

IN THE MATTER OF THE PROVISION
OF UNIVERSAL SERVICE TO
TELECOMMUNICATIONS
CONSUMERS.

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BEFORE THE
PUBLIC SERVICE COMMISSION
OF MARYLAND

CASE NO. 8745

ORDER NO. 77913

Chairman Catherine I. Riley
Commissioner Claude M. Ligon
Commissioner J. Joseph Curran, III
Commissioner Gail C. McDonald

Dated: July 17, 2002

APPEARANCES

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IN THE MATTER OF THE PROVISION OF UNIVERSAL SERVICE TO TELECOMMUNICATIONS CONSUMERS.	* * * * * * *	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND _____ CASE NO. 8745 _____

I. INTRODUCTION

Before the Public Service Commission of Maryland (“the Commission”) in this matter are two primary issues; *i.e.*, the need for a universal fund for telecommunications services in Maryland and whether access charges paid by interexchange telecommunications carriers (“Interexchange Carriers” or “IXCs”) are necessary to support basic service.¹ This case has a long history and its issues, in varying degrees, have been addressed in prior cases and, in some aspects will be addressed in other cases presently before the Commission and in future cases.

In Order No. 72348 in Case No. 8584, Phase II, *Re MFS Intelenet of Maryland, Inc.*, 86 Md. PSC 467 (1995), the Commission directed that this proceeding be instituted.²

¹ The testimony and evidence at this stage of the proceedings has focused significantly on the level of access rates charges to interexchange carriers in Maryland. *See* Verizon-MD’s Initial Brief at 1, n. 1. Within this Order, the terms “access charges” and “access rates” may be used interchangeably.

² *See also* Commission Order No. 73011 in Case No. 8715, *Re Alternative Forms of Regulating Telephone Companies*, 87 Md. PSC 232 (1996) (or Price Cap Order).

In Case No. 8715, the Commission directed the Commission Staff (“Staff”) to submit an issues list for the universal service proceeding. The instant case, Case No. 8745, was docketed by the Commission by letter order dated January 2, 1997.³ The Commission scheduled a prehearing conference for March 6, 1997 and directed Bell Atlantic-Maryland, Inc. (now Verizon-Maryland Inc., “Verizon-MD” or “the Company”) to publish notice of the proceedings throughout the State in newspapers of general circulation.⁴

On May 8, 1997, the Federal Communications Commission (“the FCC”) issued its Report and Order *In the Matter of Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, FCC 97157 (commonly referred to as “the Universal Service Order”). In response to the provisions of that order, Staff filed a supplemental universal service issues list with the Commission on July 11, 1997. The Commission gave all parties to this proceeding the opportunity to respond to Staff’s lists. After considering the presentations of all the parties at a Status Conference held on July 28, 1998, the Commission directed the parties to submit initial and reply comments relative to the first phase of Case No. 8745 in November and December of 1998, respectively.⁵

³ Staff filed its initial issues list on December 30, 1996.

⁴ Notice of these proceedings was published in each of the 23 counties and in Baltimore City.

⁵ During the course of the proceedings, motions to intervene were filed by AT&T Communications of Maryland, Inc. (“AT&T”), the United States Department of Defense and All Other Federal Executive Agencies (“DOE/FEA”), Cable Telecommunications Association of Maryland, Delaware and the District of Columbia, the Office of Attorney General, the Maryland State Department of Education and the Maryland Higher Education Commission, Sprint Communications Company L.P. (“Sprint”), the Center for Media Education, the Maryland Department of Health and Mental Hygiene, the University of Maryland System, Armstrong Telephone Company, MCI Telecommunications Corporation (now WorldCom, Inc.), Comcast Telephony Communications of Maryland, Inc., Jones Telecommunications of Maryland, Inc., Sprint Spectrum L.P., Z-Tel Communications, Inc., Network Access Solutions Corporation, Conectiv Communications, Inc., Johns Hopkins University and J. Robert Burgoyne, *pro se*. By Order of the Commission dated June 13, 1997 and such other orders as directed by the Commission, all motions to intervene were granted.

On October 7, 1998, AT&T Communications of Maryland, Inc. (“AT&T”) filed a complaint against Verizon-MD concerning switched access rates. In its complaint AT&T requested that the Commission order a \$66 million reduction in switched access rates. Verizon-MD filed its response to the complaint on December 8, 1998, arguing that AT&T had failed to provide a basis for the Commission to reduce access rates and therefore AT&T’s complaint should be dismissed.⁶ By letter dated January 15, 1999, the Commission merged the issue of Verizon-MD’s access rates into the consideration of the universal service issues docketed in Case No. 8745. The Commission heard arguments regarding the first phase of issues on February 9, 1999. Over time, a number of issues and sub-issues raised in this proceeding have been raised and addressed, at least to some extent, in other cases. For example, in its order adopting an alternative form of regulation for Verizon-MD, in Case No. 8715, the Commission reduced access rates by \$32.1 million. In that case, however, other universal service issues were deferred back to this proceeding.

By letter dated April 25, 2000, the Commission informed the parties of its intention to continue its investigation regarding the need for a universal service fund in Maryland, as well as regarding the level of access rates. The Commission directed the parties to comment on issues including: (a) reducing access charges to cost or by a second interim amount; (b) the amount of the reduction if access charges are reduced to cost; (c) the amount of reduction if access charges are reduced as a second interim measure; (d) whether Verizon-MD’s cost studies should be

⁶ Verizon-MD’s Answer was docketed by the Commission on January 21, 1999. Case No. 8745, Docket No. 119.

revised; and (e) the determination of what types of cost studies are necessary to determine the level of universal service fund (“USF”), if any.

On August 17, 2000, AT&T renewed its motion for the Commission to implement an immediate reduction in Verizon-MD’s access charges. Verizon-MD objected to AT&T’s request by letter dated September 18, 2000. On October 24, 2000, the Commission directed the parties to, among other things, determine the cost for terminating toll traffic utilizing either existing revenue-cost studies believed to be sufficiently accurate or prepare updated revenue-cost studies.⁷ The Commission further ordered the parties to comment on Staff’s proposals to reduce the residual interconnection charge (or “RIC”) and to lower the cost of the local switching component equal to the cost of local call termination which was established in Case No. 8731, Phase II. Initial and reply comments, as well as cost studies, were submitted by the parties in November and December of 2000 and became the subject of evidentiary hearings.

In March of 2001, testimony was filed by Verizon-MD and AT&T. Revised testimony was filed by Verizon-MD in May of 2001. In June of 2001 AT&T, Sprint, DOD/FEA, CWA, OPC, and Staff filed rebuttal testimony. Evidentiary hearings were held on June 25, 2001 to June 29, 2001 and on July 5, 2001. The parties submitted briefs in August of 2001.⁸ The issues for determination will be set forth more fully below.

⁷ The Commission mandated that the cost studies be forward-looking and that updated revenue-cost studies for shortfalls in rural areas meet the following guidelines: 1) use the Commission-ordered cost model inputs; 2) reflect the most current Commission-determined UNE costs; 3) report a basic service analysis of revenues and costs using the FCC’s definition of basic service and include dial tone-line and local usage; 4) report a local service analysis and include revenues and costs for basic service, yellow pages, intraLATA toll, vertical services and toll access revenues at a cost-based level; and 5) report results on a wire center basis and UNE rate zone basis.

⁸ Responses to in-hearing data requests were filed in the docket and shall be considered a part of the evidentiary record.

II. PARTIES' POSITIONS

A. Verizon-MD

Verizon-MD's case consisted of testimony and evidence presented by six witnesses: Mr. William R. Roberts, President of Verizon-MD; Mr. John R. Gilbert, Director of State Regulatory Policy and Planning for Verizon-MD; Mr. John A. Pehta, Director-Economic Costs/Regulatory Support in the Service Costs organization of Verizon Services, Inc.; Mr. Edwin F. Hall, Vice President - Corporate Books operating as the Comptroller and Chief Financial Officer for Verizon Inc.; Dr. William E. Taylor, Senior Vice President of National Economic Research Associates, Inc.; and Mr. Francis J. Murphy, President of Network Engineering Consultants, Incorporated.

In his testimony, Mr. Roberts addressed various public policy issues that existed within this proceeding and provided an outline of the testimony of other witnesses appearing on behalf of Verizon-MD. Mr. Roberts urged the Commission to maintain the current level of access charges. In support of Verizon-MD's policy recommendations, Mr. Roberts discussed: (1) various consequences that may occur if access charges are reduced; (2) the actions that have been taken by the FCC; and (3) Verizon-MD's Price Cap Plan. Mr. Roberts indicated that Verizon-MD's access charges are among the lowest in the former Bell Atlantic Region. Additionally, witness Roberts argued that competition in the intraLATA toll market does not need to be stimulated by a reduction in access charges; that a reduction in access charges would make it less attractive for Competitive Local Exchange Carriers (or "CLECs") to enter the local market; and that it is highly

unlikely that access charge reductions would benefit low-volume business and residential customers.

Mr. Roberts indicated that the FCC has determined that the elimination of implicit subsidies from access charges is best done over time. Specifically, Mr. Roberts pointed to the FCC's CALLS plan, a rate-restructuring plan wherein some rate elements, such as interstate switched access charges, were decreased while others were increased.⁹ Mr. Roberts recommended that the Commission recognize that "any access charge reductions should be balanced with increases in other rates."¹⁰ Verizon-MD opined that its Price Cap Plan would be violated if the Commission ordered a reduction in Verizon-MD's access charge revenues because it would deprive Verizon-MD of profits it earned legitimately under the Plan and undermine the efficiency goals of price regulation. Additionally, Verizon-MD argued that under the terms of the Price Cap Plan, access rate reductions outside the price cap index formula would fall under the exogenous change provision of the Plan and must be offset in the rates of other services. Ultimately, as indicated by witness Roberts, Verizon-MD concluded that even if the Commission reduced access charges, "there is no meaningful way for the Commission to enforce a requirement to flow through" the reductions.¹¹

⁹ *Access Charge Reform*, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962 (2000) (*CALLS Order*), *aff'd in part, rev'd in part, and remanded in part*, *Texas Office of Public Util. Counsel v. FCC*, 265 F.3d 313 (5th Cir. 2001), *cert. denied*, *Nat'l Ass'n of State Util. Consumer Advocates v. FCC*, 70 U.S.L.W. 3444 (U.S. Apr. 15, 2002).

¹⁰ Verizon-MD Exh. 2 at 16.

¹¹ Verizon-MD Exh. 3 at 3.

Another Verizon-MD witness, Dr. Taylor, further testified that “[b]ased upon past experience with access charge reductions, any commitment to pass through access charge reductions is unmeasurable and unenforceable. The Commission cannot control intrastate toll prices; instead, market forces and the IXC’s profitability calculation will determine price changes ... [.]”¹² Because the IXC’s toll prices are “only loosely regulated,” Dr. Taylor reasoned that there would be no way to determine what toll prices would have been absent any reduction in access charges and hence no way to determine if the IXC’s have provided flow through to their end-users.

Verizon-MD filed cost studies purporting to calculate the forward-looking cost of providing basic service, toll, access and vertical services in Maryland in compliance with the Commission’s directives. Despite its effort to comply with the Commission’s directive, Verizon-MD argued that the ordered inputs are not appropriate for use in this study. Verizon-MD maintained that for costs to be calculated on a forward-looking basis, all inputs must likewise be on a forward-looking basis; for example, a historical cost of money is irrelevant to a forward-looking cost study.

The costs contained in the study were based upon the Total Service Long Run Incremental Cost (“TSLRIC”) methodology, which represents the difference between the

¹² Verizon-MD Exh. 15 at 15.

cost the firm incurs to provide all of its products and services under study and the cost if the firm does not produce a particular service, family of services or group of services. The TSLRIC analysis sponsored by Verizon-MD reflected only the direct incremental cost of providing a service, and excluded other costs such as shared or common costs. Dr. Taylor testified that access charges should not be set at their incremental costs. According to Dr. Taylor, while incremental costs represent an appropriate starting point for pricing in general, the drawback is that prices set equal to incremental costs would not permit Verizon-MD to recover the economic costs it incurs to provide services. Examples of these economic costs include Verizon-MD's shared and common fixed costs. Verizon-MD also argued that the current level of access charges was not unfair or anti-competitive; that the "total service analysis" requested by the Commission was not useful; and that the revenues and costs of Verizon-MD's Yellow Pages subsidiary were not relevant. With respect to yellow pages, Dr. Taylor opined that the profits of Verizon-MD's Yellow Pages subsidiary cannot be used to offset the cost of basic service, since Verizon-MD does not operate that business and the business is competitive.

