error of this type could produce an implicit subsidy of interstate special access services by intrastate subscriber charges or switched access rates. This could also lead to violation of either sentence of section 254(k) because special access services are both more competitive than switched access, and not part of the services supported by universal service. In sum, separations outputs for special access are seriously out of balance, and the problem is now large enough to have a significant impact on total costs. Barring unforeseen events, the Commission should abandon the category freeze in 2009 when the current freeze expires.[87]

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[85] Vermont/Nebraska PSC, at 18-19. See, also, Idaho PUC, at 16.

[86] Idaho PUC, at 16; See, also, Vermont/Nebraska PSC, at 18.

[87] Idaho PUC, at 18.

Vermont/Nebraska PSC express similar concerns.[88]

Verizon asserts that "separations reform would not help the Commission to evaluate the reasonableness of special access rates…. Special access rates are competitively disciplined and have been declining in real terms in both price cap and price flex areas."[89] Verizon further states,

> while the category-specific rates of return calculated under the Part 69 rules are economically meaningless, as noted above, revising the separations process will not produce a more accurate picture of special access earnings. This is so because any effort to allocate costs among services or regulatory jurisdictions is inherently arbitrary, and has become even more so with the introduction of new services and technologies.[90]

The Commission should dismiss Verizon's unpersuasive argument. Rather than being "arbitrary" as Verizon asserts, assigning plant properly based on the increasing quantity of *interstate* special access lines, consistent with existing separations requirements, would correct a blatantly unfair mis-assignment of network costs to the state jurisdiction. State Consumer Advocates' initial comments demonstrated the disproportionate growth in interstate special access services:

> According to the Commission's *Statistics of Communications Common Carriers*, special access revenues for the Bells increased 29% in just one year from December 31, 2000 to December 31, 2001 and increased a total of 61% between December 31, 2000 and December 31, 2004 (from $9.4-billion to just over $15-billion). The number of special access lines increased by 103% between December 31, 2000 and December 2004. Therefore, the plant associated with this huge growth should be shifted from the

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[88] Vermont/Nebraska PSC, at 21.

[89] Verizon, at 10.

[90] Id., at 11.

> intrastate jurisdiction (where it is erroneously "frozen") to the interstate jurisdiction.[91]

State Consumer Advocates reiterate their recommendation that the Commission issue an interim order that eliminates any lingering uncertainty about states' existing authority to require carriers to assign directly all private lines and special access circuits based on existing line counts.

There are two alternative methods that would correct the mismatch between revenue and cost that could be implemented immediately without any further study, analysis or investigation. First, Cable and Wire Facility investment could be allocated among the categories on the basis of the number of voice grade equivalent lines served. These line counts are reported annually in the ARMIS 43-08 report. Second, Special Access investment could be categorized on the basis of the Special Access revenue. That is, Special Access investment as a percent of subject-to-separations total plant in service can be based on Special Access revenue as a percent of subject-to-separations total operating revenues. These data are reported in ARMIS 43-01, Table I report.

A third method based on the number of circuits rather than voice grade equivalents is also worthy of investigation. However, it is our understanding that circuit count information is not currently reported to the FCC, and thus, using such a method would require the carriers to provide additional information in a consistent manner. Developing consistent standards for that new reporting requirement would delay the

[91]Baldwin Affidavit, at para. 124, citing FCC, *Statistics of Communications Common Carriers*, for years ended December 31, 2001 through December 31, 2004, Table 2.8, year ended December 31, 2000, Table 2.10. Special Access Revenues (Acct No. 5083); Table 2.6. Total special access lines include Special Access Lines (non-switched) analog (4kHz or Equiv) and Special Access Lines (non-switched) digital (64

implementation of that method. While State Consumer Advocates remain committed to the proposition that special access investment should be directly assigned based on the cost of providing special access services, State Consumer Advocates offer these alternative temporary fix methodologies that the Commission could adopt immediately.

D. The Commission should ignore the Bells' broadband "scare tactics."

Contrary to the ILECs' rhetoric, correcting the flawed separations process will not deter economically efficient broadband investment.[92] The Commission should reject the ILECs' oft-used scare tactic of threatening to withhold infrastructure investment unless they obtain the regulatory freedoms they seek.[93] These threats are simply a transparent attempt to distract regulators from the critically important task of ensuring that ILECs fairly and efficiently assign and allocate common network costs. Verizon asserts that separations studies "could have a deleterious effect on investment in new broadband networks, potentially limiting the reach and increasing the cost to consumers of valuable new services."[94] USTelecom argues that the risk to rate-of-return companies of revising

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kbps or Equiv).

[92] The Commission's broadband goal should not be to provide a *carte blanche* for Bells' broadband deployment but rather to ensure that: (1) the most efficient supplier deploys state-of-the-art telecommunications infrastructure where it is economically viable to do so; and (2) in those instances where broadband deployment is not economically viable (that is, where the anticipated revenues would not exceed the anticipated costs), yet where regulators nonetheless seek broadband deployment for broader public policy goals, the subsidies are explicit and the most efficient providers supply the broadband.

