

**PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17105-3265**

Public Meeting held November 13, 2003

Commissioners Present:

Terrence J. Fitzpatrick Chairman
Robert K. Bloom, Vice Chairman
Glen R. Thomas
Kim Pizzingrilli
Wendell F. Holland

Generic Investigation Re
Verizon Pennsylvania Inc.'s
Unbundled Network Element Rates

R-00016683

**FINAL OPINION AND ORDER
PUBLIC VERSION**

TABLE OF CONTENTS

	<u>Page</u>
I. Introduction.....	1
II. History of the Proceeding	3
A. Development of the Record	3
B. FCC Triennial Review Order.....	8
C. FCC Memorandum Opinion and Order in Virginia Arbitration....	11
D. FCC Notice of Proposed Rulemaking re: TELRIC.....	13
III. Summary of Disposition	14
A. Final Rates to Result From This Proceeding	14
B. Final Rates for Recurring Costs	14
(1) Cost of Capital.....	15
(2) FLC Factor.....	16
(3) Outputs as to Certain UNE Rates.....	17
(4) Verizon PA Switching Cost Rates	17
C. Port Rates and Features	19
D. ISDN Calling Name and Number Delivery.....	20
E. Amended Switching Cost Study	20
F. Final Rates for Non-Recurring Costs	20
G. Rejection of Cross-Connect Charges	21
H. Density Cell Modifications	21
I. Retail Revenue Comparison Issue	21
IV. Reconsideration of Tentative Order Inputs and Assumptions	22
A. Introduction	22
B. Verizon PA’s Petition for Reconsideration	24
1. Positions of the Parties	24
2. Disposition	26
C. Verizon PA’s Recurring Cost Model	29
D. FLC Factor	30
1. Introduction	30
2. Positions of the Parties	31
3. ALJ Recommendation	35
4. Disposition	36
E. Outputs as to Certain UNE Rates	42
1. Cross-Connect Amortization Charge	46

F.	Requested Revisions to Tentative Order Assumptions	46
1.	Maintenance and Repair Expense	46
	(a) Position of the Parties	46
	(b) Disposition	46
2.	Fill Factor Utilization	47
	(a) Position of the Parties	47
	(b) Disposition	47
3.	Port Rate and Features	48
	(a) Position of the Parties	48
	(b) Disposition	49
4.	Rate for Calling Name and Number Delivery Features ...	50
	(a) Position of the Parties	50
	(b) Disposition	51
5.	Cost of Capital	52
	(a) Background.....	52
	(b) Position of the Parties	54
	(c) Disposition	56
	i. Capital Structure	57
	ii. Cost of Debt	59
	iii. Cost of Equity	60
6.	Depreciation	62
	(a) Background.....	62
	(b) Position of the Parties	63
	(c) Disposition	64
7.	Loop Conditioning and Loop Qualification	64
	(a) Position of the Parties	64
	(b) Disposition	65
8.	Loop Issues	65
9.	Other Input Factors	65
G.	Switching Rates	65
1.	Reliability of Switching Cost Study	65
H.	Non-recurring Costs	67
1.	Positions of the Parties	67
2.	ALJ Recommendation	71
3.	Disposition	72
I.	Verizon’s Motion to Amend its Switching Cost Study	73
V.	Disparate Rate Impact of Density Cell Structure	74
A.	Introduction	74
B.	Positions of the Parties	76
C.	Disposition	76

VI. Retail Revenue Comparison 77

VII. Conclusion/Order..... 77

I. Introduction

This proceeding is the continuing investigation to consider whether the existing tariffed rates for Verizon Pennsylvania Inc.'s (Verizon PA) unbundled network elements (UNEs) continue to be just and reasonable. *See* Order of August 31, 2001, at 1; 66 Pa. C.S. § 1301.

Before the Commission for consideration are the March 19, 2003 Supplemental Recommended Decision on Remand (Supp. R.D.) of Administrative Law Judge (ALJ) Michael C. Schnierle, and the Exceptions and Reply Exceptions of the Parties with respect thereto. Also before the Commission are Comments and Reply Comments filed with respect to our Tentative Order, entered in this proceeding on November 4, 2002.

Exceptions to the Supp. R.D. were filed by Verizon PA, Covad Communications, Inc. (Covad), and the Office of Consumer Advocate (OCA). AT&T Communications of Pennsylvania, Inc. (AT&T) and MCIWorldCom Network Services, Inc. (MCI)¹ filed Joint Exceptions (Jnt. Exc.) to the Supp. R.D. Replies to Exceptions were filed by Verizon PA, AT&T/MCI, Covad, Full Service Computing Corporation, t/a Full Service Network (FSN),² the OCA, the Office of Small Business Advocate (OSBA), RCN Telecom Service, Inc. (RCN), and the Commission's Office of Trial Staff (OTS).

¹ We note a recent corporate name change to MCI.

² FSN filed a Petition to Intervene on November 8, 2002, which was subsequently granted by ALJ Schnierle. *See* Tr. at 568-569.

Comments to the Tentative Order were received from Verizon PA, AT&T/MCI, Cavalier Telephone Mid-Atlantic, LLC (Cavalier), FSN and ATX Licensing, Inc. (ATX) (Joint Comments), RCN and the OCA. Reply Comments were filed by Verizon, AT&T/MCI, Covad, FSN, OTS, and RCN.

We also note that Comments were filed, at the request of the ALJ, to an issue raised in the remanded proceedings pertaining to a revenue comparison of retail rates and rates produced by certain UNEs. *See* Supp. R.D., at 41-49.

II. History of the Proceeding

A. Development of the Record

On May 7, 2002, the Recommended Decision of ALJ Schnierle was issued in this proceeding, following the conclusion of extensive hearings wherein testimony and exhibits were received and Main and Reply Briefs were filed. After consideration of Exceptions and Reply Exceptions to the May 7, 2002 Recommended Decision, we issued the November 4, 2002 Tentative Order.

In the Tentative Order, we directed Verizon PA to rerun its cost model for recurring costs consistent with the inputs and modifications directed in that order. Verizon PA was also directed to rerun its proposal to recover non-recurring costs consistent with, and based upon, the cost model proffered by AT&T/MCI. (Tentative Order at 2). The ALJ was to establish a process by which the Parties to this proceeding would be able to challenge the validity of the rates filed in response to the Tentative Order. *Id.* With regard to the process to be followed and the scope of the remanded proceedings, we stated the following:

3. That this proceeding is remanded to the Office of Administrative Law Judge for such proceedings as may be necessary and the issuance of a Supplemental Recommended Decision. The proceedings on remand shall address and consider two issues:
 - (a) First, Verizon Pennsylvania Inc. shall be directed to rerun its recurring cost model consistent with the inputs and modifications set forth in this Tentative Opinion and Order. Verizon shall also rerun the non-recurring costs using the AT&T cost model consistent with the inputs and modifications set out in the Tentative Order. Next, Verizon shall file the results of the recurring and non-recurring cost reruns within

thirty (30) days of the date of entry of this Opinion and Order. The Commission would then be required to resolve any factual disputes over whether the rates have been calculated properly. To achieve this end and to assure that the UNE rates have been calculated consistent with the determinations in this Order, the matter is remanded to the OALJ to address the accuracy of Verizon's recalculation of the rates. After Verizon files the rates, the OALJ shall establish a process to allow other Parties to challenge the validity of the rates. At the end of the process, the OALJ shall issue the Supplemental Recommended Decision, which the Commission will consider prior to issuing a Final Order in this proceeding. It is our intent that the presiding ALJ inform the Parties to this proceeding that Comments and Reply Comments to the instant Tentative Opinion and Order will be due at the same time that Exceptions and Reply Exceptions to the forthcoming Supplemental Recommended Decision are due;

- (b) Second, the remanded proceedings should address whether the Commission may, and should, attempt to ameliorate any disproportionate impact on the current UNE rates in different density cells. The exact amount of the impact upon rates in the various density cells is uncertain at this time, since the level of Verizon's rates under the inputs set in this Tentative Opinion and Order have not been determined. To assure that the Commission is in a position to make an informed decision when it issues a Final Order, the ALJ and the Parties will be directed to address any disproportionate impact upon UNE rates in the density cells. To the extent Verizon's recalculated rates show a widening disparity in rates for the density cells compared to Verizon's current UNE rates, the ALJ should address the legal and policy implications of the Commission's acting to reduce such disparities. For example, if the ALJ concludes that the

Commission may reduce any disparities, the ALJ should address whether the Commission should set rates that equalize the impact on the current rates for the different density cells.