In response to OPC's arguments, Dr. Taylor testified that the local loop is not a shared facility, and that the entire cost of the local loop should enter into a proper calculation of TSLRIC for network access services. Dr. Taylor stated that:

[T]he local loop is a facility that enables an end-user to gain access to the public switched telephone network. . . The access or connectivity gained by use of this facility is a pre-condition for being able to receive various forms of *usage* services, *e.g.*, local calling, long distant (toll) calling, Internet calling, Call Waiting and other custom features, voice messaging, etc. That is, the

local loop is the single delivery vehicle used by various providers of usage services to bring their services to the end-user. This attribute of the loop often leads observers to conclude that the local loop is a shared facility and, hence, a source of shared costs. However, from an economic perspective, the local loop is not a shared cost of all telecommunications services. Rather, it is an “output” service that is demanded in its own right. Therefore, regardless of its many *uses* or *benefits*, it cannot be thought of as an input and, most importantly, must be identified with the full cost that is added to the network when a local loop is placed in service.¹³

According to Verizon-MD witness Pehta, Verizon-MD’s cost studies calculate: (1) capital costs, which include depreciation, cost of capital and income tax expense and which are intended to reflect the cost of Verizon-MD’s investments; (2) operating expenses, that is the day-to-day expenses required to provide service such as marketing, maintenance, repair and testing; and (3) gross revenue loading factors that reflect items such as regulatory assessments and uncollectible revenues.

Verizon-MD also provided testimony regarding the cost model sponsored by AT&T, the FCC Synthesis Model. Primarily Verizon-MD argued that not only does the FCC Model contain “scores of serious platform and input flaws that cause it to produce unreliable and significantly understated estimates of Verizon-MD’s cost of providing universal service in Maryland,” the FCC Model was not designed to determine the size of a state universal service fund or approved by the FCC for intrastate fund calculations or unbundled network elements (or “UNE”) cost calculations. Other concerns stressed by Verizon-MD were that the FCC Model cannot be fully

¹³ Verizon-MD Exh. 20 at 3-4 (emphasis in original).

validated; the FCC Model cannot satisfy the Commission directives concerning cost models for this proceeding; and the FCC Model relied on the use of nationwide inputs that are inconsistent with the Model's algorithms and are not reflective of the operating realities of Verizon-MD.

In addition to the cost studies discussed above, Verizon-MD, in testimony sponsored by witness Gilbert, also provided: (1) a basic service analysis using the FCC's definition of basic service, including dial tone line and local usage; and (2) a total service analysis comparing the costs and revenues for basic service, Yellow Pages, intraLATA toll, vertical services, and intrastate access services. Verizon-MD interpreted "basic service" as including single party service; voice grade access to the public switched network; Dual Tone Multifrequency ("DTMF") signaling; access to emergency service; access to operator services; access to interexchange service; access to directory assistance; and toll limitation services. Verizon-MD interpreted level of local usage as including 30 message units. Verizon-MD based this interpretation upon the usage allowance approved by the Commission for Tel-Life service, Maryland's most basic telephone service offering.

As explained by Verizon-MD witness Gilbert, Verizon-MD also added two additional categories to its analysis: the subscriber line charge ("SLC") revenue and reciprocal compensation expense. SLC revenue is an interstate revenue stream that is designed to recover a portion of the non-traffic sensitive basic loop costs of the Dial Tone Line and because the cost study included all revenues and costs associated with the Dial Tone Line, Verizon-MD included

the SLC revenue. As for the reciprocal compensation expense, Verizon-MD claimed that it is a direct offset to its local usage revenues also included in the study at a level of 30 message units.

Additionally, Verizon-MD included both shared and common costs in its analysis because, as Verizon-MD explained it, they are costs that must be recovered by Verizon-MD's total revenues. Verizon-MD also included a 12 percent common overhead ("COH") cost.

According to Verizon-MD, its results indicated that if residential service was segregated out from business service, based upon the monthly contribution per DTL, residential Dial Tone Lines require a subsidy universally throughout the State. These subsidies are provided by the contribution received from services such as access, toll, and value added services. According to the residential basic service analysis, residential services throughout all areas of the State and business service in the most rural zone do not cover their costs. As for the basic service analysis by wire center, they concluded the bottom line is that residential service generated a negative annual contribution while business service generated a positive annual contribution.

By contrast, the results of Verizon-MD's total service analysis by wire center on an annual basis demonstrated that when all of the contributions from the other service categories are combined, they generate more revenue than costs for the majority of the UNE rate zones. Only the most rural rate zone, Zone 3, still failed to cover its costs according to this study. Verizon-MD noted that the Commission has never specified which subsidies from which services were targeted to support below cost local rates. In its experience, Verizon-MD claimed that where other commissions have reduced access, those reductions were offset with increases to other

rates. According to Verizon-MD, access only contributes a portion of the subsidization that is provided to basic service.

Verizon-MD identified several problems with the Revenue/Cost Analysis required by the Commission. Verizon-MD claimed that the Commission required approach misuses incremental costs in a quasi-revenue requirement analysis. Additionally, Verizon-MD claimed that the Commission-ordered inputs are outdated and inappropriate in determining costs for retail services.

In his written testimony, Verizon-MD witness Hall also addressed several aspects of the arguments raised by opposing parties. In particular, Mr. Hall argued against the inferences raised by AT&T witness Cosgrove's attempt to draw a parallel between access reductions and Verizon-MD's financial standing. According to Mr. Hall, "the suggestion that Verizon-MD might be able to financially withstand the reduction in access rates ... in no way legitimizes the appropriateness of doing so under price cap regulation."¹⁴ Furthermore, Mr. Hall objected to the source of intrastate data information utilized by AT&T, as he claimed that none of the reports used by AT&T have any value as a measurement of Verizon-MD's intrastate rate regulated earnings. In response to OPC's claims that Verizon-MD will be able to sustain high margins on services like local and toll usage and value added services because it provides the loop and switching, Verizon-MD argued that the nature of competition and the innovation of competitors

¹⁴ Verizon-MD Exh. 6 at 3.

ensures that there is no guarantee that a company will get the high margin services just because it provides the dial tone line.¹⁵

B. AT&T

On October 7, 1998, AT&T filed with the Commission a complaint stating that Verizon-MD was pricing access well above costs. Specifically, AT&T argued that since 1998, Maryland consumers have paid Verizon-MD \$175 million too much in access rates. AT&T also stated that the Commission had full authority to reduce Verizon-MD's access rates, and that such a reduction would not violate Verizon-MD's Price Cap Plan, nor would a reduction constitute an exogenous change under the Price Cap Plan. In addition, AT&T pledged to flow-through the entire benefit of a reduction in access rates to Maryland consumers.

AT&T argued that traditionally access rates have been used to offset the cost of local service. However, as a result of declining costs and new revenues, Verizon-MD no longer needs inflated access rates to offset its cost of providing local service in Maryland. As shown by ARMIS data filed with the FCC, Verizon-MD's revenues and net income have increased substantially since the Price Cap Plan was introduced. The ARMIS data also show that even assuming a reduction in access rates to costs, Verizon-MD's return on net investment in the year 2000 would still have been higher than in any year prior to the implementation of the Price Cap Plan. As a result, in addition to lowering switching and

¹⁵ In response to a data request, however, Mr. Hall provided a Verizon chart which essentially mirrored the ARMIS data.

transport rates, AT&T believes that the RIC (defined earlier as the Residual Interconnection Charge) and the Carrier Common Line Charge (“CCLC”) should be eliminated, since these charges are not based on any costs, but were put in place to offset or compensate Verizon-MD for revenues lost from interexchange competition.

Testifying on behalf of AT&T were: Brian F. Pitkin, Director of the Financial Services division of Klick, Kent & Allen, Inc.; Judith L. LaGarde, District Manager, Local Services and Access Management, for AT&T’s Eastern Region; Terry L. Murray, President, Murray & Cratty, LLC; Thomas J. Cosgrove, former AT&T employee and independent consultant; Michael R. Baranowski, Vice President, Klick, Kent & Allen, Inc.; Catherine E. Pitts, Contractor for AT&T; and Joseph P. Riolo, Independent Consultant.

Regarding cost recovery for the local loop, AT&T does not believe that any portion of the costs of the loop should be borne by access rates, since according to AT&T it is inefficient to recover a non-traffic sensitive cost by means of a traffic sensitive charge such as access.¹⁶ Attempting to recover non-traffic sensitive costs by using access rates sends the wrong pricing signals to customers. Further, AT&T argued that allowing Verizon-MD to price access in such a manner provides Verizon-MD with the ability to discriminate against other carriers by means of a price squeeze.

The forward-looking costs of providing local service must be identified for the purpose of determining the need for a universal service fund. In order to arrive at these costs, AT&T used the FCC’s “Synthesis Model,” the purpose of which was to estimate the cost to provide basic

telephone service.¹⁷ AT&T witness Pitkin explained the decision of AT&T to utilize the FCC Synthesis Model and the adjustments made to the Model throughout the proceeding. Mr. Pitkin testified that when the Synthesis Model is used with the Commission-ordered inputs, it is clear that the revenues from local service are more than sufficient to cover costs. Hence, AT&T recommended that the Commission determine that there is no need for a universal service fund.

However, AT&T also responded that even if the Commission determined that the Verizon-MD model should be used, there is still no need for a universal service fund. AT&T believed that if Verizon-MD used proper Commission input, and used a more reasonable definition of basic service, its revenues would still be sufficient to cover its costs. AT&T witness Baranowski further argued that the revenues Verizon-MD witness Gilbert included in his analysis from message units were greatly understated, thereby understating the level of contribution Verizon-MD received from residential and business services. AT&T concluded that each rate zone recovers its costs, and that both business and residential basic local service have sufficient revenue to recover their costs.

AT&T also spent considerable time analyzing the current financial performance of Verizon-MD. According to AT&T witness Cosgrove, AT&T utilized information provided by Verizon-MD, either to the Commission, to the FCC or to the parties during discovery. Witness Cosgrove stated that Verizon-MD's revenues have been increasing much faster than its operating

¹⁶ See AT&T Exh. 25 at 16-17.

¹⁷ The Synthesis Model was derived from the Benchmark Cost Proxy Model ("BCPM"), Version 3.0 ("BCPM"); the Hatfield Association, Inc. ("HAI") Model, Version 5.0a ("HAI"); and, the Hybrid Cost Proxy Model, Version 2.5 ("HCPM").

expenses, particularly since 1996, when Verizon-MD began operating under the Price Cap Plan.¹⁸ AT&T pointed out dramatic increases in both the revenue that Verizon-MD received from its basic local services, and the number of total switched access lines that Verizon-MD serves. Witness Cosgrove further reasoned that Verizon-MD's financial results may potentially be understated because Verizon-MD's records continue to show investment for equipment that does not exist.¹⁹ Additionally, Mr. Cosgrove testified that Verizon-MD had removed highly profitable services such as Yellow Pages, payphone and inside wiring from its regulatory oversight reporting, and that the "excellent financial results VMD has been able to achieve would be even more stellar if they were restated to include revenues, expenses and investments associated with these services."²⁰ Finally, in support of the position that Verizon-MD is a financially sound and bountiful company, Mr. Cosgrove noted that in the year 2000 Maryland consumers contributed \$5.67 per line, per month to the Verizon corporate parent, whereas customers in other Verizon states paid no dividend at all to the corporate parent.²¹

AT&T recommended that access rates be reduced to cost, plus a 12 percent markup to cover joint and common costs. As presented by witness LaGarde, under AT&T's proposal, access rates would be reduced by a total of approximately \$75 million per year. The proposed \$75 million reduction would include lowering the switching and transport costs by about \$5 million, and eliminating the CCLC and the RIC, which would reduce rates by approximately \$43

¹⁸ AT&T Exh. 17 at 5.