[93] For example, in various states, local exchange carriers asserted to regulators and/or legislators that if productivity offsets were set too high, the ILECs would not deploy state-of-the-art telecommunications networks. The ILECs have a long history of using infrastructure investment as a *quid pro quo* for regulatory relief.

[94] Verizon, at 16.

jurisdictional separations is greater than the benefit to consumers.[95] USTelecom asserts that the market is currently introducing all types of new services over new and upgraded networks and that "[a]ny change to separations might actually affect rates, it would introduce uncertainty into this process, and might actively penalize innovation and investment in the new services."[96]

ILECs want to have their cake and eat it too: they successfully lobbied for the ability to deny broadband access to competitors and to exclude VoIP[97] and broadband services from state regulatory oversight,[98] yet they now want to preclude state regulators from ensuring that consumers of intrastate regulated services do not foot the bill for these new services and technology. *Separations rules are essential to ensure that consumers of intrastate regulated services do not subsidize ILECs' forays into unregulated services.*

Verizon faults parties including the NJ Rate Counsel for a position that purportedly would discourage Verizon's next-generation infrastructure investment, stating:

> Some parties already have wrongly suggested that recent deregulatory actions merit a substantial reallocation of investment from the state to the federal jurisdiction. . . . If these views were reflected in new separations rules, network owners would face arbitrary, non-market-based limits on cost recovery, which would

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[95] USTelecom, at 6.

[96] USTelecom, at 6.

[97] In 2004, the Commission adopted the *Vonage Order* in which it declared that it had jurisdiction over VoIP services. *Vonage Holdings Corporation for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission*, WC Docket No. 03-211, *Memorandum Opinion and Order*, 19 FCC Rcd 22404 (2004) ("Vonage Order").

[98] The Commission held that DSL service is interstate in 1998. *GTE DSL Order*, 13 FCC Rcd at 22474-83. The Commission subsequently held that wireline broadband Internet service is an information service. *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, Universal Service Obligations of Broadband Providers*, CC Docket No. 02-33, et al., *Report and Order and Notice of Proposed Rulemaking*, 20 FCC Rcd 14853 (2005) ("Broadband Sharing Order").

> undermine incentives to make the massive investments that are required to deploy new, next-generation networks. Such an outcome would be inimical to the public interest and directly contrary to Congress's and the Commission's core goal of promoting the availability of broadband services.[99]

Contrary to Verizon's assertion, cross-subsidization of new unregulated lines of business with revenues from intrastate regulated services "would be inimical to the public interest." State Consumer Advocates urge the Commission to consider carefully the decision-making that a firm that confronted effective competition would undertake.

In a competitive market, Verizon would only undertake those "massive investments" for which the anticipated net present value of its anticipated revenues (and reduced expenses) exceed the anticipated net present value of all relevant anticipated costs.[100] On the other hand, *mingling* the costs of new (unregulated and/or interstate) and existing services (regulated and/or intrastate) services while *isolating* the unregulated revenue stream from state regulators' oversight is strategically prudent for the carriers, but harmful to consumers. This strategy, however, does not mean that Verizon's "massive investments" would pass a sound business case *if costs were properly assigned*

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[99] Verizon, at 16-17, citing Comments of N.J. Division of the Ratepayer Advocate, WC Docket No. 05-342, at 10-11 (Jan. 23, 2006).

[100] If the broadband market is *not competitive*, then the Commission should re-assert jurisdiction over the Bells' pricing and deployment of the service. State Consumer Advocates posit that the concentrated cable-telco duopoly indeed does not provide effective competition. See Baldwin Affidavit at para. 56, footnote 67 and para. 74, footnote 86.

and allocated. Free-riding over the common network (*i.e.,* without revenue or cost sharing) is an unfair business strategy that benefits shareholders and burdens consumers of regulated intrastate services.

State Consumer Advocates support Commission efforts to achieve ubiquitous broadband deployment at affordable rates, but, contrary to Verizon's rhetoric, the achievement of this goal should not and need not depend on a flawed separations process. As was stated in one of the affidavits supporting State Consumer Advocate's initial comments in this proceeding:

> [T]here is a distinctly different policy issue related to DSL, i.e., the deployment of broadband to rural, unserved, and underserved areas. The FCC's modification to its existing cost accounting rules to correct for the present imbalance between the allocation of DSL revenue and costs merits prompt attention. An unintended consequence of such a correction might be to create a dis-incentive for deployment in rural areas (i.e., since, under the modified accounting, the Bell could no longer recover 75 percent of common costs from the POTS customer base (through intrastate basic exchange rates and the interstate subscriber line charge), Bells would have yet one more reason to delay DSL deployment in areas that might not be profitable. This secondary effect, however, pales in significance to larger causes for disparate broadband deployment, namely the Commission's August 2005 decision ultimately to exempt DSL from USF contributions.[101]

E. Other parties also recommend that the separations process exclude costs for non-regulated services such as wireline broadband services.