(Tentative Order, slip op. at 207-208).

Earlier in the Tentative Order, we provided further guidance pertaining to the instant proceeding:

On consideration of the record evidence of this proceeding, we conclude that it may be appropriate to modify existing UNE rates consistent with the determinations contained in this Opinion and Order, as a refinement of the proper application of the Total Element Long-Run Incremental Cost (TELRIC) methodology, as is required by federal and state law. We reserve final judgment, however, pending receipt of further information, on whether [sic] the rates resulting from the tentative determinations made herein and the Comments filed with respect thereto.

(Tentative Order, slip op. at 1-2).

Verizon PA filed its revised recurring and non-recurring UNE rates, pursuant to the Tentative Order, on December 4, 2002 (December 4 Filing). The December 4 Filing, which included a set of compact discs containing the cost studies, backup, and paper printouts of the compact discs, contains the rate schedules for Verizon PA's recurring and non-recurring costs that were produced by Verizon PA's use of the inputs that the Commission directed in the Tentative Order.³ The filing included a matrix detailing how Verizon PA incorporated the ordered input changes into its cost model and where those input adjustments can be found in the work papers. Also included in the rate schedules are the pertinent rates combining Verizon PA's retail Density Cells 3 and 4 - a recommendation

proposed by Verizon PA in response to the Tentative Order's inquiry regarding the possible disparate impact of UNEs and retail density rate zones.

On December 30, 2002, Joint Comments to Verizon PA's December 4 Filing were filed by AT&T/MCI. Also, Comments regarding the possible amelioration of a disparate impact on UNE rates resulting from Verizon PA's existing retail density cell structure were filed by Verizon PA, AT&T/MCI, OTS, OCA, OSBA, Cavalier, and FSN. In Comments to the December 4 Filing, AT&T/MCI, OCA, and FSN, in addition to addressing the density cell issue, also urged the Commission to reconsider its decision to permit Verizon PA to use the Forward Looking Conversion (FLC) factor in its cost study.⁴ Cavalier, in its Comments, also addressed the issue of whether the December 4 Filing complied with the Tentative Order.

On January 13, 2003, Verizon PA filed Reply Comments regarding the density cell issue, as well as a document styled "Reply Comments" regarding Verizon PA's December 4 Filing. Verizon PA also filed a Motion to Amend the switching cost study that was submitted with Verizon PA's December 4 Filing to correct errors discovered since then. (Supp. R.D. at 5).

Also on January 13, 2003, Reply Comments concerning the density cell issue were filed by MCI, OTS, OSBA, Cavalier, FSN, and RCN.

On January 15, 2003, a Prehearing Conference was held. At that conference, the Parties agreed that there was no need for further hearings or briefs, but that additional

³ As we shall discuss in this Opinion and Order, Verizon made adjustments to its recurring cost model, beyond those specified in the Tentative Order. *See* R.D. at 7; VZ Letter of December 4, 2002.

⁴ Also on December 30, 2002, Z-Tel Communications, Inc. filed a pleading styled as Exceptions to Verizon PA's Rerun, wherein the only issue raised was the appropriateness of the FLC factor.

time was needed to review and respond to Verizon PA's Motion to amend its switching cost study. (Supp. R.D. at 5 citing Tr. at 589-597).

At the January 15, 2003 Prehearing Conference, ALJ Schnierle, *sua sponte*, raised the question of whether it was possible to check the rates generated by the TELRIC studies against some less abstract figures in order to obtain some sense of their general level.

Notwithstanding the inherent problems with such a comparison, ALJ Schnierle asked the Parties to comment on the "retail revenue comparison" issue.⁵

On January 27, 2003, Verizon, AT&T, MCI, Cavalier, and FSN filed Comments on the revenue comparison issue.

On January 29, 2003, another Prehearing Conference was held. At that conference, the Parties again agreed that there appeared to be no need for further hearings, or for briefs. AT&T and MCI stated that they would be filing an answer to Verizon PA's Motion to amend its switching cost study. (Tr. at 623). AT&T, MCI and FSN requested an opportunity to respond to Verizon PA's Comments on the revenue comparison issue. (Tr. at 625). February 5, 2003, was the date set for the filing of Reply Comments on the revenue comparison issue. *See* Supp. R.D., p. 6; Tr. at 631.

On January 30, 2003, AT&T and MCI filed a joint response to Verizon PA's Motion to amend its switching cost study.

⁵ Problems, for example, include the fact that Verizon PA's retail revenues are not based on TELRIC methodology. Also, the appropriate source of data for retail revenues was extremely contentious. *See* Supp. R.D. at 5; Tr. at 598-614; also Reply Comments/R. Exc. of FSN, at 5.

On February 5, 2003, Verizon PA, AT&T, MCI, Cavalier, and FSN filed Reply Comments on the retail revenue comparison issue. On February 6, 2003, AT&T filed a letter correcting one statement made in its Reply Comments on the retail revenue comparison issue.

With the submission of the latest Comments, the record was completed. (Supp. R.D. at 6). As duly noted in the Supp. R.D., on review of Verizon PA's December 4 Filing, ALJ Schnierle concluded that Verizon PA complied with the Tentative Order except in six areas.

ALJ Schnierle further concluded that the impact of Verizon PA's density cell structure should be addressed in a separate proceeding.

Exceptions to the Supp. R.D, and the Replies of the Parties thereto, as well as Comments to the Tentative Order, and the Replies of the Parties thereto, were filed as noted hereinabove.

B. FCC Triennial Review Order

Since the issuance of the Tentative Order, two decisions of the Federal Communications Commission (FCC) have been released which bear on the scope of Local Exchange Carrier (LEC) unbundling obligations under Section 251 of the Federal Telecommunications Act of 1996 (TA-96), 47 U.S.C. § 251, and the proper application of the Total Element Long-Run Incremental Cost (TELRIC) methodology for the pricing of UNEs. Additionally, the FCC has instituted a Notice of Proposed Rulemaking, *infra*, relative to its TELRIC pricing rules.

On August 21, 2003, the FCC released its *Triennial Review Order (FCC TRO)*.⁶ In the *FCC TRO*, the FCC primarily engaged in a reevaluation of the unbundling requirements for UNEs pursuant to its interpretation of the *necessary* and *impair* standards of TA-96. The FCC retained its interpretation of the *necessary* standard as set forth in the *UNE Remand Order*.⁷ However, the *impair* standard was modified and interpreted as requiring the FCC and state commissions to make specific, affirmative findings that UNEs should, or should not, be unbundled. (*FCC TRO*, para. 7; 84). The states engage in certain fact finding responsibilities to apply the *impair* standard on a granular basis. The fact finding responsibilities undertaken by this Commission are addressed in separate Orders. *See Procedural and Protective Order* issued in the matter of *Investigation into the Obligations of Incumbent Local Exchange Carriers to Unbundle Local Circuit Switching for the Enterprise Market*; Docket No. I-00030100; *Investigation into the Obligations of Incumbent Local Exchange Carriers to Unbundle Network Elements*; Docket No. I-00030099; and *Development of an Efficient Loop Migration Process*; Docket No. M-00031754 (Orders entered October 3, 2003).

In the instant Opinion and Order, we establish rates for the list of UNEs in Verizon PA's Tariff 216. We recognize that Verizon PA's federal statutory obligation to offer unbundled access to particular network elements at TELRIC pricing has been recently reinterpreted by the FCC in its *Triennial Review Order*. It is our intent to

establish rates in this proceeding for those UNEs for which a rate is required under federal law. We recognize that the *TRO* appears to reduce the national list of UNEs, however, we have not yet determined how, if at all, the *TRO* operates to modify the offerings set forth in Tariff 216. We refrain from addressing this issue at this time due to a related complaint

⁶ See *In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, et al., CC Docket No. 01-338, et al.