¹⁹ *Id.*

²⁰ *Id.* at 18.

million and \$26 million respectively. Witness LaGarde stressed that the CCLC and the RIC were “contribution” rates and did not represent any costs that Verizon-MD incurs in providing switched access services.²² AT&T proposed an actual access rate of \$0.002813 per minute. This rate includes common transport of \$0.000353 per minute, end office transport and termination of \$0.00225 per minute, and tandem transport and termination of \$0.0033 per minute (with 80 percent of the calls terminating at the end office and 20 percent of the calls terminating at the tandem).

AT&T’s proposed rate was determined by using the UNE interconnection rates from 8731, Phase II. AT&T witness LaGarde, as well as witness Murray, argued that the switching and transport functions that Verizon-MD performs as part of its switched access service are functionally equivalent to the tasks performed during interconnection; and as such, these rates should be set equivalent to the UNE interconnection rates determined by the Commission in Case No. 8731, Phase II.²³

AT&T argued that attempting to recover non-traffic sensitive costs by using access rates sends the wrong pricing signals to customers. Further, AT&T argued that allowing Verizon-MD to price access in such a manner provides Verizon-MD with the ability to discriminate against other carriers by means of a price squeeze.

²¹ *Id.* at 19.

²² AT&T Exh. 19 at 7.

²³ AT&T further argued that should the Commission reduce UNE interconnections rates in Case No. 8879, as it believes the Commission will, then the Commission should further reduce the switching and transport components of access rates simultaneously to match the interconnection rates determined in Case No. 8879. *See* AT&T Exhs. 19 and 25.

AT&T assured the Commission that Maryland consumers would receive the benefit of reduced access expenses. In support of its statements and in response to criticisms from Verizon-MD, AT&T pointed to past examples of where its customers have benefited from prior access charge reductions. In particular, Ms. LaGarde provided this evidence in the form of comparisons between per-minute intrastate price reductions and decreases in AT&T's average expenses, presumably representing corresponding decreases in access charges during the same period in time.²⁴ AT&T argued that, unlike Verizon-MD, access charges are a real cost that it must pay. So long as access is priced at or near \$0.05 per minute, it would not be able to offer its flagship \$0.07 per minute AT&T One Rate plan on an intrastate basis.²⁵ "The biggest cost component of intrastate long distance service is carrier access. Access reductions will translate directly into lower intrastate long distance prices."²⁶

Finally, in response to Verizon-MD's arguments that any reduction in access charges would constitute an exogenous change under the Price Cap Plan, AT&T disagreed. AT&T advocated that further reductions in access charges were contemplated by the Commission when it initiated the Price Cap Plan. In particular, AT&T argued that the Commission's jurisdiction with respect to the appropriate level of access charges was not in any way constrained or limited by the Price Cap Plan. Witness LaGarde stated that Verizon-MD "has been on notice since November 8, 1996 that access rates would be reduced to cost."²⁷

²⁴ AT&T Exh. 22 at 7.

²⁵ AT&T Exh. 19 at 11.

²⁶ *Id.* at 12.

²⁷ AT&T Exh. 21 at 13.

C. Sprint

Sprint, through its witness Mr. Mark G. Askins, argued that Verizon-MD's position that the Commission should not reduce access charges, because they should continue to be a source of subsidy in order to support lower basic retail rates, is inconsistent with §§ 254(e) and (f) of the Telecommunications Act of 1996. Sprint's reading of these Sections of the Act is that federal subsidies designed to support universal service by keeping rates affordable were intended to be explicit; and that, if states enacted rules addressing subsidization for the purpose of universal service in keeping with the Act, those rules would be consistent with the explicitness requirement of § 254.²⁸ Sprint believes that explicit subsidization or rate re-balancing is preferable to maintaining the implicit subsidy system embedded in access charges.

Mr. Askins argues that Verizon-MD's claim that current access charges are reasonable is not a valid justification or reason to leave them unchanged and not bring access charges closer to cost.²⁹ He submits that the primary driver of the cost of basic local service is the cost of the local loop, which is a non-traffic sensitive cost. Using a per-minute charge to recover what is a non-traffic sensitive cost is inappropriate and

²⁸ Sprint Exh. at 3-4. Mr. Askins also cited *Comsat Corp. v. FCC*, Docket No. 00-60044, 2001 US App LEXIS 8030 (5th Cir. May 3, 2001) which ruled that interstate access charges could not contain implicit subsidies. *Id.*

²⁹ *Id.* at 5.

inconsistent with the principle of cost causation. The FCC's CALLS Order states that non-traffic sensitive costs should be recovered through fixed, flat-rated fees."³⁰ Sprint maintained that keeping access charges at their current levels is unnecessary to keep rates for basic local service low.

Witness Askins argued that an explicit universal service fund can allow local rates to remain well below cost in areas where true "cost-based" rate for local service would be prohibitively expensive.³¹ Moderate increases in basic rates would have little measurable effect on penetration rates and subscriber levels, as long as local measured service is an option and subsidies such as Lifeline and Link-Up are available to low income subscribers. Subsidies currently implicit in access charges do not need to be maintained in that form to keep basic rates affordable; and high levels of subscribership would not be affected by allowing basic rates to rise closer to costs.³²

Further, while Sprint agreed that a CLEC would be hesitant to enter a market in which it could not recover its costs of providing service, Sprint believes that it is economically efficient to allow rates for basic local service to come closer to cost, thereby minimizing the need for contribution from other sources. The costs of providing basic service can be recovered through a combination of basic rates plus access charges, or any combination of basic rates plus access

³⁰ See Sprint Exh. 1 at 6, *citing* FCC CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249 and Eleventh Report and Order in CC Docket No. 96-45.

³¹ *Id.*

³² *Id.*

charges plus explicit universal service support.³³ In contravention to Verizon-MD, Sprint argued that it all depends on the specific circumstances faced by the CLEC. Sprint posed two possible scenarios: (1) if access charges are higher because they represent a larger contribution to covering the costs of basic service, then it is doubtful that high access charges alone act as an incentive to entry; or (2) if the profit margin on access charges is higher and the margin represents a windfall to the Incumbent Local Exchange Carrier (or “ILEC”), Sprint agrees with Verizon-MD witness Roberts’ characterization. In the latter case, the Commission would have to decide if the proper regulatory goal is for CLECs to enter a market purely in pursuit of monopoly profits in the form of artificially high margins they can earn on access rates. Sprint’s position is that competition in the market for basic local service should be competition for basic service and not competition for artificially inflated access charges.³⁴

Finally, Sprint disagreed with Verizon-MD that lower access rates will not result in lower toll rates for customers. Sprint’s experience has been that access charge reductions are passed through to end-users in the form of lower rates; and in Sprint’s case, those savings actually have been enjoyed by end-users in advance of the effective date of the access charge reduction. Sprint stated that it was an active participant in the CALLS proposal before the FCC; and as part of the terms of agreement, Sprint agreed to pass through access charge reductions created by that

³³ *Id.* at 7.

³⁴ *See id.* at 8.

policy. Sprint disagreed with Verizon-MD's arguments that IXCs' promises of flow-through are unmeasurable and unenforceable.³⁵

D. DOD/FEA

Mr. Harry Gildea submitted testimony on behalf of DOD/FEA in this case.³⁶ According to DOD/FEA, reductions in access charges would clearly create the opportunity for reductions in message toll charges that could benefit residential and business customers. The most controversial issue, asserts DOD/FEA, is whether such potential would in fact be realized.³⁷

Witness Gildea observed that reductions in access charges permit IXCs to offer new and more attractive pricing plans. When customers subscribe to optional calling plans that reduce the effective per-minute price of their calls, the customer is getting a price cut.³⁸

Additionally, Mr. Gildea noted that message toll service is perceived to be highly elastic. Thus, he asserted, lower prices stimulate more toll calling.³⁹ Mr. Gildea noted further that the message toll market is more competitive than the local exchange market. Consequently, he noted, IXCs battle each other to gain customers based on the prices they offer.⁴⁰

In order to insure that IXCs flow through access charge reductions to end-use customers, DOD/FEA recommended that the Commission mandate that if an IXC cannot demonstrate full flow-through, Verizon-MD will be directed to suspend the access charge reduction for that IXC

³⁵ *Id.* at 10.

³⁶ Mr. Gildea is a consultant with Snavely King Majoros O'Connor & Lee, Inc.

³⁷ DOD/FEA's Initial Brief at 2.

³⁸ *Id.* at 6.

³⁹ *Id.*

⁴⁰ *Id.* at 6-7.

for a one year period.⁴¹ Mr. Gildea proposed that in such a case the IXC's access charge revert to the pre-existing rate. He also suggested that Verizon-MD be directed to reduce monthly end-user access line charges (residential and business) by an amount equal to the reductions in access charges that were not passed through.⁴² Mr. Gildea believes this strategy has the appropriate incentives and disincentives to ensure a high level of compliance. He does not believe this approach would pose any increased burden on the Commission's Staff.⁴³

In response to Verizon-MD's observation that increased competition has occurred in the intrastate toll market with little impact on the prices end-users pay, DOD/FEA witness Gildea emphasized that "[u]nless message toll service has zero price elasticity...reductions in prices to [end-users] [resulting from access charge reductions] will stimulate demand."⁴⁴ Additionally, he noted that while higher ILEC access charges allow CLECs to charge IXCs more and thereby encourage entry into the local exchange market, low prices for basic service (maintained by the high access charge subsidy) directly cut the revenue potential for CLECs seeking to compete in the local exchange market.⁴⁵ Mr. Gildea emphasized that "artificially low [local exchange service] charges by [ILECs] pose a virtually impenetrable barrier to the development of competition[.]"⁴⁶ He argued that competition is important to FEAs because new suppliers may offer innovative approaches that meet FEAs' needs for reliability, redundancy, service quality and technical

⁴¹ *Id.* at 7.

⁴² *Id.*

⁴³ *Id.* at 8.

⁴⁴ *Id.*

⁴⁵ *Id.* at 9 (emphasis in text).

⁴⁶ *Id.* at 10.

innovation.⁴⁷ Also, the more firms competing in the market increases the likelihood that FEAs will obtain high-quality telecommunications services at the lowest possible cost.⁴⁸ DOD/FEA noted that universal service is as important to FEAs as it is to other customers. For purposes of security and space, many FEA facilities are sited on large land panels in small communities located outside urban areas.⁴⁹

According to DOD/FEA, the Commission should not accept OPC's claim that an access charge reduction, along with compensating increases in the prices of basic service, would impair achievement of the Commission's universal service objectives in Maryland.⁵⁰ DOD/FEA suggested that increases in monthly line charges would be offset by reductions in the message toll rates that all users pay. Furthermore, DOD/FEA noted that the monthly access charge is only a part of the cost of basic local exchange service. Verizon-MD's customers also incur local usage charges.⁵¹ DOD/FEA also suggested that "[u]ntil inputs are investigated further in Case No. 8879, Verizon-MD should be required to use the inputs ordered by the Commission in Case No. 8731, Phase II."⁵²

In his surrebuttal testimony, Mr. Gildea agreed that Staff's recommended procedure to determine whether IXC's are passing the benefits of access charge reductions on to consumers is simpler than his own.⁵³ However, he maintained that "proportional" distribution of access charge

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.* at 11-12.

⁵⁰ DOD/FEA's Initial Brief at 9.

⁵¹ *Id.* at 10; DOD/FEA's Reply Brief at 2-3.

⁵² *Id.* at 13-14.

⁵³ DOE/FEA Exh. 2 at 2.

benefits should mean that business customers will receive a percentage of the total benefit that is based upon their percentage contribution to Verizon-MD's intrastate message toll revenues.⁵⁴

In response to OPC witness Dunkel's testimony, Mr. Gildea noted that "[Mr. Dunkel] presents no evidence that reductions in access charges would harm residential ratepayers or impair 'universal service.'"⁵⁵ Finally, DOD/FEA seemed supportive of the positions expressed by Sprint witness Askins that favor reducing access charges.⁵⁶

In conclusion, DOD/FEA recommended that the Commission order a substantial reduction in intrastate access charges and that the Commission adopt the following safeguards:

- Mandate that if an IXC cannot demonstrate full flow-through, Verizon-MD should be directed to suspend the access charge reduction for a one year period; or
- Alternatively, direct Verizon-MD to reduce monthly [end-user] access line charges (residential and business) by an amount equal to the reductions in access charges that were not passed through.