The Idaho PUC, Iowa Board, and Vermont/Nebraska PSC recommend excluding

[101] Baldwin Affidavit, at para. 110, footnote 132, citing *Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities, Universal Service Obligations of Broadband Providers*, CC Docket No. 02-33, *Report and Order and Notice of Proposed Rulemaking*, 20 FCC Rcd 14853 (2005).

costs for non-regulated services. Specifically, these regulators refer to wireline broadband as a "semi-deregulated" service that receives inconsistent treatment by the FCC and individual states. The Idaho PUC, Iowa Board, and Vermont/Nebraska PSC recommend that common definitions be put into place for the treatment of wireline broadband.[102] The Idaho PUC and Vermont/Nebraska PUC further argue that the recent decisions that switched traffic terminating at an ISP and VoIP traffic are both interstate in nature changes the boundaries between intrastate and interstate traffic, such that the 75% intrastate/25% interstate allocation factor is no longer appropriate.[103]

The Idaho PUC and Vermont/Nebraska PSC also comment on the mismatch between the assignment of DSL revenues and cost, observing that DSL revenues increasingly are assigned to non-regulated services, while 75% of the expenses are assigned to the state. Vermont/Nebraska PSC states that "[a]t worst DSL may be the cause in fact of substantial incremental loop costs to upgrade existing plant, while the majority of those costs get assigned to intrastate; and switched service revenue can disappear if the carrier provides only DSL on the loop."[104] Vermont/Nebraska PSC argue that even larger mismatches may be occurring with fiber deployment.[105] The Idaho PUC and Vermont/Nebraska PSC recommend that the Commission take these steps:

- Adjust the 75%/25% fixed factor applicable to all loops so as to increase the interstate share.

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[102] Idaho PUC, at 12-13; Iowa Board, at 7-8; and Vermont/Nebraska PSC, at 14-15.

[103] Idaho PUC, at 14; Vermont/Nebraska PSC, at 16-17.

[104] Vermont/Nebraska PSC, at 17; Idaho PUC, at 15.

[105] Id.

- Adjust usage-based separations factors to adjust for ISP traffic and VoIP.

- Adopt a new fixed factor for DSL and fiber loops or develop a new separation method for DSL services, fiber services and other services "that generate only interstate or preemptively nonregulated revenues."[106]

The Commission should acknowledge the concerns raised in State Consumer Advocates' initial comments and supporting affidavits and echoed by other commenters such as Vermont/Nebraska PSC. There is a chorus of support for revising the 75%/25% loop allocation factor.[107] State Consumer Advocates do not dispute the value of state-of-the-art broadband networks to society, and indeed, contend that they are of sufficient importance that the Commission should not have deregulated them.[108] However, the Commission, once having relinquished its oversight of broadband services, should now ensure that this deregulated line of business carries its full share of common network

[106] Vermont/Nebraska PSC, at 18; Idaho PUC, at 15.

[107] Vermont/Nebraska PSC, at 18; Idaho PUC, at 15. In discussing the 75%/25% split, the Pennsylvania PUC states: "The PaPUC urges the FCC to recognize and address, in some kind of remedial fashion, the fact that this interim freeze imposes costs on intrastate regulators for growing interstate services. The PaPUC is concerned that intrastate regulators continue to assume responsibility for 75% of the regulated costs of the local loop even as the FCC 'federalizes' newer services such as Digital Subscriber Line (DSL) service, Voice over Internet Protocol (VoIP), Broadband over Power Lines (BPL), and Internet Service Provider (ISP) services that often rely on this local loop. Moreover, access to the regulated local loop for these services is often determined by federal special access prices that ensure recovery of the 25% allocated to interstate services but not the 75% allocated to intrastate regulators." Pennsylvania PUC, at 3.

[108] In the 1980s, digital switches were "state of the art," but regulators appropriately retained jurisdiction over carriers' deployment of these switches. Simply because a technology or service is state-of-the-art, it does not follow that the service is a competitive service or that it should be deployed outside of regulatory oversight. *See* Baldwin Affidavit, footnote 114. (By contrast, customer premises equipment innovations appropriately occurred outside of regulatory oversight, because they are supplied in a competitive market). Those services that represent a public good, such as traditional highways, and information highways, and those services that exhibit externalities particularly merit regulatory scrutiny. Now, however, having yielded its oversight, the Commission's responsibility is to ensure that carriers assign a fair share of common network costs to their unregulated lines of business.

costs. If the Commission fails to do so, consumers clearly will have the worst of both worlds -- they will lack the protection that regulatory oversight of broadband deployment and costs would provide and yet will bear the cost of broadband deployment.

The Commission should reject arguments that it is too difficult to conduct separations. Verizon submits that in the five years since the freeze was adopted "there has been an explosion of distance- and usage-insensitive services that defy jurisdictional classification and further exacerbate the arbitrary nature of jurisdictional cost allocations."[109] The Pennsylvania PUC raises concerns about state regulators' ability to assign costs to regulated and unregulated services, and therefore to ensure that non-regulated costs are not recovered from regulated costs, "given the exponential use of the local loop to provide increasingly federalized, and unregulated, information services using telecommunications equipment and networks."[110] State Consumer Advocates have offered several specific approaches for correcting the presently outdated and unfair allocation system. Any of the approaches that State Consumer Advocates describe in their initial comments and in these reply comments would represent a vast improvement over the status quo. State Consumer Advocates urge federal and state regulators to adopt these approaches in a timely manner to correct the flawed foundation for interstate and intrastate regulated rates.