⁷ See *Implementation of the Local Provisions of the Telecommunications Act of 1996*; 15 FCC Rcd 3696 (1999).

pending at Docket No. R-00038871. Accordingly, Verizon PA will be directed to rerun its cost study incorporating the directives in this Order, and to provide an output for all of the UNEs currently contained in the approved Tariff 216. Further, we request that Verizon PA's compliance filing identify those UNEs, if any, that Verizon PA believes should be removed from Tariff 216 as a result of the *TRO*. We understand that this temporary inclusion of "de-listed" UNEs does not work any hardship on Verizon PA due to Verizon PA's continuing obligation to offer such UNEs under existing interconnection agreements. We anticipate resolution of the impact of the *TRO* prior to expiration of Verizon PA's interconnection agreement obligations.⁸

In the *TRO*, the FCC also concluded that Section 271 of TA-96, 47 U.S.C. § 271, provides an independent obligation for former Regional Bell Operating Companies (RBOCs) to provide access to loops, switching, transport, and signaling. The pricing for these elements, however, is not required to meet the standards of TELRIC. (*FCC TRO*, para. 656). The elements that are unbundled solely due to the requirements of Section 271, rather than 251 of TA-96, must be priced on a just, reasonable, and not unreasonably discriminatory basis according to 47 U.S.C. §§ 201; 202. Based on the foregoing considerations, the elements unbundled solely due to Verizon PA's authority to provide in-region, intraLATA services are not the subject of the instant proceeding and will, to the extent needed, be addressed separately.

Finally, the *FCC TRO* provided limited clarifications of FCC rules specifically pertaining to the proper implementation of the TELRIC costing methodology. Clarification was provided concerning two components of the FCC TELRIC pricing rules: cost of capital and depreciation. Those clarifications will be discussed in the areas in which they are addressed as components of the cost model used in these proceedings.

⁸ This determination is also without prejudice to any "change of law" disputes which may arise in the context of interconnection or other agreements between Verizon PA and competitors.

Upon review of the *FCC TRO*, we conclude that the record, which includes the proceedings on remand, has been conducted within the parameters of the clarifications provided by the FCC concerning the two TELRIC determinants and that no further remand proceedings are required.

C. FCC Memorandum Opinion and Order in Virginia Arbitration

The second FCC proceeding is *In the Matter of: . . . Petition of WorldCom, Inc. . . for Preemption . . of the Virginia State Corporation Comm. . . .*; CC Docket No. 00-218, et al.; Rel. August 29, 2003), *applications for review pending (VA Arbitration #2)*. In this proceeding, the FCC Wireline Bureau Staff, acting in place of the Virginia State Corporation Commission, considered various cost issues in the context of an arbitration proceeding between Verizon Virginia, Inc. (Verizon VA), AT&T Communications of Virginia, Inc., and WorldCom, Inc., arising under 47 U.S.C. § 251.

In *VA Arbitration #2*, the FCC Staff analyzed and resolved several issues which are of interest to issues raised by the participants in the instant UNE Remand proceedings. In particular, the FCC Staff considered the Modified Synthesis Model (MSM) recurring cost model proposed by AT&T/MCI for the development of recurring costs for UNE loops. The FCC Staff also considered the use of Verizon VA's proposed Forward-Looking Conversion Factor (FLC) as an adjustment to Annual Cost Factors for estimating forward-looking expense for specific categories of expenses. The FCC Staff also considered an appropriate, TELRIC-compliant, cost of capital for Verizon VA. Finally, the FCC Staff considered the competing cost models for non-recurring costs.

Regarding the use of the MSM cost model, the FCC Staff concluded that the MSM better met its TELRIC cost model criteria for pricing unbundled loops.⁹ (*VA Arbitration #2*; para. 49; 171). Verizon VA's proposed model was, however, used to develop TELRIC rates for switching, signaling and transport. *See VA Arbitration #2*, para. 367. This Commission recognizes that the analysis of the FCC Wireline Bureau Staff is merely instructive, at this juncture. On consideration of the analysis employed by the FCC Staff in the *VA Arbitration #2*, we do not find it necessary to modify our conclusion to adopt Verizon VA's proposed cost model, with the modifications which are discussed herein, as the basis for developing recurring costs. *See VA Arbitration #2*, paras. 50-52.

Regarding the Verizon-proposed FLC, the FCC Staff agreed with Verizon VA that forward-looking expenses could be calculated by applying a productivity factor to current expenses. The FCC Staff considered the FLC adjustment relative to plant specific accounts and rejected it in favor of the use of a Current Cost/Book Cost ratio method. (*VA Arbitration #2*, para. 140).

In arriving at an overall cost of capital for Verizon VA, the FCC Staff utilized a 7.86% cost of debt, a 14.37% cost of equity capital (using a Capital Asset Pricing Model methodology), and a capital structure of 20% debt and 80% equity, to adopt a 12.95% overall cost of capital as proposed by Verizon VA. (para. 104).

Finally, in *VA Arbitration #2*, the FCC Staff considered the competing cost models for non-recurring costs and adopted the non-recurring cost model proffered by AT&T/MCI. (para. 567). This is a result consistent with our Tentative Order.

⁹ The criteria, originally taken from costing model approaches in the universal service context, are that the cost model be: (1) consistent with TELRIC rules; (2) transparent and adjustable; and (3) verifiable. *Id.*

As noted, the determinations of the FCC Staff in its *VA Arbitration #2* are not binding upon this Commission. However, where noted, we find that decision instructive for our consideration of Pennsylvania-specific issues and shall review the reasoning of the FCC Staff for its applicability to the facts of the instant proceeding.

D. FCC Notice of Proposed Rulemaking re: TELRIC

The FCC has instituted a Notice of Proposed Rulemaking (NPRM) to comprehensively review its rules applicable to the pricing of UNEs. *See In the Matter of Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*; WC Docket No. 03-173 (Released September 15, 2003) (*UNE NPRM*). The FCC undertakes the *UNE NPRM* while reaffirming its commitment to forward-looking costing principles. (*UNE NPRM*, para. 29). However, the NPRM invites comments on issues pertaining to several issues which are involved in the present case. They include solicitation of comment on the following, non-exhaustive list of issues: (1) the relevance of FCC statements made in the universal service context for specific TELRIC pricing rules (para. 48); (2) the proper considerations to be used in making network assumptions (paras. 49-61); (3) specific network inputs, including, *inter alia*, fill factors, switch discounts, cost of capital, depreciation, and expense factors (paras. 62-113); and (4) non-recurring costs (paras. 114-130).

Initiation of the FCC's NPRM does not warrant any delay in the conclusion of this proceeding.

III. Summary of Disposition

A. Final Rates to Result From This Proceeding

On consideration of the December 4 Filing in response to our Tentative Order, as well as the Comments to said filing and to the Tentative Order, the Supplemental Recommended Decision, and Exceptions and Replies, we shall establish final rates for UNEs in this proceeding consistent with the discussion, below, and subject to this Commission's review of a compliance tariff filing by Verizon. We shall direct Verizon PA to file a tariff or tariff supplement, with supporting data and documentation, which will revise its Tariff Pa. P.U.C. No. 216 consistent with, and which conforms to, the inputs and directives contained in this Final Opinion and Order.

B. Final Rates for Recurring Costs

Verizon PA shall file rates for recurring costs, consistent with, and which conform to, the modifications and directives contained in this Final Opinion and Order. The Tentative Order conclusions and determinations are modified, to the extent consistent with the discussion, below.

In our Tentative Order, we expressly reserved final judgment, pending receipt of further information, on the rates resulting from the tentative determinations made therein and the comments filed with respect thereto. (slip op. at 2). We, hereby, make final our determination for the development of UNE rates that are based on applicable FCC rules implementing TELRIC principles. *See* 47 C.F.R. § 51.505(e), including the recent clarification of those rules in the *FCC TRO*. We also note, as stated above, that even though we are not bound by the FCC's *VA Arbitration Order #2*, it does provide additional insight on various determinations we reach in this Opinion and Order based on our understanding of the law and the FCC's regulations.

We shall continue to set UNE rates based on Verizon PA's recurring cost model, as revised by our Tentative Order modifications to the inputs and assumptions of said model.¹⁰ However, we reconsider several of the inputs and adjustments used by Verizon PA in its computation of TELRIC-compliant UNE rates in three areas.