In order to prevent any further delay in bringing the benefits of lower access charges to consumers, DOD/FEA recommended that the Commission base any decisions on the cost of access services on the cost factors set forth in Case No. 8731, Phase II.

In his rebuttal testimony, Mr. Gildea stated that the federal government has a substantial interest in this case given the presence of some its large facilities in Maryland, including the National Security Agency, Andrews Air Force Base, the Social Security Administration and

⁵⁴ *Id.* at 3.

⁵⁵ *Id.*

⁵⁶ *Id.* at 4.

others.⁵⁷ He disagrees with Verizon-MD that access charges should not be reduced. Further, Mr. Gildea disagreed: (1) that access charge reductions would solely benefit wholesale customers; (2) that access charge reductions will not stimulate competition in the intrastate message toll market and will impair competition in the local exchange market; and (3) that increases in residential local exchange rates would impair the achievement of universal service objectives. Mr. Gildea noted the significance which Verizon-MD attaches to revenue neutrality and maintaining a contribution from access charges in order to keep basic local exchange rates at low levels; however, he does not address this in his testimony.⁵⁸ DOD/FEA asserted that if access charges are reduced, all IXCs will be able to lower their message toll rates. Lower message toll rates, he noted, benefit all customers, both residential and business callers.⁵⁹ DOD/FEA witness Gildea disagreed with Verizon-MD that IXCs have no motivation to reduce their charges to end-users.⁶⁰ According to DOD/FEA: “[e]ven if some carriers were inclined to ‘pocket’ the savings from access charge reductions, at least one [perhaps some may] try to gain an advantage over ... competitors by reducing ... rates ... with the threat of losing market share, the remaining IXCs must follow with rate changes or rate packages that ultimately benefit all users of message toll services”.⁶¹

⁵⁷ DOE/FEA Exh. 1 at 3.

⁵⁸ *Id.* at 4.

⁵⁹ *Id.* at 5.

⁶⁰ *Id.* at 6.

⁶¹ DOD/FEA’s Initial Brief at 3. “If an IXC can price its services to pay through all access charge reductions and still cover its marginal costs, it is motivated to take this step.” *Id.* at 5.

E. CWA

Mr. Peter Catucci, Vice President of CWA filed testimony on their behalf. CWA supported Verizon-MD's position, stating that Verizon-MD has done more for union employees than AT&T. CWA cited the fact that Verizon-MD recently brought "hundreds of union jobs to Prince George's County" and that AT&T has "not shown any interest in bringing union jobs to the State."⁶² Moreover, CWA stated that AT&T should "not be rewarded for its lack of investment in the unionized workers of this State."⁶³

F. OPC

OPC maintained that the Commission should reject AT&T's request for a reduction in switched access rates, because Verizon-MD's access charges, by definition, are not providing a subsidy to basic local service. Rather, through access charges, IXCs are paying their fair share of the cost of using the local loop. OPC urged the Commission to recognize in its order that some portion of the cost of the local loop must be allocated to intrastate toll services and find that there is no need for a Universal Service Fund in Maryland at this time.

Primarily through the testimony of its consultant, Mr. William W. Dunkel, OPC provided two standard economic definitions of cost; *i.e.*, the Total Service Long Run Incremental Cost ("TSLRIC") and the Stand Alone Cost ("SAC").⁶⁴ The TSLRIC of any service is the additional cost incurred when the service in question is added to a network that already provides all other

⁶² See CWA Exh. 2 at 2.

⁶³ *Id.* at 2-3.

⁶⁴ OPC Exh. 15. OPC also presented through the Testimony of Thomas M. Regan a comparison of the two types of cost models, TSLRIC vs. TELRIC.

services offered by the company. The mathematical equation for TSLRIC is the Company's total cost of producing all services, including the questioned service, minus the Company's total cost of producing all of its services without the questioned service. TSLRIC only considers those costs directly caused by the provision of a service, which is why the TSLRIC is considered the price floor for any service. In contrast, the SAC is calculated by including 100 percent of all facilities needed to provide a service, as if that were the only service being provided. Mr. Dunkel characterized the SAC as a good's or service's price ceiling. Therefore, most goods and services in a successful business are priced somewhere between their TSLRICs and their SACs.⁶⁵ As such, prices set above the TSLRIC do not necessarily produce a subsidy, which is a point that is admitted by both AT&T and Verizon-MD. In fact, according to well-established economic principles, a service is only producing a subsidy if it is priced above its SAC.⁶⁶ Examination of both the TSLRIC and the SAC of basic local service, vertical services and switched access service demonstrates that all these services are priced above their TSLRICs but below their SACs, and that the residential basic local exchange service generates the largest contribution above its TSLRIC.⁶⁷

OPC's primary argument for retaining current access rates is that the loop is a joint and common cost, and all services that use the loop should contribute to paying its costs. OPC offered the following points in support of its position. One, a telephone company's decision to install a loop facility is based upon the anticipation of receiving all potential revenues generated by

⁶⁵ *Id.* at 17; 20.

⁶⁶ However, one should note that prices in excess of SAC do not conclusively establish that a subsidy is present.

the loop, including those from inter- and intraLATA toll services, vertical services, xDSL, etc. Verizon-MD agreed that this was true. OPC argued that this admission by Verizon-MD is significant, because it demonstrates that it is not just basic local exchange service that causes a company to incur the costs of the loop but rather all possible revenues that the loop generates. A second point resulting from this fact is that increasing the rates for basic local service does not specifically promote competition, because it is the total expected loop revenues from a number of services that influence a company's decision to install/lease the local loop.⁶⁸ Third, apportioning 100 percent of the loop costs to basic local exchange service violates the Telecommunications Act of 1996. In this regard, § 254(k) of the Act specifically requires "universal services" to bear no more than a reasonable share of joint and common costs. Since basic local exchange service is an universal service, it cannot properly be required to bear 100 percent of the costs of the loop under the Act. OPC offered evidence that a number of other states have determined that basic local service should not bear 100 percent of the costs of the loop.⁶⁹

OPC argued that the CCLC that IXCs pay to Verizon-MD is basically rent for use of the loop. In return, the IXCs are allowed unlimited use of Verizon-MD's loop facilities. According to OPC's calculation, the CCLC, based on 4.5 billion minutes of access traffic, includes a contribution of less than \$0.90 per line per month, which constitutes slightly less than six percent of the cost of the loop. This is a far more economical way for IXCs to pay for using the local

⁶⁷ *Id.* at 26.

⁶⁸ *Id.* at 39.

⁶⁹ *Id.* at 40.

loop than leasing a loop at the UNE price of \$14.50.⁷⁰ Similarly, the RIC was established to collect revenues from switched access so that other switched access rates could be lowered, such as tandem office switching. If the CCLC and/or the RIC are eliminated, rates for other switched access elements must be increased to recover those revenues.

Overall, OPC argued that if access service is priced at only its TSLRIC, then the price includes none of the costs of providing the loop, such as depreciation, return on investment and maintenance. Proper rate design principles, proper economic principles, legislative requirements, court decisions, and common sense, all dictate that the prices IXCs pay must support a portion of the costs of the loop facilities.

⁷⁰ *See id.* at 44-47.

Regarding Yellow Pages revenues, OPC argued that the success which ILECs enjoy in providing yellow pages directories is a by-product of the users' recognition that the ILEC is the acknowledged, authoritative source of complete, up-to-date, telephone number information. As a result, advertisers prefer it and place their ads there. OPC demonstrated how this perception on the part of directory users led to Verizon-MD's failure to successfully provide yellow page listings outside of its own home territory. Imputation of yellow pages revenues is a legitimate way of treating such revenues and does not subsidize basic local service. A corrected "Total Services" analysis would distribute Yellow Pages revenues among residential and business services on a per-line basis.⁷¹

With respect to the level of access rates, OPC maintained that access charges in Maryland are well below the average per-minute revenue earned by AT&T in Maryland. In addition, the imputation requirement currently in place protects IXCs from a price squeeze, since Verizon-MD is required to price toll services equal to or above the sum of its tariffed rates from switched access and the incremental costs of its non-access portions. AT&T just has to be as efficient as Verizon-MD in providing the non-access portions of toll services.⁷²

OPC offered evidence from AT&T's own intrastate toll rates showing that there is little, if any, difference between AT&T toll rates in states with low intrastate access

⁷¹ *See id.* at 60-67.

⁷² *See id.* at 70.

charges compared to states with higher intrastate access charges. OPC's conclusion was that there is no certainty that the IXCs will pass through access charge reductions to end-users. Nor is there any method currently known which would allow state commissions to insure that IXCs pass through such reductions.

OPC claimed that switched access service is provided on a LATA-wide basis, which is a larger area than is usually covered by local service termination.⁷³ Thus, the average distance that a switched access call is carried by a LEC is longer than the average distance that the LEC would carry a local "termination" call. In addition, the percent of the switched access calls that have to go through two LEC local switches is probably higher than the percent of local termination calls that have to go through two switches or two central offices. OPC opined that since no empirical data was presented with regard to this issue, there is no record evidence to justify a presumption that the cost of these two different services is identical.⁷⁴

OPC further argued that AT&T's request that switched access rates be reduced by eliminating some charges and reducing others should be rejected. IXCs should have to pay some portion of loop costs and not be allowed a free ride on the local loop. In addition,

⁷³ *Id.* at 68-69. OPC's assertion is incorrect for the type of switched access that is predominantly used: Feature Group D. Feature Group D terminates traffic to a designated end office. Feature Group A, which does provide LATA-wide termination, is rarely used today. Feature Group B terminates traffic within a tandem's serving area.

⁷⁴ Staff submitted that Verizon-MD's intrastate access rate is much greater than the interstate access rate, if the Presubscribed Interexchange Carrier Charge is excluded from the calculations. However, OPC argued interstate access rates are not based on cost, but are the direct result of the closed-door negotiations which led to the CALLS proposal. In addition, the Subscriber Line Charge, paid each month by end-users, helps reduce per-minute interexchange rates. If the Commission wants to place a fixed charge on customers bills similar to the SLC, then intrastate access rates could legitimately be reduced.

OPC stated that AT&T has provided no evidence that the level of contribution which it is making to joint and common costs is unreasonable. At one-ninth of their stand alone costs, AT&T's current switched access rates are not excessive, but are very close to the median of intrastate switched access rates in the rest of the United States. Finally, reducing access charges could result in the need for a universal service fund that would have to be paid for by end-users and would result in higher local rates.⁷⁵

G. Staff

Dr. Carlos Candelario, Assistant Director of the Telecommunications Division of the Public Service Commission of Maryland, testified on behalf of Staff.⁷⁶ Staff summarized that this case involves two basic issues: (1) whether a state universal service fund should be established in Maryland; and (2) whether the Commission should reduce intrastate switched access charges.⁷⁷ With respect to the two issues identified, Staff recommended that a state universal service fund not be established at this time and that the Commission should reduce intrastate switched access charges by approximately \$70 million.⁷⁸

Both Verizon-MD and AT&T filed cost studies purporting to identify the costs of basic service. Staff accepted Verizon-MD's classification of local service costs and revenue, but disagreed with Verizon-MD's decision to limit local usage to 30 message units and to exclude

⁷⁵ *Id.* at 69-71.

⁷⁶ Mr. Geoffrey Waldau, formerly Director of the Telecommunications Division, provided pre-filed direct testimony on behalf of Staff, which testimony was subsequently adopted by Dr. Candelario.

⁷⁷ Staff's Initial Brief at 1.

⁷⁸ *Id.* at 8.

Yellow Pages data. As for AT&T's cost study, Staff indicated that it was unable to review it in detail prior to filing its testimony.

Staff also criticized the method used by Verizon-MD to arrive at its revenue shortfalls for each wire center. In particular, Staff disagreed with Verizon-MD's decision to compute shortfalls for each wire center by class of customer (residential and business). Instead, Staff argued that it is more reasonable to calculate any revenue shortfall by area or wire center, regardless of customer class.⁷⁹

Staff proffered that the Commission should be concerned about subsidized areas, not subsidized classes of customers or services. Staff reasoned that business customers generate revenues that exceed costs in many wire centers, which makes up for some of the revenue shortfall from residential customers. In its analysis, Staff combined the business and residential deficits and surpluses at the wire center level, and concluded that basic service, taken as a whole, is not subsidized. Staff opined that given this contribution by business customers, and Verizon-MD's robust earnings, access rates can be reduced to cost without jeopardizing universal basic service and without decreasing telephone penetration rates in the State.⁸⁰

Staff defined access services as switched access, wherein interexchange carriers utilize the local exchange switch of a local exchange carrier ("LEC") to interconnect

⁷⁹ *Id.* at 12.