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[109] Verizon, at 16, citing *Wireline Broadband Order*, at para. 142, fn 434.

[110] Pennsylvania PUC, at 2.

F. There is little support for any one of the *Glide Path II* proposals.

Despite Commission requests for input regarding the merit of the proposals outlined in the *Glide Path II Paper* and for analysis as to how the proposals account for the many changes in the industry over the past 15 years, few comments address the *Glide Path II* proposals in detail.[111] Carriers, for the most part, either support a continuation of the freeze or total abandonment of separations rules.[112] On the other side are those that support further analysis and submit that the Commission must obtain more information from carriers before moving forward with reform.

Qwest correctly notes that Options 1 (continue the interim freeze on an annual basis) and 2 (extend the freeze past June 30, 2006) are now moot.[113] On the other hand, JSI asserts that of the *Glide Path* proposals, only Option 1, is satisfactory for rate-of-return carriers.[114]

Qwest gives cautious support to Option 3 (use fixed factors), but opposes any special conditions on companies using fixed factors which would lead to higher USF contributions. The Vermont/Nebraska PSC argue in favor of searching for ways to reduce the cost of complying with regulations, including the movement from usage-based factors to fixed factors, perhaps over a multi-year phase-in period. In addition, they contend that categorization of plant and expense accounts should be eliminated where

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[111] *FNPRM*, at para. 30.

[112] Verizon, at 17-18; Associations, at 2; AT&T, at 3; Verizon, at 14; WTA, at 1; BellSouth, at 5; USTelecom, at 1.

[113] Qwest, at 31-32. See, also, Baldwin Affidavit, at para. 35.

possible.[115] However, as stated in the Baldwin Affidavit, submitted with State Consumer Advocates' initial comments, Option 3 does not adequately address the "severe imbalance" of costs between the local loop and the unregulated lines of business it supports.[116]

No compelling reasons have been put forth for support of Option 4 (use of fixed rates and residual ratemaking) and the Option should be taken off the table given that it would "seem to usurp states' rate setting responsibility by leaving them 'residual' rates to recover."[117] Alexicon opines that "[t]his then becomes some type of a circular, non-logical proposal. It also sets the stage to force all companies to become some type of price cap regulated entity, eliminating current options for rate-of-return regulation and cost recovery."[118]

Regarding Option 5 (coordinating separations changes with USF and intercarrier connection changes), as stated previously in these reply comments, many commenters recognize the interconnectedness of the reforms currently under review by the Commission in various proceedings. However, the Commission should dismiss calls to act in other proceedings prior to addressing concerns in this proceeding. At a minimum, the Commission should act on NARUC's resolution and clarify that states can require carriers to directly assign all private lines and special access circuits based on existing

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[114] JSI, at 2.

[115] Vermont/Nebraska PSC, at 13.

[116] Baldwin Affidavit, at para. 36; See, also, Alexicon, at 8.

[117] Baldwin Affidavit, at para. 37.

line counts.[119] As stated in State Consumer Advocates' initial comments, "[d]elay in re-initializing excessive state rates harms consumers, and therefore, states should not await the conclusion of this proceeding before examining carriers' costs."[120]

Qwest suggests that Option 6 (eliminating separations) is impossible until ILECs are relieved of their common carrier obligations.[121] As stated in the Baldwin Affidavit: "Unless and until effective competition disciplines ILECs' market power, federal and state regulators require access to cost accounting information to fulfill their responsibility to ensure that rates are just and reasonable and that ILECs do not over-recover their costs in the two distinct jurisdictions."[122] Alexicon suggests that using Option 6 to eliminate separations is premature. Alexicon notes that all states may not support the option and thus the result may be a "hodge-podge of methods, rules, or accounting requirements that become much more cost and time intensive than existing uniform Federal Rules."[123] If the Commission does consider Option 6, it should do so only in the context of the "exit ramp" conditions outlined by the Iowa Board, Idaho PUC, and Vermont/Nebraska PSC and discussed below.

G. The Commission should reduce rates for interstate regulated

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[118] Alexicon, at 8.

[119] See discussion in the next section.

[120] State Consumer Advocates, at 7.

[121] Qwest, at 31-32.

[122] Baldwin Affidavit, at para. 39.

[123] Alexicon, at 9.

services and state regulators should reduce rates for intrastate regulated services to correspond with the re-assignment and re-allocation of billions of dollars of investment to unregulated services and to interstate special access services.

Because the *status quo* unfairly penalizes consumers of regulated services, and particularly consumers of intrastate regulated services, the Commission should take immediate steps to ameliorate the present mis-assignment and mis-allocation of costs. The Commission should consider the solutions and methodologies utilized by Ms. Baldwin and Dr. Loube in their affidavits submitted with the State Consumer Advocates' initial comments, and also discussed above.