(1) Cost of Capital

As explained more fully, below, the clarifications provided by the *FCC TRO* necessitate our reconsideration of the cost of capital input for the determination of UNE rates. The recent FCC clarifications are a change from the assumptions used in the past to determine cost of capital. In the Tentative Order, based on the existing level of competition, we adopted a cost of capital of 9.83%. In light of the recent FCC guidance on this issue, we shall revisit our cost of capital conclusion. We shall, on reconsideration of the record, adopt an overall cost of capital of 12.37%, as explained in detail, below.

¹⁰ We note that UNE rates for recurring costs produced by the MSM and associated models proffered by AT&T/MCI, in this proceeding, have produced rates for certain UNEs which are similar to those rates we adopt in this proceeding. Consequently, the rates produced by the MSM are within a zone of reasonableness. Therefore, this Commission concludes that, notwithstanding certain theoretical criticisms noted in the Tentative Order regarding the MSM, the MSM and associated models may be suitable for adopting rates for recurring costs in this proceeding. *See* Supp. R.D. at 40-41, citing *Verizon v. FCC*, 535 U.S. 467, 122 S. Ct. 1646, 152 L. Ed. 2d 701 (2002); *see also VA Arbitration #2*.

(2) FLC Factor

We reconsider our approval of the Forward-Looking Conversion Factor, also referred to by Verizon PA as a Forward-Looking to Current Conversion Factor (FLC). *See* Tentative Order at 59. On consideration of the record herein and the positions of the parties we, hereby, reject the proposed FLC adjustment to Verizon PA's Annual Cost Factors (ACFs) in the manner implemented by Verizon. We find that Verizon PA's implementation of the FLC in this proceeding is circular in nature and has improperly resulted in an overstatement of TELRIC-adjusted expenses. Consequently, the overstatement of TELRIC-adjusted expenses has resulted in an excessive allocation of expenses used in Verizon PA's recurring cost model for the determination of UNE rates.

Therefore, based on the foregoing, we shall describe the flaws in Verizon PA's application of the FLC factor in these proceedings and direct Verizon PA to correct these flaws in its compliance filing. The proper application of the FLC factor, by itself, should result in an overall reduction in UNE rates from the December 4, 2002 cost model run.

To the extent Verizon PA proposes an FLC or "FLC-like" adjustment for consideration in the pending, consolidated loop cost proceeding, it shall bear the burden of proof and provide all supporting work papers for its computation of this factor. *See* Docket No. R-00028028, *Verizon Consolidated Loop Cost Study Proceeding*. Verizon PA shall have the burden of proof that the FLC is calculated properly and does not result in a "circular" restoration of embedded expenses which are not acceptable as valid inputs in a TELRIC-compliant loop cost model. Our conclusions herein shall be without prejudice to a thorough consideration of any proposed FLC or "FLC-like" adjustment in the pending, consolidated loop cost proceeding and without prejudice to whether the FLC should be replaced with the CC/BC ratio.

(3) Outputs as to Certain UNE Rates

The third area concerns specific UNE rates that appear to be anomalous outputs of the cost model. On review of the rates proposed in the December 4 filing, we observe that the output rates from Verizon PA's cost model have produced large unexplained fluctuations, especially increases in the rates, for certain UNEs.

On consideration of the record, we address this concern by requiring Verizon, in its compliance filing, to provide a specific, concise explanation and verifiable documentation for each specific UNE rate that varies by 50% or more, up or down, from the current rate. The Parties may comment on the rates and Verizon PA's explanation if they disagree with Verizon PA's calculation of the rates. Further, the Parties are not foreclosed from commenting on any rate that they believe has been miscalculated, regardless of the magnitude in the change to the rate.

(4) Verizon PA Switching Cost Rates

Several of the parties have pointed out, and the presiding ALJ agreed, that Verizon PA did not fully comply with all of the Tentative Order's directives. Based on the failure of Verizon PA's switching cost study to adhere to the directions in the Tentative Order and certain identified computation errors, we reject the rates produced in the December 4 Filing.

Verizon PA filed a Motion to Amend its Switching Cost Study (Motion) which was filed after Verizon PA made its December 4 Filing in response to the Tentative Order directives. On January 30, 2003, AT&T/MCI responded to the Motion pointing out additional, alleged errors which should be addressed before action on the Motion. *See* Supp. R.D. at 22. The Supplemental Recommended Decision did not address these alleged errors or make recommendations as to their effect on Verizon PA's Motion to revise its switching cost study.

Based on the foregoing, we conclude that the December 4 Filing is not a reliable basis on which to establish UNE switching rates in light of the unresolved allegations of computational error and the failure of the switching cost model to implement the directives of the Tentative Order. Therefore, we shall direct Verizon PA to properly rerun its UNE switching rates as follows.

First, Verizon PA is directed to rerun its SCIS and related switching cost studies and implement the five (5) adjustments found by ALJ Schnierle to be mandated by our Tentative Order but improperly implemented. This shall include the use of the appropriate methodology to implement the “melded” new switch/growth switch discount proposed by AT&T/MCI, which was estimated to produce a 20% reduction from the December 4 Filing. Second, the rerun of the switching cost study shall also include the Commission’s adoption of a 12.37% cost of capital. Finally, Verizon PA’s rerun shall also fully implement the directives concerning the rejection of Verizon PA’s application of the FLC in this proceeding and direction as to the proper application of the FLC in this proceeding. Verizon PA shall provide all work papers to demonstrate its compliance with these directives.

C. Port Rates and Features

Verizon PA failed to meet its burden of proof regarding its proposed change in port rates and available features. Verizon PA is directed to return its port rates and port rate structure to the rates and rate structure established in the Commission’s *Global Order*.¹¹ Specifically, Verizon PA is directed to include all port features which existed under the *Global Order*’s two options for a full-featured port and limited port as summarized below:

Option A:

Rate per port, per month * \$2.67

* Shall include all Vertical Features that are currently included in the Originating and Terminating Local Switching rates.

Option B:

Rate per port, per month * \$1.90

* Shall include all features in the port except 3-Way Calling which will be priced individually at the prices below:

3-Way Calling, rate per month	\$0.52
Centrex Intercom, rate per month	\$0.45
Custom Ringing, rate per month	\$0.16
Calling Number Delivery, rate per call	\$0.002

¹¹ *Re: Nextlink Pennsylvania, Inc.*, 93 PA PUC 172, 196 PUR4th. 172(1999), *aff’d. sub nom., Bell Atlantic-Pennsylvania, Inc. v. Pa. Public Utility Comm’n*, 763 A.2d 440 (Pa. Cmwh. Ct. 2000), *reargument den.* (Jan. 5, 2001), *appeal on other grounds pending.*

D. ISDN Calling Name and Number Delivery

Verizon PA has conceded that its computation of charges for “Calling Name and Number Delivery” were erroneous. As such, we direct Verizon PA to correct the computation error and calculate the rate appropriately based on our directive concerning the implementation of the FLC factor.¹²

E. Amended Switching Cost Study

We shall adopt the ALJ’s recommendations that Verizon PA’s switching cost study submitted in response to the Tentative Order failed to comply with the directives contained therein, except in certain limited areas. We direct final UNE switching cost rates be calculated consistent with the discussion above.

F. Final Rates for Non-Recurring Costs

We affirm our conclusion to adopt rates for non-recurring costs based on the non-recurring cost model (NRCM) proffered by AT&T/MCI (AT&T/MCI NRCM) in this proceeding. As such, Verizon PA shall file rates which are consistent with this Final Opinion and Order. Also, Verizon PA’s Petition for Reconsideration of the Tentative Order’s adoption of the AT&T/MCI NRCM is denied, consistent with the discussion in this Final Opinion and Order.

¹² See AT&T/MCI Comments at 28 and VZ Reply Comments at 29-30.

G. Rejection of Cross-Connect Charges

We shall reject Verizon PA's inclusion of certain cross-connect charges as unauthorized and unsupported by the record. *See* AT&T/MCI Jnt. Exc. at 6.

H. Density Cell Modifications

We conclude that the record is insufficient for us to direct a revision to the structure of Verizon PA's density cell rate zones at this time. Consistent with our observations in the Tentative Order, we direct that this issue be addressed in a separate Technical Conference.

I. Retail Revenue Comparison Issue

We reject a retail revenue comparison since it has no merit in this proceeding.