⁸⁰ Staff Exh. 5 at 29.

transmission facilities and route traffic. It enables end-users to originate and terminate toll calls and to connect with the long-distance carrier of their choice. For that service, the LEC charges a tariffed rate, which is the access charge.⁸¹ In Case No. 8584, Phase II, the Commission capped switched access rates and mandated that any competitive local exchange carrier proposing switched access rates above those of Verizon-MD are required to provide supporting cost data and to receive explicit Commission approval.

Staff equates switched access with a “bottleneck facility” that is a network element that could impede the entry of competition, or discourage competition.⁸² A “bottleneck facility” is a facility (*e.g.*, a loop) where one carrier has monopoly control of some indispensable input needed by another carrier to complete its service.⁸³ In the current telecommunications environment, Staff argues that switched access is similar to local call termination. Local call termination is priced at a cost-based rate, including the cost of the switch and common overhead, but not the cost of the loop. Because of the inherent similarities between the two and Verizon-MD’s continued domination over switched access, Staff recommended that the Commission base the charge for switched access on cost-based rates for the switch and optional transport.

Staff argued that loop costs should not be included in the switched access charge, but instead should be recovered from carriers’ end-user customers and not from carriers that compete with Verizon-MD for basic services by inflating switch-related rates.

⁸¹ *See id.* at 4.

⁸² *Id.* at 7.

⁸³ *Id.* at 5.

Switched access is a necessary competitor input because toll calls must traverse Verizon-MD's network.⁸⁴ Staff proposed that inter-carrier compensation, such as access rates, should be forward-looking incremental costs plus a reasonable overhead. Access costs should include local switching, optional transport, signaling and billing, but should not include the residual interconnection charge, the common carrier line charge, or a cost of the loop.

Profit or contribution is the difference between revenue and cost. Contribution is needed to cover overheads and common costs. If there is not enough contribution to cover overheads and common costs, a carrier's service will not be economically viable in the long-term. Staff agreed with Verizon-MD's descriptions that the Commission had purposely set rates for other services, such as access, above their cost to keep certain rates artificially low. However, Staff did not agree that this should continue on a going-forward basis. On a going-forward basis, access should be priced at a cost-based level.

Staff argued that a reduction in switched access charges would not constitute an "exogenous factor" in Verizon-MD's price cap plan, because the Commission had already planned for further reductions when the Price Cap Plan was initiated.⁸⁵ The further reduction recommended by Staff in this proceeding is "endogenous" to the price cap plan. The Commission already has fully anticipated and provided financial resources to Verizon-MD, with the view of also setting access charges to cost in this proceeding. The delay in implementing the Commission's goal of bringing access charges to cost has benefited Verizon-MD in the interim.

⁸⁴ *Id.* at 34.

⁸⁵ *Id.* at 46; Staff's Initial Brief at 23-27.

Staff also recommended that the Commission not permit the rebalancing or de-averaging of basic service rates, because the company has ample resources to maintain basic service rates at current levels.⁸⁶ Staff calculated that even after imposing its recommended access rate reduction, Verizon-MD still would be earning a rate of return well in excess of 12 percent.

According to Staff, Yellow Pages operations have traditionally supported local exchange services. Staff argues that while Verizon-MD's Yellow Pages business may have been moved to a separate subsidiary, some of the profits (*i.e.*, the imputed amount of \$36 million ordered in Case No. 8462) should be available to continue to support basic services.⁸⁷

Staff recommended that flow-through of any access charge reduction should be required of the State's ten largest IXCs, and that these companies should be required to hire auditors to verify the flow-through. Based upon the requirement of Case No. 8584, Phase II capping access rates at the rate Verizon-MD charges, other CLECs providing access would have to decrease their access rates accordingly.

Staff also argued that the costs of the loop facility are shared and common costs and should not be allocated to just one service, but should be included in the stand alone costs of numerous services including vertical service, toll services and basic service.⁸⁸ Although the stand-alone cost of switched access would include the cost of the loop, this does not mean that the price competitors pay for switched access should include the cost of the loop. There are

⁸⁶ Staff Exh. 5 at 47.

⁸⁷ *Id.* at 48.

⁸⁸ *Id.* at 35.

numerous other retail services providing positive contribution that Verizon-MD can use to recover loop costs. Access service should not be one of the services from which a contribution to loop costs is required, because of the potential for competitive price squeezes.

Finally, Staff concluded that access charges do not subsidize individual, identifiable services, such as payphone services. If the Commission reduces access rates to cost, Staff believes that all parties would agree that any and all contribution or subsidy to basic service from access service would be removed.⁸⁹

III. DISCUSSION AND DECISION

A. Universal Service Fund

As will be discussed in detail below, the Commission herein determines that there is no need for a State-wide Universal Service Fund. The parties have stated throughout these proceedings that there is no need to establish a universal service fund. The Commission agrees, as no facts have been presented to warrant the establishment of a universal service fund for telecommunications in the State of Maryland.

In Case No. 8584, Phase II, the Commission instituted a proceeding, Case No. 8745, in which cost studies would be presented that “would answer questions about whether residential rates cover incremental, shared, and common costs and whether additional revenues need to be obtained from a universal service funding mechanism.”⁹⁰

⁸⁹ *Id.* at 59.

⁹⁰ *Re MFS Intelenet of Maryland, Inc.*, 86 MD PSC 467 (1995).

All parties to these proceedings are in agreement that there is no need for a state universal service fund in Maryland at this time. However, their reasons for arriving at this conclusion differ. Verizon-MD states that the revenues from access and other services make it possible to maintain below-cost residential rates. They support their argument with figures from their cost model. Verizon-MD calculates costs and revenues of basic local residential service, which it defined as the local loop, 30 message units of local usage per month, reciprocal compensation, and the Subscriber Line Charge (“SLC”). For residential service alone, based on Verizon-MD’s definition, cost less revenues produces a statewide annual deficit. To make up for this shortfall, Verizon-MD argues access charges should not be reduced. If access charges are left untouched, there is no need for a USF.

OPC also argues that there is no need for a state universal service fund because statewide, Verizon-MD’s revenues exceed its costs.⁹¹ However, OPC does not support reducing access charges because while access is priced above its Total Service Long Run Incremental Cost (“TSLRIC”), it is not priced above its stand-alone costs (“SAC”). By accepted economic definition, access charges are neither creating nor receiving a “subsidy.” If access charges were reduced to incremental cost, then IXCs would be using the local loop for free and Verizon-MD would not be recovering some portion of its joint and common costs.

AT&T, Sprint and Staff also found no need for a state USF. They contend that basic local service does not need to be subsidized, that Verizon-MD is currently overearning, and that

⁹¹ OPC’s Initial Brief at 34.

access charges can and should be reduced. They point out that the intention to reduce access charges was begun in Case 8715 and postponed until consideration of universal service could be included. Now that it has been established that there is no need for a state universal fund, access charges should be reduced to cost.

The issue of whether there is a need for a Maryland Universal Service Fund can be broken down into two distinct sub-parts: (1) whether a state-operated universal service fund is needed; and (2) whether basic local rates are being subsidized through access charges. After considering this matter and the positions of the various parties that were advocated at length during this proceeding, the Commission finds that there is no need, at this time, to establish a Maryland Universal Service Fund. As discussed below, the testimony and cost details provided throughout this proceeding show that on a statewide basis, the revenues from local service are greater than their cost.

B. Basic Local Service

In determining first whether basic local service is subsidized, both the cost and revenues for basic local service need to be specified. Staff witness Candelario stated:

The cost models include the following network components for basic service: the loop and associated outside plant, central office terminations, switch, local transport, signaling system, and billing. Overhead costs include maintenance and other support personnel, vehicles, fuel, power, land and buildings and other overhead costs.⁹²

⁹² Staff Exh. 5 at 26.

Using this definition, Verizon-MD's costs associated with basic local service can be modeled with Commission-ordered inputs, including 12 percent overhead, computed cost for providing Dial Tone Line ("DTL"), and all usage for both business and residential lines.⁹³ There appears to be no disagreement among the parties about the elements composing costs, although AT&T's model computes total costs at more than \$100,000,000 less than that computed by Verizon-MD.⁹⁴

Determining basic local service revenues is more complicated. Verizon-MD defines revenues for basic local service as the combined revenues from DTL, 30 message units of local service and the SLC. Using only these services as revenue sources, basic

⁹³ For purpose of examining the veracity of Verizon-MD's claim that there is a need to subsidize basic local service, the Commission accepts Verizon-MD's use of a cost model to determine the cost of basic local service, including the cost of the following network components: the loop and associated outside plant, central office terminations, switch, local transport, signaling system and billing. The Commission also accepts Verizon-MD's inclusion of the costs associated with maintenance and other support personnel, vehicles, fuel, power, land and buildings and other overhead costs. While the Commission is mindful of the need for Verizon-MD to recover the costs of providing local residential service while maintaining reasonable local rates, the Commission agrees with Staff that in determining the revenues produced by basic local service, it is not sufficient to use only the revenue generated by 30 message units per residential line per month. Rather, the Commission accepts Staff's restatement of Verizon-MD's local service analysis which includes all local usage revenue and imputation of some part of Yellow Pages revenue. Staff's calculations for both business and residential basic service show that Verizon-MD is covering its costs and producing a profit.

⁹⁴ See Staff Exh. 5, Attachment C.

local residential service produces an annual deficit. However, when combined with business revenues, also computed on the same basis as residential rates, the two services produce a positive contribution.

Verizon-MD does not accept that this level of profit is sufficient to determine that basic local service rates do not need to be subsidized. Verizon-MD points out that the excess revenues come primarily from business customers; *i.e.*, the customers most likely to be targeted by competitors. Given that Verizon-MD has already experienced a loss of intraLATA toll revenues, Verizon-MD witness Gilbert asserts that the Company must be prepared for further losses in the more profitable services it provides.⁹⁵ For these reasons, Verizon-MD claims that rates for basic local service must be subsidized. Moreover, Verizon-MD asserts that because of the reciprocal compensation Verizon-MD must pay to CLECs, in large part for internet access by ISPs, an additional cost per line also should be included in the final cost figures for Verizon-MD.

Staff disagrees with Verizon-MD's claim that basic local service must be subsidized, and points out that most residential and business customers make considerably more than 30 calls per month. If the contributions for all local usage from both business and residential service are included in the analysis, Verizon-MD earns a profit from residential service and a substantial profit from business service, which together total a healthy annual profit.

⁹⁵ See Verizon-MD Exh. 23 at 21-22.

C. Yellow Pages Revenue

In addition, Staff imputes \$36,000,000 of the profit Verizon-MD realizes on its Yellow Pages operations, increasing the total annual profit for Verizon-MD for dial tone line, total local usage, the SLC and Yellow Pages.⁹⁶ Verizon-MD witness Gilbert claimed in his testimony that Yellow Pages revenues should not be included in this analysis for three reasons.⁹⁷

First, witness Gilbert argues that Verizon-MD is no longer subject to rate of return regulation, but rather is subject to a Price Cap Regulatory Plan adopted by Order No. 73011 issued on November 8, 1996 in Case No. 8715, *In the Matter of the Inquiry into Alternative Forms of Regulating Telephone Companies*, by which Plan the Commission now regulates Verizon-MD's prices, instead of its earnings. Under the Price Cap Plan, Verizon-MD would be able to retain the benefit of any income efficiencies it could generate, so long as rates are capped at appropriate levels. For this reason, witness Gilbert argues that imputation of revenues for purposes of revenue requirement calculations has no place in price cap regulation.⁹⁸ Second, Yellow Pages Information, a Verizon-MD subsidiary, now publishes Yellow Pages; and as such, Verizon-MD no longer has a direct claim on those revenues. Third, the Commission has a long-standing policy in the regulation of gas and electricity of recognizing the separation of regulated and unregulated operations. The Commission has required that costs and revenues from unregulated

⁹⁶ See Staff Exh. 5 at 48.