The allocation of at least $20 billion, and as much as $60 billion in common network plant investment to the Bells' unregulated and/or interstate services (corresponding to the significant and increasing demand for DSL, bundled services, and video offerings) would yield lower basic intrastate rates. Under an intrastate price cap system, this correction to the Bells' cost accounting would represent an exogenous change that should lower intrastate rates, and under traditional rate of return regulation, this correction would lower Bells' intrastate revenue requirement, also yielding lower rates for consumers.

Over-simplifying in order to illustrate the magnitude of the impact, and assuming a 10% return on investment, the $20 billion or $60 billion reduction in intrastate plant in service would lower the intrastate annual revenue requirement by more than $2 billion or $6 billion. Translating this amount into a per-line, monthly amount, and using the approximate 124 million access lines shown in Table 6 above, this preliminary correction would lower intrastate monthly consumer bills by at least between one and three dollars.

The actual reduction would be significantly more because the lower plant investment would also yield lower depreciation charges and other expenses.

If Bells were required to assign network investment based on interstate special access lines, monthly intrastate consumer bills would decline even further. Presently, consumers' state rates are excessive, and, therefore, timely clarification and reform by the Commission is critically important to yield just and reasonable rates and to prevent anticompetitive cross-subsidization of competitive services.

H. As a matter of law and sound policy, the Commission should reject carriers' attempt to preclude states from assigning and allocating costs to the interstate and to unregulated categories.

Various carriers seek to preclude states from exercising their legal authority to review and, as necessary, correct, Bells' assignment and allocation of network costs and expenses.[124] For example, Verizon asks the Commission to "make clear that states are not free to compel carriers to alter the frozen category allocations"[125] and seeks Commission rejection of NARUC's request for direct assignment of private lines and special access circuits based on current line counts:

> The Commission should reaffirm the broad scope of the freeze in order to prevent states from demanding the reclassification of investment from intrastate to interstate. Not only would such reallocation compel the same burdensome studies that the freeze was intended to eliminate, it would also result in a state's ability to reclassify as "interstate" investment that, under the Commission's rules, must be considered intrastate. Permitting states to mandate such reallocation would undermine the freeze as well as the overall concept of a unified, national approach to jurisdictional

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[124] See, *e.g*. Verizon, at 19-21; Qwest, at 25-26; USTelecom, at 3, 7.

[125] Verizon, at 19.

separations, and thus would be preempted.[126]

The Commission must unambiguously reject these efforts for the reasons set forth in detail in the State Consumer Advocates' initial comments.[127] Separating costs fairly may be a complex task and may even be an arcane process, but neither the complexity nor the esoteric nature of the separations process renders it irrelevant to the task of establishing just and reasonable rates. Verizon notes that not all states have moved from a cost-based regulatory regime, and states:

> Until the reform process is completed, the Commission should establish a mechanism to eliminate preemptively separations requirements in jurisdictions that have already transitioned to regimes that do not impose regulatory requirements based on archaic notions of cost or otherwise rely on separations and then preempt those states from imposing any new cost allocation rules. In jurisdictions that do still rely on separations, the Commission should extend the current freeze and encourage regulators in those jurisdictions to eliminate archaic rate regulation regimes and accompanying unworkable cost allocation rules in order that consumers may fully realize all the benefits of today's intensely competitive marketplace.[128]

Verizon neglects to describe the benefits that "consumers may fully realize." Contrary to Verizon's misplaced reasoning, the Commission should not abandon separations unless and until state regulators have had ample opportunity to re-initialize intrastate regulated rates based on comprehensive, ILEC-supplied data,[129] about the assignment and allocation of cost away from the public network to unregulated and/or interstate services.

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[126] Id., at 21, citing *Crockett Tel. Co*, 963 F.2d at 1567, 1573; *Hawaiian Tel. Co.*, 827 F.2d at 1275-76.

[127] State Consumer Advocates; Baldwin Affidavit, at paras. 18-27, 62-63.

[128] Verizon, at 2.

[129] ILECs can minimize the level of complexity and contribute to an expeditious regulatory review by

Verizon also describes its own version of a "glide path," contending that

> the Commission should establish a glide path toward discontinuing separations requirements in jurisdictions that no longer utilize separations and adopt a mechanism now that permits carriers to eliminate separations in those jurisdictions that no longer rely on separated costs. In particular, to ensure a smooth transition with minimal burdens on both carriers and states, the Commission should adopt a streamlined process to remove separations requirements on a per-carrier, state-by-state basis. This process should allow any carrier no longer subject to regulation that relies on costs in a particular state to petition this Commission to eliminate separations requirements for that state. The separations requirements should automatically end for that carrier in that state if the state does not object within a set period and demonstrate that separations-derived costs actually are used in regulating telephone rates.[130]

Contrary to this recommendation, separations requirements should not sunset, but rather should only expire if and when a state demonstrates to the Commission that the process is no longer necessary. State Consumer Advocates disagree with Verizon's assertion that the "Commission has authority to adopt binding separations rules (including a federal policy that eliminates separations requirements in certain circumstances) and to preempt inconsistent state requirements."[131] Separations data and processes are integral to states' fulfillment of their responsibility to ensure just and reasonable rates for intrastate regulated services.