IV. Reconsideration of Tentative Order Inputs and Assumptions

A. Introduction

Section 252(d)(1) of TA-96 provides, in pertinent part, that the state commission must set just and reasonable, nondiscriminatory rates for the lease of UNEs based on the cost of providing that network element, which may include a reasonable profit. 47 U.S.C. § 252(d)(1).¹³ This provision also provides that the state commission must determine rates for UNEs without regard to a rate-of-return, or other rate based proceeding. FCC rules implementing Section 252(d)(1) of TA-96 also state that embedded costs, retail costs, opportunity costs, or revenues to subsidize other services, are factors that shall not be considered in a calculation of the forward-looking economic cost of an element. *See* 47 C.F.R. § 51.505.

In setting just and reasonable UNE rates consistent with federal and state requirements, state commissions are given discretion to review cost studies provided by the incumbents, which studies should be consistent with the requirements of 47 C.F.R. § 51.505(e):

- (e) Cost study requirements. An incumbent LEC must prove to the state commission that the rates for each element it offers do not exceed the forward-looking

¹³ The FCC, in the *Local Competition Order*, concluded that the definition of “normal” profit is embodied in “reasonable profit” under Section 252(d)(1), where this is the total revenue required to cover all of the costs of a firm, including its opportunity costs. “Economic” or “supranormal” profit is any return in excess of normal profit. (*Local Competition Order*, para. 699).

economic cost per unit of providing the element, using a cost study that complies with the methodology set forth in this section and § 51.511;

and, 47 C.F.R. § 51.511:

§ 51.511 Forward-looking economic cost per unit.

- (a) The forward-looking economic cost per unit of an element equals the forward-looking economic cost of the element, as defined in § 51.505, divided by a reasonable projection of the sum of the total number of units of the element that the incumbent LEC is likely to provide to requesting telecommunications carriers and the total number of units of the element that the incumbent LEC is likely to use in offering its own services, during a reasonable measuring period.
- (b)(1) With respect to elements that an incumbent LEC offers on a flat-rate basis, the number of units is defined as the discrete number of elements (e.g., local loops or local switch ports) that the incumbent LEC uses or provides.
- (2) With respect to elements that an incumbent LEC offers on a usage-sensitive basis, the number of units is defined as the unit of measurement of the usage (e.g., minutes of use or call-related database queries) of the element.

The Supreme Court of the United States has upheld both the FCC jurisdictional authority to promulgate rules implementing the TELRIC methodology and the application of the TELRIC methodology, itself. *See AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 326 (1999); *Verizon Comm. v. FCC*, 535 U.S. 467 (2002).

B. Verizon PA's Petition for Reconsideration

1. Positions of the Parties

Prior to our consideration of modifications to the inputs and assumptions applicable to the cost models which we shall use as the basis for determining UNE rates in this matter, we address Verizon PA's Petition for Reconsideration or Clarification of the Tentative Order (Petition). It is axiomatic that the principles of *Duick v. PG&W*, 56 Pa. P.U.C. 553 (1982), guide our overall analysis of the merits of a request for reconsideration.

On November 15, 2002, Verizon PA filed its Petition seeking reconsideration and/or clarification of our rejection of its NRCM and adoption of the AT&T/MCI NRCM. In the Tentative Order, we directed that non-recurring rates be calculated using the AT&T/MCI NRCM. *See* Tentative Order, slip op. at 177-179. On November 25, 2002, AT&T/MCI filed a Joint Answer to the Petition. As of the date the Supplemental Recommended Decision was issued, this Commission had not rendered a decision on Verizon PA's Petition.

In its Petition, and in its Comments to the Tentative Order, Verizon PA raises two general contentions on the effect of adopting the AT&T/MCI NRCM as it relates to Verizon PA's rerun of its recurring and non-recurring cost models. Initially, Verizon PA continues to assert that the Verizon NRCM is, in fact, forward-looking and other jurisdictions, particularly the jurisdiction of Delaware, have accepted the Verizon PA NRCM in UNE proceedings.

Regarding the effect of our adoption of the AT&T/MCI NRCM on Verizon PA's implementation of its recurring cost and non-recurring cost models, Verizon PA argued that: (1) it should be permitted to adjust rates for recurring costs to account for the fact

that the AT&T/MCI NRCM treats as recurring, certain costs that Verizon PA's model treats as non-recurring; and (2) Verizon PA should be permitted to develop non-recurring costs for those costs which the AT&T/MCI NRCM did not address, but Verizon PA maintains are "left out" of the AT&T/MCI NRCM. *See* Petition; also VZ Cmnts. at 26-27.

In their Joint Answer, as well as Reply Comments, AT&T/MCI respond with two considerations. They first note that Verizon PA's allegations that the AT&T/MCI NRCM is inadequate because it does not account for all non-recurring costs which Verizon PA alleges it should be entitled to recover were raised in Verizon PA's Reply Exceptions to the May 7, 2002 Recommended Decision. Thus, these Parties assert that the Commission was aware of these arguments at the time the Tentative Order was rendered. Second, AT&T/MCI note that if there were "missing elements," Verizon PA has not shown why such rates could not be developed based on the methods and assumptions of the AT&T/MCI NRCM.

Finally, with regard to Verizon PA's request to increase its recurring cost UNE rates, AT&T/MCI state:

It is important to remember that AT&T/MCI's proposed recurring rates in this case included the functions not covered in the NRCM. Those recurring rates were substantially lower than those proposed by Verizon, and those adopted as part of the Tentative Order. Thus, if the Commission adopts recurring rates that are higher than those proposed by AT&T/MCI, the Commission has already included recovery for the functions Verizon claims should be NRCs [non-recurring costs]. The Commission must recognize that it would be raising the UNE recurring rates even higher if it were to accept the argument that Verizon can increase recurring rates to account for areas not included in the AT&T/MCI NRCM.

(AT&T/MCI Jnt. R.Cmnts. at 33-34).

Cavalier, in a somewhat general response to Verizon PA's proposals for non-recurring costs, provides an estimate of its calculation of the number of years it would take a CLEC to "break even" in a sale of residential service given the level of "upfront" non-recurring costs. (Cavalier Cmnts. at 6-7).¹⁴

2. Disposition

The Tentative Order's conclusion to reject Verizon PA's NRCM is affirmed as the final action of the Commission. Therefore, we deny Verizon PA's Petition, consistent with the discussion contained in this Final Opinion and Order.

"Non-recurring costs" (NRCs) may be thought of as the "installation" or "set-up" costs an incumbent LEC incurs when processing and provisioning a competitive LEC order for a UNE. The NRCM calculates the one-time charges for provisioning service to CLECs and these charges are unavoidable for interconnection with, and customer migration from, Verizon PA's ubiquitous network. We affirm our conclusion to adopt the AT&T/MCI NRCM because the AT&T/MCI model more accurately depicts the type of costs which we find acceptable in a least-cost, forward looking environment.

See Tentative Order, slip op. at 177-180.

We acknowledge the plausibility of Verizon PA's concern that the use of AT&T/MCI's NRCM creates a minor incongruity with respect to recurring and non-recurring costs in two respects. The first consideration in this area, as observed by ALJ Schnierle, generally relates to the preference for consistent network assumptions. This preference may be extrapolated to also include a preference for consistent recurring and

¹⁴ We note that the OSBA, in Reply Exceptions, maintains that adjustments to cost models should be made because they result in a more reasonable measure of wholesale costs and not because they yield a beneficial outcome biased to competitors or incumbents. (OSBA R.Exc. at 5).

non-recurring cost models. *See* Tentative Order at 178. The *FCC TRO* has further clarified that the goal of TELRIC should be to employ consistent network assumptions (as compared to mere wholesale adoption of a proposed costing model) for all the components of TELRIC. *See FCC TRO*, para. 680. The modifications that we direct Verizon PA to implement to bring its recurring cost model into TELRIC-compliance result in a high degree of consistency in network assumptions as between the two models adopted for use in these proceedings. While said modifications are not touted as bringing a mathematical exactness to the various approaches taken by Verizon PA and AT&T/MCI, the modifications are acceptable for consistency under TELRIC. This approach is also consistent with the FCC Staff's decisions to recommend changes to cost models and inputs which represent a fusion of those models and inputs which are most consistent with the goals of TELRIC. *See VA Arbitration #2*.