⁹⁷ Verizon-MD Exh. 23 at 13.

⁹⁸ *Id.*

operations be recorded “below the line,” thereby assuring that shareholders, not ratepayers, share in the risks as well as the rewards of such operations. Verizon-MD believes that the Commission should follow the same policy with regard to Yellow Pages revenues.

Staff argues that Yellow Pages revenue has traditionally supported local exchange service. In support of its argument, Staff points to correspondence between Verizon-MD (then Bell Atlantic-Maryland) and the Commission’s Executive Secretary. In a letter from Verizon-MD, dated December 17, 1996, on pages 1 and 2, Verizon-MD states:

The Staff, however, seems to be concerned that unless the Commission conducts a hearing, it would for some reason be “forever foreclosed” from addressing the question of the imputation of Yellow pages revenues in the future. That is not so, and BA-MD has never suggested otherwise.

To the extent the Commission shares the Staff’s concern, BA-MD hereby acknowledges that it understands the Commission will retain, after the directory reorganization, the same regulatory authority to determine, to the extent necessary, the appropriate imputation of Yellow Pages revenue.

In a responsive letter from the Commission to Verizon-MD, dated December 18, 1996, the Commission states that:

After considering this matter at the December 18, 1996 Administrative Meeting, the Commission authorized the Company to transfer its directory operations to a structurally separate subsidiary. The Commission also noted that this authorization rests upon the premise that it retains the same regulatory authority in this area before and after the transaction.

Staff also points out that in Case No. 8462, Order No. 70324, the Commission allowed Verizon-MD to move its Yellow Pages operation to a separate subsidiary, but imputed a fixed

amount of the profits back to support basic services. The Commission did not impute all profits, only \$36,000,000, allowing Verizon-MD to retain any growth in profits from Yellow Pages. Actual current profits from Yellow Pages are substantially higher than the amount previously imputed by the Commission.

The Commission accepts Staff's analysis and imputes \$36,000,000 in Yellow Pages revenue to the revenue column for basic local service. The Commission also accepts Staff's use of revenues from all usage, not just the 30 message units used in Verizon-MD's analysis. Incorporating these modifications into the analysis of revenues and costs calculated by Verizon-MD's model with Commission-ordered inputs shows that Verizon-MD clearly earns an annual profit from providing basic local residential and business service.

Arriving at this figure requires that revenues as well as costs be averaged across residential and business service and across the rate centers in the state. This is appropriate because, as Staff witness Candelario points out:

It is appropriate to combine residential and business customers because a competitive decision to serve a rural wire center (*e.g.*, extend a network, set up transmission capacity, collocate, advertise) would be based on the combined market in that area. There are economies of scope derived from serving both classes of customers. Economies of scope are present when the cost to produce many services (and serve many classes of customers) together is less than the cost to produce or serve each by itself.⁹⁹

The Commission's examination of whether basic local service is subsidized indicates that current revenues statewide from DTL, total usage and the SLC paid by residential and business

customers, more than cover the costs of providing basic local service to those same customers. Although the Commission recognizes that the current situation with regard to earnings from basic local service could change with competition, possibly reducing Verizon-MD's share of revenues, AT&T witness Cosgrove's rebuttal testimony provides graphic evidence that Verizon-MD's basic local service revenues have increased significantly over the past decade, closely paralleling the increase in number of subscriber lines.¹⁰⁰ Mr. Cosgrove claims that this growth "belies any claims [Verizon]-MD might make of substantial competitive inroads in local service markets."¹⁰¹ As Mr. Cosgrove's chart is based on information supplied by Verizon-MD to the FCC and was not rebutted by Verizon-MD, the Commission will set aside the issue of competition undermining Verizon-MD's basic local service revenues until such time as it appears to be ripe for consideration.

In addition, the Commission notes the arguments presented by OPC, *i.e.*, that the SLC in combination with the Pre-subscribed Interexchange Carrier Charge ("PICC") rose from \$4.35 per month per primary residential line to \$5.00 on July 1, 2001, and rose again

⁹⁹ Staff Exh. 5 at 31.

¹⁰⁰ AT&T Exh. 17, Chart 3.

¹⁰¹ *Id.* at 7.

to \$6.00 as of July 1, 2002. Additionally, the FCC has authorized a further increase in the SLC, resulting in a combined total of \$6.50 effective July 1, 2003.¹⁰² The change that became effective on July 1, 2001 has already increased Verizon-MD's annual revenues from basic local service just from primary residential lines by \$19,339,554 (\$0.65 per line x 2,479,430 residential lines reported in ARMIS for 2001), and those revenues will be further increased by a minimum of \$29,753,160 resulting from the second SLC increase which began July 1, 2002, for a total minimum annual increase of \$49,092,714. As the SLC was to be increased again by another \$0.50 as of July 1, 2003, Verizon-MD's annual revenues will also continue to increase. In addition, the SLC for secondary lines and for business lines will increase revenues even more.

Finally, with regard to reciprocal compensation, the Commission finds unconvincing Verizon-MD's argument for including an amount per line as a cost of providing basic local service. The FCC has ordered the reciprocal compensation rate to be reduced to \$0.0007 per minute of use over the next 2-3 years, which considerably reduces this expense for incumbent local exchange carriers, and also established a limit on the number of calls which can qualify for reciprocal compensation.¹⁰³ Even Verizon-MD witness Gilbert admitted that it would be appropriate to modify Verizon-MD's calculation of expenses for providing basic local service once the FCC's order was enacted.¹⁰⁴ Since this is an expense that can be expected to be

¹⁰² *Cost Review Proceeding for Residential and Single-Line Business Subscriber Line Charge (SLC) Caps; Access Reform; and Price Cap Performance Review for Local Exchange Carriers*, CC Docket Nos. 96-262 and 94-1, FCC 01-161, rel. June 5, 2002.

¹⁰³ *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Compensation for ISP bound Traffic*, CC Docket Nos. 96-98 and 99-68; FCC-01-131; 16 FCC Rcd 9151 (2001).

¹⁰⁴ Transcript at 572.

reduced in the near term for Verizon-MD, the Commission does not find it appropriate to incorporate it now in a determination of the ongoing costs of providing basic local service.

Based upon the above discussion, the Commission determines that there is no need for a Maryland universal service fund, and that by the evidence of the models and by Verizon-MD's own financial reports filed with the FCC, basic local service revenues do not need to be subsidized since revenues exceed expenses. Indeed, the evidence presented in this case shows that the revenues from basic services generate substantial profits over and above costs.

D. Switched Access Charges

The Commission will next address the issue of whether there should be a second reduction in the rates that Verizon-MD charges interexchange carriers for switched access. The term "access charge" refers to the compensation paid to local exchange carriers for the use of their network by interexchange carriers and other telecommunications service providers.¹⁰⁵ Access charges are broken down into two distinct categories: (1) special access or communication channels that connect customer premises and IXC "points of presence" and that do not use the end office switches of the local exchange company; and

¹⁰⁵ *Competitive Telecommunications Ass'n v. FCC*, 87 F.3d 522 (D.C. Cir 1996).

(2) switched access, with the connection at both the originating and terminating ends of a call using the local exchange company's switches. The access charges being considered in the instant proceeding are charges for switched access. Before the Commission addresses whether switched access charges are to be reduced, a brief review of the history of access is warranted.

Until the early 1970s, most telephone subscribers obtained both local and long-distance telephone services from the same company; *i.e.*, the pre-divestiture Bell System consisting of Bell Operating Companies ("BOCs"), which were owned and operated by American Telephone and Telegraphy Company ("AT&T"). In Maryland, with few exceptions, that company was the predecessor to Verizon-MD, namely the Chesapeake and Potomac Telephone Company of Maryland ("C&P"). The Commission then (as now) regulated the provision of local and intrastate telecommunications services, while the Federal Communications Commission regulated interstate services. As the FCC has noted:

Much of the telephone plant that was used to provide local telephone service (such as the local loop, the line that connects a subscriber's telephone to the telephone company's switch), is also needed to originate and terminate interstate long-distance calls. Consequently, a portion of the costs of this common plant historically was assigned to the interstate jurisdiction and recovered through the rates that AT&T charged for interstate long-distance calls. The balance of these costs of the common plant was assigned to the intrastate jurisdiction and recovered through the charges administered by the state commissions for intrastate services.¹⁰⁶

¹⁰⁶ *In the Matter of Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing End User Common Line Charges*, 12 FCC Rcd 15982, 15990 (1997).

The changes to the telephone industry began at the national level in the 1970s, when MCI and other interexchange carriers (“IXCs”) began to provide long-distance services in competition with AT&T and sparked the events that would ultimately lead to AT&T’s forced divestiture. In 1978, the rates that AT&T would charge long-distance competitors for originating and terminating interstate traffic over the facilities of its local exchange affiliates were governed by agreements approved by the FCC.

Federal District Court Judge Greene subsequently issued his Modification of Final Judgement (“MFJ”) in the Department of Justice’s anti-trust suit against AT&T, *U.S. v. AT&T*, 552 F.Supp 131 (D.D.C. 1982) *aff’d sub nom, Maryland v. U.S.*, 1033 S.Ct. 1240 (1983). The MFJ required the separation of the local exchange operations of the BOCs from the rest of AT&T’s operation, including its long-distance business, effective January 1, 1984. In response to the MFJ, the FCC adopted uniform access charge rules in 1983 to replace the earlier agreements.

Given the changing telecommunications architecture, the Commission also conducted proceedings to address the potential effects of the MFJ. During one such proceeding, C&P argued to the Commission that (at that time) there was no system by which it could allocate and recoup its intrastate revenue requirement; and as such, those revenues would have to be recovered from end-users. As an alternative, C&P filed proposed intrastate access service tariffs to cover switched access, special access, and ancillary services provided to interexchange

carriers that would permit it to be made whole. The intrastate access tariffs filed by C&P basically mirrored C&P's interstate access filing made with the FCC.

In Case Nos. 7450 and 7735, the Commission recognized that as a result of the MFJ, C&P would no longer be the sole provider of intrastate long-distance service in Maryland and would lose substantial revenues associated with that service, and C&P's local switched network would be accessed by AT&T of Maryland and other IXCs for the initiation and completion of long-distance calls handled by those carriers.¹⁰⁷ The Commission noted that it would be inappropriate for C&P to bear the costs of providing access-related plant used for the benefit of other carriers, and that these costs should be borne by the users of the system.¹⁰⁸ The Commission permitted the intrastate access tariffs filed by C&P to go into effect, but noted that its action did not mean ... "we have made an irrevocable determination on the various access related issues. We will continue to observe access charge developments at the FCC and in the Congress, and monitor the operation of the filing authorized in this proceeding."¹⁰⁹

The Commission described the service provided by C&P wherein an IXC makes use of C&P's equipment to initiate and/or complete a traditional long-distance call within the State as "switched access services." The mechanics of switched access are as follows. The IXCs have "points of presence" located in various parts of the State. When a long-distance call to be carried by an IXC is initiated by an end-user within Maryland, it is routed over C&P's network through a variety of lines and end office equipment, to an IXC's point of presence. The call is

¹⁰⁷ *Re Chesapeake and Potomac Telephone Company of Maryland*, Order No. 66504, 74 Md. PSC 595 (1983).

¹⁰⁸ *Id.*

then routed over the IXC's equipment from one point of presence to another. Once it reaches the other point of presence, it is rerouted from the second point of presence, over other local telephone company wires and offices, to the called party. The rates for switched access, as accepted by the Commission, consisted of several elements and were intended to compensate C&P for the costs of providing access to the three separate portions of its local network which are used by the IXCs in the provision of long-distance service.