BellSouth states that reform of the separations process "should embrace relief that not only stabilizes and simplifies the jurisdictional separations process but also eliminates

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providing comprehensive and fully supported cost information.

[130] Verizon, at 11.

[131] Id., at 12, citing 47 U.S.C. Sec 221(c), 410(c); *Crocket Tel. Co. v. FCC*, 963 F.2d 1564, 1567 and 1573 (D.C. Cir. 1992); *Hawaiian Tel. Co. v. Public Utils. Comm'n of Haw*., 827 F.2d 1264, 1275-76 (9th Cir.

the process under the appropriate circumstances."[132] State Consumer Advocates do not oppose reasonable measures to simplify the jurisdictional process, provided that such measures ensure that unregulated and interstate services bear a fair share of common network costs and expenses.

The Wisconsin PSC agrees with Option 6 of the *Glide Path II* paper that the industry is nearing the point where the separations process is eliminated for some companies whose rates are either market-based, or price regulated.[133] However, the Commission should consider the "exit ramp" that the Idaho PUC, Iowa Board, and Vermont/Nebraska PSC recommend for incumbent carriers, which would end separations requirements after rigorous conditions have been met. The Idaho PUC states:

> If separations results are not relevant for any regulatory purpose, no carrier should bear the cost of conducting separations studies and reporting separations data. Accordingly, the FCC should establish an "exit ramp" option for incumbent carriers to terminate their separations obligations.[134]

The Iowa Board's, Idaho PUC's and Vermont/Nebraska PSCs' support for an exit ramp is predicated on conditions, stating: "any decision to eliminate a carrier's separations data should be made only after carefully examining the current uses of that data."[135] The conditions outlined by the Idaho PUC, the Iowa Board, and Vermont/Nebraska PSC for carriers to take the "exit ramp" from separations include the following:

1987), *cert. denied*, 487 U.S. 1218 (1988).

[132] BellSouth, at 2.

[133] Wisconsin PSC, at 5.

[134] Idaho PUC, at 6. *See, also,* Iowa Board, at 2; Vermont/Nebraska PSC, at 6.

[135] Iowa Board, at 2; Idaho PUC, at 6; Vermont/Nebraska PSC, at 9.

- A carrier should be required to waive the right to claim exogenous low-end rate adjustments for price caps in the interstate jurisdiction;

- A carrier should be required to "assert that it is deregulated in the state jurisdiction" and to waive all rights to a claim of unconstitutional confiscation of its property under the Fifth Amendment;

- An affected state commission should be required to certify that it has no use for separations data from the particular carrier, "nor does it expect to have such a need."

- In order to allow USAC calculation of universal service support for "exiting carriers" and other, the FCC should freeze the carrier's universal service payments as of the date of "opt-out."

- The FCC should exclude the carrier from future calculation of industry averages that depend upon jurisdiction categorization and separations.[136]

These proposed conditions are a reasonable start. In addition, carriers should waive their right to claim exogenous low-end rate adjustments for price caps in the intrastate jurisdiction as well. Also, although a carrier's waiver of all rights to a claim of unconstitutional confiscation is appealing, it is not clear that this could occur under all circumstances.

Clearly, it could be challenging for a state commission to know in advance that it would not have a future need for separations data. Also, a carrier's USF support, though frozen, could be excessive. On the other hand, if it could be tailored to withstand unexpected circumstances, the requirements that carriers waive their rights to a claim of unconstitutional confiscation of its property under the Fifth Amendment addresses State

[136] Idaho PUC, at 8; Iowa Board, at 4; Vermont/Nebraska PSC, at 9.

Consumer Advocates' concern that carriers, at one point in the future, will seek recovery of the costs of fiber business plans gone awry. Also carriers' waiving the right to claim exogenous low-end rate adjustments in the interstate and intrastate jurisdictions mitigates the present lopsided "risk-sharing" where consumers bear the risk of new infrastructure deployment and carriers reap the revenues. Finally, State Consumer Advocates recommend that federal and state regulators re-initialize rates even if the separations process is abandoned. As shown above, billions of dollars are at stake, and are being borne unfairly by customers of intrastate regulated services.

IV. THE STATUS QUO HARMS CONSUMERS AND IS UNSUSTAINABLE.

A. The Commission should reject proposals to hold the separations process hostage to other ongoing proceedings.

State Consumer Advocates urge the Commission to reject industry's efforts to stonewall reform of the separations process. ILECs support further delay in resolving the outstanding issues in the separations process, and support continuation of the *status quo*.[137] The Western Telecommunications Alliance ("WTA") suggests that not only should the Commission delay separations reform further while resolving other industry proceedings, but also proposes that the Commission delay any resolution of separations issues "until it has allowed more time for certain critical technological and industry trends to become more clear."[138] One could ask, when will that be? And equally, when

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[137] Qwest, at ii; USTelecom, at 7; Associations, at 8; Alexicon, at 2-3.

[138] Western Telecommunications Alliance ("WTA"), at 1.

has it ever been?