The second major consideration raised by Verizon PA is with regard to the specific adjustments proposed. Verizon PA argues that the AT&T/MCI NRCM assumed that certain recurring costs would be considered in Verizon PA's recurring cost model, which were not. Also, Verizon PA argues that the AT&T/MCI NRCM does not produce rates for all of Verizon PA's non-recurring activities that Verizon PA maintains are provided in furnishing UNEs, at present. Based on the foregoing, Verizon PA incorporated into the December 4 Filing its proposed adjustments to its recurring UNE costs and rates based on the adoption of the AT&T/MCI NRCM. As noted by ALJ Schnierle, Verizon PA acknowledged that its December 4 Filing contained adjustments to its recurring cost runs beyond those required by the Tentative Order in an effort to recoup the recurring costs which were not addressed by the AT &T/MCI NRCM.

Thus, in the Rerun, Verizon made additional adjustments to its recurring cost model runs beyond those specified in the Tentative Order. At this point of this decision, the purpose of noting that fact is not to pass judgment on those additional adjustments, but merely to note their existence.

(Supp. R.D. at 7 referencing Letter of December 4, 2002 at 2-3; also Supp. R.D. at 13-16 citing AT&T/MCI Jnt. Exc.).

Therefore, the Verizon-made adjustments to its recurring cost model appear reasonable in light of our adoption of the AT&T/MCI NRCM. Based on the foregoing, we reject the AT&T/MCI argument that the adjustments should not be made. However, we agree with AT&T/MCI and the other Parties that no further adjustments are necessary.

With regard to Verizon PA's non-recurring rates, we noted in the Tentative Order that “. . . the NRCM, presented at AT&T/MCI Stmt. 7.0 (Walsh Dir.), which contains the non-recurring charges produced by the NRCM, presents key rates for UNEs that are more in line with the forward-looking principles necessitated by a proper application of TELRIC.” (slip op. at 179). Verizon PA has not presented any convincing argument that its proposed NRCM is more suited to the mandated TELRIC environment. We emphasize that we do not require Verizon PA to perform any services without compensation. Rather, we conclude that the functions Verizon PA claims are not addressed in the AT&T/MCI model are functions which do not reflect a TELRIC network.

Based on the foregoing, Verizon PA's Petition is denied. Verizon PA has the opportunity to file a new non-recurring cost study for the Commission's consideration which implements applicable TELRIC rules. (Tentative Order at 180).

C. Verizon PA's Recurring Cost Model

We note that we are not required to consider expressly or at great length each and every contention raised by a party to our proceedings. *Univ. of Pa. v. Pa. PUC*, 485 A.2d 1217, 1222 (Pa. Commw. Ct. 1984). Any Exception or argument that is not specifically addressed herein shall be deemed to have been duly considered and denied without further discussion.

In our Tentative Order, we concluded that we would adopt Verizon PA's proposed cost model, with modifications, as the basis for setting UNE rates for recurring costs in this proceeding. We concluded that the model, as modified by the specific assumptions and inputs we directed therein, provided an appropriate framework which enabled this Commission to exercise informed judgment in setting UNE rates which comply with TELRIC principles. (Tentative Order at 27). We shall continue to set UNE rates based on Verizon PA's recurring cost model, as revised by our modifications to the inputs and assumptions of said model, in this proceeding. As noted, the FCC Staff, in *VA Arbitration #2*, used the AT&T/MCI proffered MSM for the determination of loops, while using Verizon PA's model, with modifications, for switching, signaling and transport. (*VA Arbitration Order #2*; para. 49).

D. FLC Factor

1. Introduction

The forward-looking economic cost of an element equals the sum of the TELRIC of the element and a reasonable allocation of forward-looking common costs. 47 U.S.C. § 51.505(a); *TRO* at para. 14. As noted by the FCC in the *TRO*, the TELRIC of an element is the sum of three components, operating expenses, depreciation, and cost of capital. *FCC TRO* at para. 671, referencing *Local Competition Order* at para. 703; see also *VA Arbitration Order* at para. 29). In the *UNE NPRM*, the FCC observed:

One area of controversy in state pricing proceedings has been the calculation of monthly operating expenses. In theory, the monthly operating cost should be calculated by estimating the total forward-looking operating expense associated with a particular network element (*e.g.*, by conducting time and motion studies of likely maintenance activities) and then dividing the total operating expense by the appropriate number of units, such as lines, to obtain the expected average operating expense. Such an approach is difficult to implement in practice, however, so regulators often estimate projected operating expenses by multiplying the projected investment in the network by an annual cost factor (ACF). An ACF typically is a ratio of current expenses to current investment for a particular account. The ratio is multiplied by the projected investment to obtain the projected expenses. An alternative method of calculating monthly operating costs is to look at current operating expenses and make any adjustments to reflect anticipated experience in the period for which the projection is made, such as adjustments for productivity and inflation.

(*UNE NPRM*, para. 109) (Notes omitted).

Consequently, in theory, the FLC proposed by Verizon PA in this proceeding is, ostensibly, but one method by which it proposes to ensure that when an ACF is applied to

Verizon PA's forward-looking investment, a forward-looking expense is produced. (Tentative Order at 61).

2. Positions of the Parties

The impact of the FLC and its reconsideration was the subject of vigorous comment by the Parties. AT&T/MCI, the OCA (supported by the OTS), Cavalier, and FSN/ATX, each advocate that we reconsider our approval of the FLC and specifically replace the FLC with a Current Cost to Book Cost (CC/BC) ratio.

AT&T/MCI, in their Comments, point out that in the Verizon PA cost model adopted in the *MFS-III* proceeding, Verizon PA used a "current cost/book cost" ratio or CC/BC ratio to convert embedded costs to forward-looking costs. (AT&T/MCI Cmnts. at 14-19). These Parties explain that use of expense to investment ratios is a modeling shortcut that is standard in the telecommunications industry as a means of estimating expenses attributable to specific levels of investment. AT&T/MCI further state that the CC/BC ratio insures that these ratios are internally consistent. In the present case, these Parties argue that Verizon PA abandoned the CC/BC ratio and replaced it with the FLC.

AT&T/MCI continue to oppose the FLC. They comment that Verizon PA did not explain its departure from prior modeling assumptions in using the FLC factor by, for example, explaining why the process used in *MFS-III* did not accurately capture forward-looking expenses.¹⁵ AT&T/MCI comment that the FLC has operated to increase Verizon PA investment ratios 44.5% before consideration of the CC/BC ratio. Also, the FLC has generated expense to investment ratios that are approximately twice those produced by the *MFS-III* methodology. (AT&T/MCI Cmnts. at 16).

¹⁵ Verizon PA's justification that an FLC adjustment is needed to avoid the double effect of TELRIC on expenses is also discounted by AT&T/MCI. (Comments at 15).

Thus, the FLC has operated to increase expense to investment ratios, which AT&T/MCI argue, runs counter to the likely assumptions that should accompany a forward-looking, TELRIC environment. These Parties also state “. . . many of the embedded Verizon PA inefficiencies, which are the result of labor-intensive efforts to use technologically obsolete equipment to serve increasing demand, will not exist in the forward-looking environment. As telephone technology improves and equipment becomes more sophisticated, it also becomes less labor-intensive and more “user-friendly” to operate and maintain.” (AT&T/MCI Cmnts. at 16-17).

AT&T/MCI estimate that replacing the CC/BC ratio with the FLC increased Verizon PA’s loop rates in Density Cell #4, alone, by over \$6.50 per month. (AT&T/MCI Cmnts. at 18). Finally, the Parties attack the use of the FLC as a violation of TELRIC principles by tying UNE costs to the incumbent’s existing network. (AT&T/MCI Cmnts. at 18-19).

The OCA, through the affidavit of Dr. Ben Johnson, advocates rejection of the FLC and its replacement with the CC/BC ratio. This step would have the additional benefit, according to the OCA, of addressing the disparate UNE rate impact between Verizon PA’s different density cells as the replacement of the FLC factor with the CC/BC would produce the greatest benefit in Density Cell #4. We reproduce an excerpt based on the affidavit of Dr. Johnson showing his analysis of the impact of replacing the FLC with the CC/BC:

2-Wire Basic Unbundled Loop UNE *	Proposed Tentative Order Rates With FLC Factor *	Proposed Tentative Order Rates With CC/BC Adjustment **	% Reduction Using CC/BC**	Rate Change Using CC/BC
Density Cell 1	\$ 7.10	\$ 5.70	19.7%	\$1.40
Density Cell 2	\$ 9.75	\$ 7.55	22.5%	\$2.20
Density Cell 3	\$13.12	\$ 9.88	24.6%	\$3.24
Density Cell 4	\$23.76	\$17.24	27.4%	\$6.52

* Supplemental R.D. at 25.