In 1985 the matter of switched access rates was again addressed by the Commission.¹¹⁰ As when this matter was initially considered in 1983, the Commission permitted a switched access tariff rate structure that was based upon the interstate access tariff filed with the FCC to go into effect. In this Order, the Commission observed:

The single most expensive element is the carrier common line rate element. This rate element pertains to the dial tone line ("DTL"), which is the line from the [end-user] to the C&P wire center serving the [end-user]. The next element of switched access service is composed of three end office (or wire center) rate components. These end office rate elements are local switching, line termination, and intercept. The next element of switched access service is the local transport element, which is the provision of a line from the end office to the [IXC's] point of presence.¹¹¹

Further, the Commission acknowledged that the FCC had expressed its intent to phase out the usage-sensitive carrier common line charge, and in lieu thereof, to impose a flat rate charge on the end-users of the dial tone lines.¹¹²

¹⁰⁹ *Id.*

¹¹⁰ *See Re Chesapeake and Potomac Telephone Company of Maryland*, Case Nos. 7851, 7816, Order No. 67033, 76 Md. PSC 238 (1985).

¹¹¹ *Id.* at 299.

¹¹² *Id.* at 300.

The Commission has considered access charges in several proceedings since 1985. The structure of the switched access rate has remained the same, although the level of the charge itself may have decreased. Prior to this proceeding, the Commission most recently considered Verizon-MD's switched access charges in 1996, as part of the Price Cap Plan. The current switched access charge consists of the carrier common line charge ("CCLC"); local transport and tandem switching; residual interconnection charge ("RIC") and local switching. Because the current intrastate switched access charges are based upon the initial FCC structure, a review of the definitions and purposes of the charges at the federal level is informative.

The FCC defines the various interstate access rate elements as follows. The interstate carrier common line charge ("CCLC") is intended to recover the costs allocated to the interstate jurisdiction which are associated with the line connecting the end-user's premises with the local switch. These costs are not traffic sensitive. The local switching rate is intended to recover the costs allocated to the interstate jurisdiction which are associated with connecting a call coming in on one line or trunk to another line or trunk connected to the switch, the switching system, and line and trunks cards. Transport service is the component of interstate switched access service corresponding to the transmission and switching of traffic between the incumbent LEC's end office and the IXC's points of presence. The FCC required incumbent LECs to establish a non-cost based transport interconnection charge ("TIC") to recover the revenue difference between what the LECs would have obtained under the equal charge rate structure and what they would obtain from the interim, facility-based transport rates, as well as the remaining 80 percent of the

tandem revenue requirement. In *CompTel v. FCC*, 87 F.3d 522, 532 (D.C. Cir. 1996), the Court of Appeals directed the FCC to eliminate the TIC or to provide a reasoned explanation for retention of this non-cost based rate element.

Access charges at the federal level have undergone a number of modifications since the access charge system was first initiated pursuant to Judge Greene's Modified Final Judgment.

The FCC has indicated that:

[T]o the extent possible, costs of interstate access should be recovered in the same way that they are incurred.[.] This approach is consistent with principles of cost-causation and promotes economic efficiency. Thus, non-traffic-sensitive costs should be recovered in the same way that they are incurred. Thus, non-traffic-sensitive costs should be recovered through fixed, flat-rated fees. Similarly, traffic-sensitive costs should be recovered through corresponding per-minute access rates. The Commission's rules, however, are not fully consistent with this goal. In particular, because the Commission has taken a cautious approach in addressing affordability concerns, it has taken measured steps toward this goal by limiting the amount of the allocated interstate cost of a local loop that is assessed directly on residential and business customers as a flat monthly charge.¹¹³

Therefore, the FCC has embarked on a policy of phasing out access charges intended to recover non-traffic sensitive costs, such as the CCLC, and has begun this process by lowering these rates considerably. The FCC has indicated that the costs recovered by the CCLC are non-traffic sensitive costs which should be borne by the end-user instead of IXCs. According to the FCC, the costs recovered by the residual Transport Interconnection Charge ("TIC") are costs

¹¹³ *In the Matter of Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing End User Common Line Charges*, 15 FCC Rcd 12962, 12967-68 (2000) (footnote omitted).

that do not appear to be attributable to interstate transport but instead are merely subsidy producers. Staff and AT&T both proffer positions which advocate that the Commission modify access charges at the State level and bring the cost of the RIC, the State equivalent to the TIC, to zero.

In 1996, the Commission adopted an alternative method of regulation for Verizon-MD. In adopting the Price Cap Plan, the Commission accepted Verizon-MD's current rates for all Other Than Competitive services except access. At that time, the Commission reduced access rates by \$32 million in order to promote competition, and also considered eliminating the Residual Interconnection Charge ("RIC"). The Commission stated:

However, we share the FCC's views in the Interconnection Order regarding the interstate RIC, otherwise known as the Transport Interconnection Charge, or "TIC." In determining whether access rates should be collected by the incumbent LEC when a reseller purchases unbundled elements of the incumbent's network, the FCC ruled that for an interim period the incumbent LEC may collect the CCLC and 75 percent of the TIC. The FCC concluded that the nature of most of the revenues recovered through the TIC is unclear and subject to dispute, although a portion of the TIC is associated with certain costs related to particular transport facilities. We therefore find that BA-MD may continue to collect 75 percent of the intrastate RIC for all intrastate minutes traversing BA-MD's local switches.

We are convinced that the monopoly inputs of switched access should be reduced to cost. However, we note OPC's and BA-MD's concern that universal service may be jeopardized by a massive rebalancing of access charges. In view of the decisions contained in today's order, it is time to move forward with the universal service proceeding established in Case 8584, Phase II. See 86 Md. PSC at 495, Ordered Paragraph (3). We direct Staff to submit a list of

issues for the universal service proceeding by December 30, 1996. The issue list should include an evaluation of the CCLC and the RIC.¹¹⁴

E. Access Rate Reduction

In the Commission's analysis of the present case, several issues bear upon the Commission's decision to implement access rate reductions. The first and foremost is how the cost of access should be determined. AT&T and Staff argue that access should be considered a network element; and in order to foster competition and eliminate the opportunity for the ILEC to engage in price squeezing, its price should be set to incremental cost. OPC opines that some portion of loop costs should be included in the price charged for access, because if it is not, then the IXCs have use of the loop for free. Verizon-MD cautions that if the price of access is reduced to incremental cost, basic local service rates must be increased to make up for the shortfall. Therefore, in considering a further reduction of Verizon-MD's access rates at this time, the Commission must also determine whether the overall effect of a revenue reduction would detrimentally impact Verizon-MD's financial viability. The evidence most useful in this analysis has been provided by Verizon-MD, directly through its cost studies and indirectly, through information provided to the FCC and the SEC and presented by AT&T witness Cosgrove.

Verizon-MD argues against access charge reductions, maintaining that its cost studies indicate that basic local residential service requires subsidization, and that the revenues from access charges provides that necessary subsidization. Both AT&T and Staff have recommended

¹¹⁴ *Re Alternative Forms of Regulating Telephone Companies*, 85 MD PSC at 266-267 (1996).

that access charges be reduced to cost, in part, by eliminating both the CCLC and the RIC. The rationale for this position was that these charges do not cover any specific costs. AT&T also proposes achieving this reduction by reducing the local and tandem switching rate to the current local call termination rates (*i.e.*, \$0.00225 and \$0.0033, depending on where the traffic is delivered). Staff also recommends setting the local switching component to the current local call termination rate, in addition to eliminating both the CCLC and the RIC. Staff offers an historical analysis showing that both the CCLC and the RIC were created to continue the subsidization of local service by toll service after the separation of AT&T from the seven regional Bell Operating Companies. However, with the advent of competition at the local level, access to the local network became a necessary network element for competitors; and this element is controlled, in most of the country, by the former monopoly provider.

In past decisions, the Commission has set local call termination at the cost of switching and did not include a portion of the local loop.¹¹⁵ In 1998, the Commission established prices for unbundled network elements (“UNE”) offered by Verizon-MD to ILECs.¹¹⁶ In that Order, the Commission again set the rate of local call termination at a cost-based level that included the cost of the switch, but not a portion of the cost of the loop. The UNE loop rate set by the Commission included the cost of the loop, but not a portion of the cost of the switch. The UNE switching rate set by the Commission included the cost of the switch but not a portion of the cost

¹¹⁵ *Re MFS Intelenet of Maryland, Inc.*, 86 Md. PSC 467, 480 (1995).

¹¹⁶ *Re Agreements and Arbitration of Unresolved Issues Arising Under Section 252 of the Telecommunications Act of 1996*, 89 Md. PSC 152 (1998).

of the loop. Staff argues that in pricing switched access, the Commission should reflect the same philosophy of a cost-based rate with no allocation of loop cost.

Current access charges are intended to compensate the ILEC for the IXC's use of the local network. Staff argues that the costs that should be included in access rates are forward-looking incremental costs plus some reasonable contribution to shared and common costs. Thus, access rates should recover the costs associated with local switching, optional transport (exchange trunking costs associated with toll calling), signaling (to set up calls), and billing. The switching component includes investments for the set-up of the call, its associated minutes of use and Automatic Message Accounting billing. The shared costs include switching costs such as the switch processor, which is shared over a number of services. Staff stresses that properly computed access charges should not include loop costs.

Verizon-MD's witness Taylor argues against moving directly to cost-based intrastate access rates, citing as precedent the FCC's decision to gradually phase out implicit subsidies using market forces. In opposition, Staff points out that in the transition period from a monopoly to a competitive market, market forces will not drive access charges to cost in the near term. While such a situation may develop, if competition is to flourish, the Commission must move now to reduce the price of competitor-required inputs to cost.

Verizon-MD's witness Gilbert presented data on a Total Service Analysis for both residential and business service for the State in Exhibit JRG-4 of his Direct Testimony.¹¹⁷ His results showed a substantial annual net profit. This Total Service Analysis includes costs and

revenues for Dial Tone Line, all local usage, toll, switched access, value-added services, the SLC, Yellow Pages and the cost of reciprocal compensation. In response to a data request about sources of revenue that were not included in Verizon-MD's Total Service Revenue/Cost Analysis, Verizon-MD made the following statement:

Verizon-MD's Revenue/Cost analysis included approximately 75 [percent] of Verizon-MD's total intrastate revenues. Major sources of revenue that were not included were: Vertical Services (*e.g.*, ISDN, DID, PDN, Hunting); Private Line Services (*e.g.*, Alarm Circuits, Analog Data, Digital Data, High Capacity, Foreign Exchange, Voice Grade); Special Access; Billing Services; Operator Services; Coin Services; Listing Services (*e.g.*, Non-List, Non-Pub, Add'l Listing) Directory Assistance. See July 26, 2001 Response to in-hearing transcript data request, June 27, 2001 – p., #662.¹¹⁸

The total of the above-listed revenues, which is identified as proprietary information, is significantly more than the revenues reported in this proceeding by Verizon-MD for its statewide Total Service Analysis for both residential and business service. Since Verizon-MD was unable to provide the cost of the services associated with these revenues, the total amount of profit from these services cannot be determined. However, since these are services that are subject to competition, it is assumed that they do generate positive income for Verizon-MD.

One final note on revenues not reported in Verizon-MD's total service analysis is provided in OPC's Initial Brief. OPC pointed out that other revenue sources not included in Verizon-MD's Total Service Analysis were revenues related to its sale of new retail services such as DSL, from line sharing (*i.e.*, revenues Verizon-MD receives from CLECS and DLECS for use

¹¹⁷ Verizon-MD Exh. 22.

of Verizon-MD's loop facilities for the purpose of providing xDSL services), from loop lease, and from inside wire service. The Commission finds that the record in this proceeding shows that even without reporting all sources of revenue, Verizon-MD remains a financially viable public service company.

A further indication of the financial health of Verizon-MD was provided by AT&T witness Cosgrove. In Chart 1, page 6, on data taken from ARMIS Report 43-01, Verizon-MD's Total Intrastate Operating Revenues and Total Intrastate Operating Expenses are charted for the years 1990 to 2000. Expenses in 1990 are approximately \$0.85 billion and increase to \$1.05 billion by 2000. In that same time period, revenues increase from \$1.15 billion to \$1.55 billion.¹¹⁹

Mr. Cosgrove also highlights the success of the current price cap plan with Chart 12 (page 25) of his May 21, 2001 rebuttal testimony. The chart shows the intrastate return on average net investment for the years 1990-2000, based on data from ARMIS Report 43-01. What is clear from the chart is that Verizon-MD's rate of return has steadily and significantly increased since the inception of the Price Cap Plan in 1996. As Mr. Cosgrove stated, "[m]y testimony explains that if the access reductions AT&T recommends are implemented, Verizon-MD's financial performance will still exceed that of any year prior to implementation of the price

¹¹⁸ AT&T requested that the responses provided by Verizon-MD in its July 26, 2001 correspondence be admitted into the record. The response of Verizon-MD answering an in-hearing information request by the Commission itself is automatically part of the record.