State Consumer Advocates concur that the intercarrier compensation and universal service proceedings are linked to the separations investigation, and, that, therefore, the Commission should not consider the matters of each proceeding in isolation.[139] However, the Commission can and should move forward in this proceeding. Consumers should no longer continue to bear the cost of regulatory inaction regarding separations. As stated in initial comments: "Delay in re-initializing excessive state rates harms consumers, and, therefore, states should not await the conclusion of this proceeding before examining carriers' costs."[140]

Furthermore, the Commission should issue an interim order removing any residual uncertainty about states' rights to remove the costs of non-regulated and interstate activities from intrastate rates.[141] Finally, the Commission should reject calls for delay based upon continuing technological developments in the industry. The industry is continually changing and recent technological developments are precisely the reason reforms in the separations process are needed and the *status quo* is no longer acceptable.[142] Indeed, the seismic changes in the industry necessitate Commission attention. Furthermore, contrary to ILEC proposals, the Commission should reject the

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[139] Qwest provides an example: "the proposals of Qwest and others for IC reform could entail a shift of revenues and costs for certain services from the intrastate jurisdiction to the interstate jurisdiction. The Commission's separations rules must accommodate such a shift without unnecessarily skewing the results." Qwest, at 3. Qwest also states that separations reform may affect USF support to certain areas. Id., at 6.

[140] State Consumer Advocates, at 7.

[141] Id., citing Baldwin Affidavit, at paras. 18-27, 62-63.

[142] As stated in initial comments: "Both Ms. Baldwin's and Dr. Loube's affidavits clearly demonstrate that the status quo unfairly burdens customers of regulated intrastate services." Id., at 9.

Missoula Plan's proposed increase of the SLC (or any other proposals to increase the SLC), and should reject any proposed increases to high cost support until the Commission examines the carriers' *properly allocated* costs.[143]

B. Contrary to industry assertions, the benefits of the separations rules far outweigh the costs.

The industry complains loudly about the burdens of complying with separations rules.[144] For example, Verizon expresses concern regarding the "considerable costs on carriers, costs ultimately absorbed by consumers" imposed by the separations rules[145] and further states that "Verizon alone devoted at least 60 employees and 11 major computer systems to maintaining the separations databases and performing separations calculations."[146] However, the advantages that ILECs enjoy as a result of their historic dominance in telecommunications markets significantly outweigh the purported disadvantage to ILECs of being required to comply with separations rules.

The benefits of separations reform outweigh the inconvenience to ILECs. Inaction benefits the industry and harms consumers. It is not surprising that the ILECs raise their voices in opposition to "complex" separations rules whereby they would be held accountable for the way that they spend money and the way that they recover those monies from consumers.

ILECs also raise concerns about competitive neutrality. BellSouth states that

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[143] Id. at 9-10.

[144] See Qwest, at 11, 13; BellSouth, at 2.

[145] Verizon, at 8.

[146] Id.

because only ILECs are required to separate costs, the application of separations rules creates a competitive imbalance in the telecommunications market.[147]

The Wisconsin PSC states:

> Comprehensive separations reform should promote innovation and efficient investment. Separations methods need to move away from the results-oriented approaches used by regulators of monopoly utilities, and instead make changes consistent with technological changes and corresponding market judgments regarding cost recovery. Those changes should mirror how the industry's unregulated competitors assign their costs to services.[148]

Yet Alexicon notes that there has been little competition for many of its clients (small, rural ILECs) and thus no real comprehensive reform is needed. However, Alexicon asserts that jurisdictional separations rules should apply to competitive carriers who receive Universal Service Funds and that the rules allow regulators to review cross-subsidy allegations and continue price and rate-of-return regulation for the small ILECs.[149]

The Commission should afford no weight to the ILECs' complaints about the purported anticompetitive effect of the separations process. ILECs are quickly re-monopolizing markets and enjoy the significant advantages associated with historic monopoly dominance in many telecommunications markets. The enormous advantage that their historic monopoly position bestows upon them more than compensates the ILECs for the unique responsibility to account for their costs properly.

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[147] BellSouth, at 1; see also Qwest, at 12, AT&T, at 6, USTelecom, at 3.

[148] Wisconsin PSC, at 6-7.

[149] Alexicon, at 10.

C. The Commission should reject calls to continue the separations freeze; doing so unfairly requires consumers of intrastate regulated services to subsidize unregulated services and/or interstate services.

Many industry commenters take the position that if the Commission determines that there is still a need for separations, then the separations freeze should simply be continued..[150] For example, Verizon proposes that the Commission extend the current freeze until it eliminates separations altogether, suggesting the reforming separations would be "futile" and that the "problems endemic to separations cannot be fixed."[151]

As State Consumer Advocates described in detail in initial comments and in the accompanying affidavits, the status quo is unacceptable. Although State Consumer Advocates disagree with the Wisconsin PSC's assertion that the continued study of the

[150] See, e.g., id., at 3; JSI, at 7, WTA, at 1.