** Affidavit of Ben Johnson, Phd. Attached as Appendix A. (OCA Exc. and Cmnts. at 4).¹⁶

The OCA urges us to reconsider the use of the FLC factor. The OCA points out that, at such time as the Tentative Order was issued, the Commission was not aware of the dramatic effect on UNE loop rates in Density Cell #4 resulting from the FLC factor. (OCA Exc./Cmnts. at 7). The OCA, similar to the position of AT&T/MCI, notes that through the FLC, Verizon PA increased forward-looking expenses, rather than decreasing said expenses – a result that is expected in a forward-looking network. Adjusting expenses based on the CC/BC ratio would result in a lower expense to plant ratio and a reduced level of expenses. (OCA Exc./Cmnts. at 9).

Finally, the OCA makes two concluding arguments on this issue. It observes that this Commission gave weight to the fact that two jurisdictions which considered the FLC, New York and Massachusetts, allowed its use in calculating forward-looking expenses. However, since the issuance of the Tentative Order, the Public Service Commission of the District of Columbia has considered the FLC factor for Verizon Washington, D.C. and

¹⁶ Dr. Johnson was not subjected to cross-examination concerning this affidavit as it was appended to the Exceptions of the OCA.

rejected it. (OCA Exc./Cmnts. at 9). Also, the OCA maintains that the conceptual basis for the FLC adjustment is unsound. *Id.*

FSN/ATX, summarize the FLC-CC/BC adjustment and make the following points. Similar to the observations of other Parties who advocate the rejection of the FLC, FSN/ATX observe that the FLC is an adjustment which was not presented in Verizon PA's cost studies prior to these proceedings. FSN/ATX notes that in Verizon New Jersey's recent UNE case, Verizon PA submitted cost studies similar to those presented in Pennsylvania, but without a proposed FLC.¹⁷ FSN/ATX concede that Verizon PA is correct when it states that there are two methods of reducing an incumbent's embedded costs to forward-looking cost levels. The first method is to go through each account and reevaluate the costs to reduce the embedded costs in the account to forward-looking levels. The second method is the use of the annual cost factor (ACF). Unlike prior cost studies, FSN/ATX aver that Verizon PA has done both. Although Verizon PA claims that the Commission must apply the FLC to avoid double-counting forward-looking expense reductions, as explained by FSN/ATX, the problem is that Verizon PA has failed to properly apply the first method. Thus, Verizon PA has retained virtually all (allegedly 95%) of its embedded costs in its cost study and the forward-looking conversion by the first methodology has not been conducted. (FSN/ATX Jnt. Cmnts. at 16-18).

FSN/ATX also note the recent rejection of the FLC in the District of Columbia. They continue that the replacement of the FLC with the CC/BC ratio will be crucial to the amelioration of the urban/suburban/rural rate disparity in UNEs. FSN/ATX estimate the impact of the rejection of the FLC to be over \$6.00 per month in Density Cell #4. (FSN/ATX Jnt. Cmnts. at 18).

¹⁷ See *In the Matter of the Board's Review of Unbundled Network Element Rates, Terms, and Conditions of Bell-Atlantic New Jersey*; Docket No. TO00060356 (September 13, 2002); 2002 N.J. PUC LEXIS 298.

Verizon PA, in its Reply Comments, continues to defend the FLC as straight-forward and used as part of the calculations to derive its ACFs. Verizon PA explains that the FLC factor can be understood as an expression of how many cents (or fraction of a cent) per dollar of investment will be spent on maintenance in the forward-looking environment. (VZ R.Cmnts. at 11-12).

Verizon PA further explains:

Verizon PA's cost study uses the already-reduced *forward-looking* expense (e.g. for maintenance) in the numerator in this calculation. The FLC is used to ensure that the denominator is likewise the *forward-looking* investment cost. If Verizon PA used the book investment of the present-day company without applying the FLC factor to reduce that number to reflect the Commission's assessment of the TELRIC cost of the relevant investment, then the resulting factor would be understated: Verizon PA would be dividing the reduced maintenance expense by too large an investment number, and thus coming up with too few cents on the dollar being spent for maintenance.

(VZ R. Cmnts. at 12).

3. ALJ Recommendation

ALJ Schnierle observed that replacement of the FLC with the CC/BC ratio would be an adjustment that would act to ameliorate the disparity between UNE rates across all Verizon PA density cell rate zones and that such an adjustment would have the most substantial effect on Density Cell #4. (Supp. R.D. at 40).¹⁸ However, the ALJ did not make a recommendation concerning the merits of the FLC. (Supp. R.D. at 33).

¹⁸ Verizon acknowledges that the FLC has a greater cost impact in Density Cell #4 as Density Cell #4 has almost double the investment base of Density Cell #1 and the FLC adjusts investment. *See* VZ R.Exc. at 5, n. 4.

4. Disposition

The FLC continues to be a controversial area for the development of just and reasonable, TELRIC-compliant UNE rates. In the Tentative Order, we noted that Verizon PA's application of the FLC to its ACFs was an adjustment that had not been presented in prior cost models in proceedings before us. (slip op. at 61). Based on the novelty of this factor and its substantial impact on the proper forward-looking expenses associated with Verizon PA's forward-looking investment, we conclude that the principles of *PG&W v. Duick* are met.

The FLC is Verizon PA's attempt to maintain a constant ratio between forward-looking expenses and its embedded investment. See May 7, 2002 Recommended Decision of ALJ Schnierle at 28; Tentative Order at 57, 61. As explained in the Tentative Order, slip op. at 61, the ACF is an overall ratio of current annual expenses to embedded investment costs and is a widely accepted approach to estimating projected operating expenses. The ACF ratio is applied to forward-looking investment costs in order to develop an estimate of the forward-looking annual expenses. However, Verizon PA's position is that since the current annual expenses it uses in the ACF calculation are conformed to TELRIC principles by application of productivity and inflation factors (and certain other adjustments), an FLC factor is needed to avoid a double TELRIC adjustment when the ACF is applied to forward-looking investment costs. (Tentative Order, slip op. at 62).

AT&T/MCI have continuously taken the position that application of the FLC effectively restores the cost reductive effect of applying the ACF to the forward-looking (usually lower) investment costs.

In the Tentative Order we observed that Verizon PA's use of the FLC, as computed in the December 4 Filing, is necessarily imprecise given that Verizon PA's

methodology applies an overall FLC based on company-wide¹⁹ data to plant-specific ACFs for Pennsylvania.²⁰ We tentatively concluded that “the record in this proceeding supports use of the FLC so long as the initial forward-looking annual costs used under the ACF are properly adjusted in accordance with TELRIC principles.” And, of course, we can approve use of the FLC only if the FLC, itself, is properly computed and applied to Verizon PA’s estimated cost data. *See* Tentative Order at 62.

In our Tentative Order, we determined that in light of the foregoing observations, Verizon PA’s computations for the ACF and subsequent FLC computations are, at best, rough estimates of what a utility’s actual forward-looking costs would be under “real world” conditions for each UNE in the cost study. *Id.* at 62.

In approving the FLC in the Tentative Order, this Commission also took administrative notice that the FLC, in concept, has been accepted by the New York and Massachusetts state commissions. However, there is a split among the jurisdictions on the validity of the FLC. The FLC has been rejected in the jurisdiction of Delaware. More recently, the District of Columbia Public Service Commission (D.C. PSC) considered this factor and rejected it -- *See In the Matter of the Implementation of the District of Columbia Telecommunications Competition Act of 1996 and Implementation of the Telecommunications Act of 1996*; Formal Case No. 962; Order No. 12610 D.C. PSC (December 6, 2002) (*D.C. UNE Proceeding*); as did the Maryland Public Service Commission (Maryland PSC) . *See In the Matter of the Investigation into Rates for Unbundled Network Elements Pursuant to the Telecommunications Act of 1996*; Order No. 78552; Case No. 8879 (June 30, 2003). The D.C. PSC and Maryland PSC, rejected the proposed FLC factor based on the underlying reasoning for the factor and the mathematics

¹⁹ The .692 percentage is, however, based on Pennsylvania-specific information.