¹¹⁹ In Chart 5, provided by Mr. Cosgrove, Verizon-MD's intrastate operating income margin for the year 2000 is compared to all the other states in the Verizon footprint. At just under 35 percent income margin, it is behind only West Virginia and Virginia, and significantly above the average of just over 25 percent operating income margin. However, Data

cap plan.”¹²⁰ Based upon the evidence submitted to the Commission, including exhibits submitted by Verizon-MD itself, it is clear that Verizon-MD is a healthy, financially sound company.

The Commission agrees that access charges should be moved closer to cost.¹²¹ The Commission determines that it is now appropriate to implement a second reduction in Verizon-MD’s switched access charges. The Commission finds it possible to reduce access charges without jeopardizing current local residential service rates, since Verizon-MD’s basic service costs are currently covered by basic service revenues. Consistent with the Commission’s approach in Case No. 8715, the instant reduction is meant to further the process of gradually reducing access charges towards cost, but is not intended to achieve that total reduction instantaneously; and as such, it is a second interim reduction. The Commission directs that switched access charges be reduced by approximately \$13.61 million dollars.¹²²

The method which the Commission chooses to utilize in implementing this second phase of access charge reductions is to decrease the Residual Interconnection Charge

later supplied by Mr. Hall to the Commission showed that of all the Verizon states, only New York and Virginia exceeded Verizon-MD’s five-year average intrastate rate of return from 1996 to 2000.

¹²⁰ AT&T Exh. 17 at 3.

¹²¹ However, the issue of whether the cost of the loop should be regarded as a joint and common cost is one on which the Commission defers a final decision.

¹²² In its compliance filing, Verizon-MD shall demonstrate an actual reduction in access rates by \$13, 610,095.00. Hereafter, this amount shall be expressed as \$13.61 million.

("RIC") in the amount of \$13,610,095, or approximately by half. The Commission chooses the RIC, because the Commission allowed Verizon-MD to implement this charge in 1994 so that Verizon-MD's local transport rates would match the interstate rates. On the interstate side, these transport charges have been moving to cost. By evidence supplied by Verizon-MD in this proceeding, access charges without the RIC will still be priced above cost. Thus, the Commission finds that the RIC can be reduced. With respect to the reduction in the switching and transport costs, the Commission is convinced by Staff's and AT&T's arguments that the price of these inputs should approximate cost, as that cost was determined by the Commission in Case No. 8731, Phase II. This accounts for the additional \$5 million dollar reduction.

Although the rate change ordered by the Commission today represents approximately \$18.61 million in annual revenue reductions to Verizon-MD, any actual reduction in annual net income experienced by Verizon-MD should be considerably less. This is because of the simultaneous decrease in reciprocal compensation. The decrease in the amount of reciprocal compensation that Verizon-MD will have paid out in this past year represents a significant reduction to Verizon-MD's costs. Moreover, this reduction will increase over the next two years, if Verizon-MD accepts the terms of the FCC's reciprocal compensation order.¹²³

¹²³ The DC Circuit Court of Appeals remanded, but did not vacate, the FCC's order establishing the reciprocal compensation scheme.

The Commission does not find that reducing the CCLC at this time is advisable. While there is no cost basis for the level of the CCLC, it is unclear that the elimination of the CCLC is in the public interest. In this regard, AT&T is correct in its assertion that, on an intrastate basis, the RIC and CCLC were based on ensuring revenue neutrality rather than on any measure of cost. However, since the revenues earned through Verizon-MD's collection of the CCLC are capped, the Commission finds that it is in the public interest to continue the assessment of the CCLC for the time being; and the Commission hesitates to further reduce access charges at this time.¹²⁴

In making the decision to reduce access charges, the Commission is mindful of the representations made by the IXCs that participated in this proceeding that they would pass on any reductions which they experienced to their end-user customers. The Commission is equally mindful of the fact that there is no way to guarantee that the end-user, particularly the residential end-user, would actually realize a financial benefit from the access charge reductions. Staff and DOD/FEA proposed various mechanisms intended to monitor the flow-through of access charge reductions to the end-user. The Commission rejects these proposals at this time. However, the Commission reserves the right to establish a mechanism to monitor the flow-through in the future, if the Commission finds such a mechanism is necessary.

¹²⁴ The CCLC is set so that it recovers \$3,283,333 per month; the charge is trued-up so as to cap the amount collected. *See Verizon-MD Tariff No. 217, Section 3.*

The Commission believes that the IXCs' end-users should enjoy the benefit from these reductions. Therefore, the Commission orders the direct flow-through to Maryland end-use telecommunications customers of the full amount by which access charges are reduced in this case. The Commission further directs that in addition to the \$13.61 million access charge reduction ordered herein, \$5 million will continue to be collected by Verizon-MD, but shall be escrowed by Verizon-MD pending the conclusion of a Phase II proceeding in which a mechanism for returning these funds to the IXCs' end-users shall be developed. At that time, the funds will be distributed accordingly.

The IXCs have maintained that any reduction in access charges ordered by the Commission would be flowed-through to their end-users, dollar for dollar. The Commission's Order in this case provides for an access charge reduction of \$18.61 million, but ensures that almost a third of the realized reduction will go directly to the end-users, while the IXCs, in keeping with their representations, will flow-through the remainder on their own volition. The practical result of this proposal is that the IXCs and the end-users will realize an overall reduction in access charges of \$18.61 million: IXCs will see a reduction on their bills of \$13.61 million, while the IXCs' collective end-users, at the conclusion of Phase II, will receive a *further* direct benefit of the access charge reductions in the amount of \$5 million. In furtherance of Phase II to this proceeding, the parties are hereby directed to file initial comments pertaining to this issue within 45 days of the date of this Order, with reply comments due two weeks thereafter.

F. Effect on Price Cap Plan

The Commission's Price Cap Order permits Verizon-MD to seek recovery of exogenous cost changes.¹²⁵ Under that Order, the Commission defined exogenous costs as "those costs triggered by administrative, legislative or judicial action that are beyond the control of BA-MD and not otherwise included in the price cap formula."¹²⁶

According to Verizon-MD, an access charge reduction in this proceeding would violate the letter and spirit of the Company's Price Cap Plan, unless the access charge reduction is treated as an exogenous change and the Commission allows rates to be rebalanced to compensate the Company for any lost access charge revenues. Staff opposes the Company's view.

Staff noted that in the Price Cap Order, the Commission concluded that "access charges should be reduced to promote telecommunications competition in Maryland and to reduce toll rates for Maryland customers."¹²⁷ As Staff further noted, the Price Cap Order stated that the Commission is "convinced that the monopoly inputs of switched access should be reduced to cost."¹²⁸ In ordering the initial \$32 million reduction in access charges, the Commission simply observed that it was not directing that any additional changes be made to the switched access rate

¹²⁵ Price Cap Order, 87 Md. PSC at 238.

¹²⁶ *Id.* at 260

¹²⁷ Staff's Initial Brief at 24, *citing* Price Cap Order at 266.

¹²⁸ *Id.*

element *at that time*, as emphasized by Staff.¹²⁹ Staff posits that “[t]aken together, this language clearly indicates that the Commission intended further reductions in access charges.”¹³⁰

In response, Verizon-MD cites Case No. 8772, *In the Matter of the Commission’s Investigation into Local Calling Boundaries*. In his Proposed Order, the Hearing Examiner in that case stated that “it is my opinion that exogenous events can include regulatory action that results in revenue lost to BA-MD, and that Bell Atlantic should be permitted to apply for their recovery in the event that the Commission directs a change in the size of local calling areas.”¹³¹ According to Verizon-MD, “any reduction in access charges would constitute an exogenous change because it would be an administrative change outside of Verizon-MD’s control.”¹³²

The Commission believes, however, that the Company’s reference to Case No. 8772, and its arguments regarding the criteria for exogenous cost changes or revenue losses, are wholly irrelevant in the present context. On this record, Verizon-MD has not demonstrated that access charges subsidize basic rates or ensure universal telephone service in Maryland. Moreover, since the Commission’s initial access charge reduction in Case No. 8715, the Company has been on notice that further reductions would be forthcoming, in order to advance the Commission’s stated goal of moving access rates closer to cost. As AT&T correctly noted:

The Commission has clear authority to reduce Verizon’s access rates ... Indeed, from the outset the Commission structured the Price Cap Plan to enable it to accomplish its goal to reduce

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *In the Matter of the Commission’s Investigation Into Local Calling Area Boundaries*, Case No. 8772, Proposed Order of Hearing Examiner, 91 Md. PSC 510, 521-22 (2000).

¹³² Verizon-MD’s Reply Brief at 16.

access to cost. As the Commission explained in its April 3, 1997, Brief to the Circuit Court of Wicomico County in response to MCI's appeal of the Price Cap Plan, the Plan "would not prevent ... the Commission from lowering prices on access services..." and is not intended and simply does not alter the Commission's authority over BA-MD." The Court agreed, finding that "what the Commission referred to as being "frozen: for the three year period is the maximum rate that may be charged for access services. The Court is unable to read into the Commission's decision any preclusion to the [sic] lowering access rates."¹³³

The Commission's action today is merely a continuation of a decision made in the Price Cap Order; *i.e.*, to reduce access rates closer to cost. This is an action that was or should have been fully expected by the Company, and therefore was not outside of Verizon-MD's control and does not meet the criteria of an exogenous change. Furthermore, the Commission remains obligated to ensure that Verizon-MD's rates, even considering the Company's flexibility under the Price Cap Order, are just and reasonable. Thus, the Commission reserves the right, in this proceeding or in other cases, to further adjust access rates as the Commission deems necessary.

IV. CONCLUSION

WHEREFORE, upon consideration of the record developed in this proceeding, the Commission finds that there is no need for a universal service fund in Maryland at this time, and that a \$13.61 million, second interim, reduction in access rates paid by interexchange carriers should be made at this time, with an additional \$5 million to be retained by Verizon-MD to be refunded to end-use customers through procedures established by the Commission in a Phase II

¹³³ AT&T Exh. 21 at 11 (citations omitted).

proceeding. In order to assure the direct pass-through of a \$5 million sum certain amount of the reduction directed herein, the Commission institutes a Phase II proceeding to receive comments from parties and interested persons regarding appropriate mechanism to deliver these benefits to end-use consumers.

IT IS, THEREFORE, this 17th day of July, in the year Two Thousand and Two, by the Public Service Commission of Maryland,

ORDERED: (1) That the switching and transport components of the switched access rates charged by Verizon-Maryland Inc. and other Competitive Local Exchange Carriers to Interexchange carriers shall forthwith be reduced by \$13.61 million, which shall be flowed through to end-users by interexchange carriers through reduced intrastate toll rates;

(2) That \$5 million of the revenues collected by Verizon-Maryland Inc., in the form of switched access rates from interexchange carriers, shall be retained by Verizon-Maryland Inc. and placed in escrow to be refunded directly to end-use customers in accordance with procedures to be adopted by the Commission in a Phase II proceeding;

(3) That within thirty days of this Order, Verizon-Maryland Inc. and other Competitive Local Exchange Carriers operating in the State of Maryland shall file with the Commission amended tariffs reflecting the reductions to local switching rates and the residual interconnection charge (RIC) as directed in this Order;

(4) That the amended tariffs filed in accordance with Ordered Paragraph 3 shall be subject to acceptance by the Commission and the designation of appropriate effective dates;

(5) That all Interexchange Carriers and other regulated entities using local switched access shall, upon acceptance by the Commission of the tariffs referenced in herein, comply with the terms of this Order governing toll call tariffs.

(6) That a Phase II proceeding be docketed to develop a mechanism for returning the \$5 million dollars, which will be retained in escrow by Verizon-Maryland Inc. pursuant to Ordered Paragraph 3, to end-use telecommunications customers in Maryland;

(7) That initial comments in Case No. 8745 Phase II shall be submitted within forty-five days from the date of this Order and that reply comments, if any, shall be submitted within fourteen days thereafter; and

(8) That all motions not expressly granted within this proceeding are hereby denied.

Commissioners