[151] Verizon, at 14.

separations process has thus far produced no significant harm to the market or consumers, it does agree with the conclusion that "to permanently extend the freeze and to not explore and consider more substantial changes to separations policy and mechanics would fail to recognize the real, and continuing, evolution of the telecommunications marketplace."[152]

Contrary to other commenters urging the total abandonment of separations or continuation of the status quo, the Idaho PUC urges the Commission to "rewrite the Part 36 separations manual" noting that "the industry seems unwilling to comply with the existing separations manual."[153] The Commission should resist the temptation to simply abandon or freeze separations indefinitely simply because, as the Idaho PUC suggests: "[t]he LEC industry will be highly likely to resist any effort to mandate compliance with existing rules when the freeze expires in 2009."[154]

D. The Commission should issue a detailed data request in a timely manner.

Carriers' opposition to a data request is unpersuasive because, among other reasons, it is based on the unfounded proposition that separations accounting is unnecessary. USTelecom submits that there is no need for additional data given that the separations regime is frozen and its position that separations should be abolished. USTelecom states that "[t]here is no need, therefore, for additional data regarding the

[152] Wisconsin PSC, at 1-2.

[153] Idaho PUC, at 19.

[154] Id.

accuracy of this obsolete regulatory accounting process."[155] This assumes that the world in 2006 has not changed from the world as it was in 2000.[156] That proposition is flatly contradicted by the industry's own submissions here.

Furthermore the carriers argue that it is burdensome to comply with the proposed data request because they have largely abandoned separations studies since the 2001 freeze.[157] The Commission is now reaping the consequences of inaction and continuation of the separations freeze for five years. It appears that the carriers have long ago decided for themselves that separations data would not be needed in the future.

AT&T proposes that "the Commission should first address whether jurisdictional separations is necessary for interstate rate making purpose before it asks ILECs to invest the time and resources necessary to respond to the nine page request."[158] Qwest similarly proposes that the Commission first reform separations, limiting the data required, and then seek data: "Once the Commission is comfortable with a particular separations plan, then the Commission should issue a targeted data request to determine whether the industry can provide the information necessary to implement separations reform without an undue burden. "[159]

The carriers have turned the regulatory process on its head. The Commission

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[155] USTelecom, at 9.

[156] The current allocation factors and category relationships frozen in 2001 are based on the carriers' separations studies using data from calendar year 2000. FNPRM, at footnote 25.

[157] Qwest, at 18-19; Associations, at 3, 13; AT&T, at 10; Verizon, at 18.

[158] AT&T, at 10.

[159] Qwest, at 17.

should first have access to all relevant information in order to address the issues in this proceeding and make an informed decision regarding the future of separations. As the Commission recognized in the FNPRM, "[T]he information derived from such a data request will be useful in assisting the Commission as it contemplates comprehensive separations reform."[160] The industry seeks to limit the options for reform by limiting the amount and type of information available to the FCC, state commissions, state consumer advocates, and others. The Commission should dismiss this tactic outright and instead should act immediately to address the current information asymmetry among stakeholders so that all parties can contribute adequately to the revision of cost accounting rules.[161]

Similarly, the Commission should reject Verizon's assertion that the collection of data would be "premature" because the current freeze does not end until 2009 and the current data would therefore be "stale."[162] Of course, then, in 2008 the industry will submit that there is insufficient time and resources to devote to the problem. The Commission should reject the industry's circular reasoning whereby information is either stale (because it was collected too early) or the industry lacks time and resources to provide the information (because the Commission did not give ample warning of its need for information). Furthermore, the Commission should collect data now in order to have the requisite time to analyze the impact of the seismic changes in the industry that have

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[160] FNPRM, at para. 33.

[161] State Consumer Advocates, at 12.

[162] Verizon, at footnote 29.

taken place since 2000, the year upon which the current allocations are based.

In addition to the specific recommendations set forth in initial comments,[163] State Consumer Advocates also recommend that the Commission direct carriers to provide information on the quantities of interstate special access circuits that they supply, to assist the Commission in quantifying the investment and expenses that should be assigned to interstate private line services rather than to the intrastate jurisdiction.

V. CONCLUSION.

State Consumer Advocates urge the Commission to implement timely reform to the separations process to ensure that: 1) consumers of intrastate and interstate regulated services do not cross-subsidize incumbent local exchange carriers' pursuit of unregulated fiber, video, and other technologies and services, and 2) consumers of intrastate regulated services do not cross-subsidize interstate regulated services, such as special access. State Consumer Advocates also urge the Commission to eliminate any lingering ambiguity about states' rights to assign and allocate appropriate portions of common network plant and expenses to unregulated and to interstate services. States' scrutiny of carriers' costs is essential to ensure that state regulators can fulfill their responsibility to set just and reasonable rates, whether through exogenous adjustments to price cap systems, re-initialization of rates, or traditional rate of return regulation. Federal guidance and reform on separations would facilitate states' rate-making, but, delay in such guidance and reform should not deter states from undertaking their own independent review of

[163] State Consumer Advocates, at 12; Baldwin Affidavit, at para. 100; Loube Affidavit, at para. 53.

how carriers assign and allocate common network plant

Respectfully submitted,

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