²⁰ In note 387, of the *VA Arbitration #2*, the FCC Staff observed that the FLC, unlike the CC/BC, is the same for all accounts, and is multiplied by embedded investment figures which do not reflect price changes over time.

relied upon in its implementation. Also, we find it instructive that the FCC Staff, in the *VA Arbitration #2*, has also rejected the FLC, reasoning as follows:

139. For similar reasons, we reject the FLC factor advocated by Verizon. The purpose of the ACFs is to calculate forward-looking expenses by multiplying an expense-to-investment ratio by forward-looking investment. Although Verizon purports to do this, in fact it estimates forward-looking expenses based on past expenses, adjusted for productivity and inflation as described above. Then, with the FLC factor, Verizon develops its ACFs, which it then uses to “calculate” the same forward-looking expense figure with which it started. As AT&T/WorldCom note correctly, the approach taken by Verizon is circular because it starts with forward-looking expenses, which is [sic] supposed to be the end result of the ACF calculation.

While not rejecting the FLC in all respects, on review of Verizon PA’s implementation and its impact, we find that the FLC’s implementation in the December 4 Filing must be rejected. We shall direct Verizon PA to remove its application of the FLC factor in developing its ACFs, and to rerun its cost study on that basis, consistent with the discussion contained in this Final Opinion and Order. Verizon PA has failed to meet its burden of proof in this area. Further, the mathematics surrounding the FLC’s implementation in this proceeding supports our conclusion that the FLC (as applied) is contrary to FCC TELRIC rules in that it results in an overstatement of Verizon PA’s estimates of forward-looking UNE expenses. We estimate the overstatement to be approximately 22%, on average, but shall direct Verizon PA to determine the specific percentage by which the FLC factor has overstated each category of expenses, consistent with the discussion contained in this Final Opinion and Order.

We find an overall reduction to Verizon PA's UNE rates to be expected because the FLC methodology applies Pennsylvania-specific investment data to plant-specific ACFs for Pennsylvania and, in operation, seeks to reduce or even cancel out the annual forward-looking expense savings that can be realized with newer generation and less costly telecommunications equipment. Indeed, it is more reasonable to assume, for purposes of estimating forward-looking TELRIC compliant UNE expenses, that new, more efficient and more reliable telecommunications equipment can be expected to reduce maintenance, reduce space requirements, reduce labor for installation and possibly yield longer service lives. The assumptions used in Verizon PA's cost study, as reflected in the FLC computations, do not appear to reflect this important trend in telecommunications costs, and, accordingly, Verizon PA's application of the FLC has overstated its estimated forward-looking UNE expenses.

Also, the flaw in Verizon PA's application of the FLC, is further contrary to TELRIC principles in that the FCC's TELRIC pricing rules equate the incumbent's cost of providing network elements with the cost today of building a local network that can provide all the services its current network provides, using the least-cost, most-efficient technology currently available. *See VA Arbitration #2*, para. 669. Rather than use the FLC factor to maintain a ratio of expenses to investment to replicate a network capable of providing the same services as its existing network, Verizon PA uses the factor to

virtually guarantee its recovery of a fixed dollar amount of its estimated expenses based on the level of expenses associated with the existing network.²¹

Our conclusion is best illustrated by a review of Verizon PA's December 4 Filing, particularly Part G "Factors and Support," at G-2d Tab marked "Recurring FLC for COH." In Part G of Verizon PA's cost study, Verizon PA presents its proposed application of the FLC. Similar to the observations made by the D.C. P.S.C., Maryland, P.S.C., and the FCC Staff, Verizon PA's application of the FLC is circular in nature and rather than act to decrease expenses associated with a forward-looking, least cost network, the FLC adjustment has actually increased expenses on a percentage basis. This increase is improper and we direct that Verizon PA's compliance filing shall correct it.

In the December 4 filing, Verizon PA calculated the Pennsylvania investment ratio used for the FLC factor to be 69.2% (or 0.692). This percentage was determined by dividing the Pennsylvania-specific adjusted forward looking booked investment [BEGIN PROPRIETARY]

[END PROPRIETARY]²² by its actual booked investment as of End of Year 1999 [BEGIN PROPRIETARY] [END PROPRIETARY].²³ Verizon PA then proceeded to use this factor to develop the rates set forth in the filing as follows.

Using source data gathered on a regional basis,²⁴ Verizon PA subtracted its regional common overhead costs [BEGIN PROPRIETARY] [END PROPRIETARY] from

²¹ Using the FLC as described is tantamount to assuming that Verizon PA's operating expenses, as a percentage of plant value, increase by 30.8% in a TELRIC environment. This assumption is contrary to the characteristic of the telecommunications industry as a declining cost industry. It is also contrary to Verizon annual report data. Verizon PA's annual reports filed with the Commission show that from 1997 through 2002, there has been an average annual decrease in operating expenses as compared with investment. See also AT&T/MCI Stmt. 8.0 at 73-74 (testimony that expenses will decrease in a forward-looking network).

²² Verizon PA shows its summary calculation of the adjusted forward looking book investment in Part G at G-10, Tab marked "Input from Investment Managers." The calculation implements revisions to total switch, loop and interoffice facilities investments required by our Tentative Order.

²³ Verizon PA sets forth a summary of its EOY 1999 General Ledger in Part G at G-10, Tab marked "EOY 1999 General Ledger."

²⁴ The region identified is "Verizon-East," which is commonly understood to include Pennsylvania. Part G-2d, Tab "Recurring FLC for COH."

its regional booked expense [BEGIN PROPRIETARY] [END PROPRIETARY] resulting in an Adjusted Booked Total Expense [BEGIN PROPRIETARY] [END PROPRIETARY]. Next, Verizon PA multiplied [BEGIN PROPRIETARY] [END PROPRIETARY] by 0.692 to arrive at a regional TELRIC-adjusted Product expense level [BEGIN PROPRIETARY] [END PROPRIETARY]. This level consists of capital cost expenses of [BEGIN PROPRIETARY] [END PROPRIETARY] and direct expenses of [BEGIN PROPRIETARY] [END PROPRIETARY]. We have no objection to the calculations to this point.

The next step is flawed and as part of the rerun Verizon PA should not repeat the following computation. Verizon PA takes the direct expense portion [BEGIN PROPRIETARY] [END PROPRIETARY] of the TELRIC-adjusted booked expense level and divides it by the FLC factor of 0.692. The result is a claimed region-wide direct expense of [BEGIN PROPRIETARY] [END PROPRIETARY], thus, canceling the effect of the prior multiplication.²⁵ The claimed direct expense of [BEGIN PROPRIETARY] [END PROPRIETARY] is approximately 44% higher than the TELRIC-adjusted level of [BEGIN PROPRIETARY] [END PROPRIETARY].²⁶ When combined with the unadjusted Capital Cost Expense portion of Booked Expense of [BEGIN PROPRIETARY] [END PROPRIETARY], this results in estimated TELRIC expenses of [BEGIN PROPRIETARY] [END PROPRIETARY], which is approximately 22% higher than the appropriate TELRIC-adjusted Product expense of \$12,510,582,808. In other words, we observe that Verizon PA's proposed application of the FLC in this exhibit results in an overstatement of regional expenses by approximately [BEGIN PROPRIETARY] [END PROPRIETARY], assuming no other clarifications.

²⁵ Not only does this computation restore the FLC reductions computed on line 6, Part G 2d of the December 4 Filing (compact disc schedule attached), the detail explaining line 10 of this schedule and the derivation of [BEGIN PROPRIETARY] [END PROPRIETARY] does not actually compute to [BEGIN PROPRIETARY] [END PROPRIETARY]. See Part G-2d of December 4 Filing.

²⁶ Similarly, we object to Verizon PA's treatment of common costs, *i.e.*, shared expense, which reflect the same 44% overstatement. See Tab G-2d, line 6.

The FLC was used similarly to adjust the Verizon PA ACFs used to calculate Pennsylvania-specific rates. Verizon PA adjusted its Pennsylvania-specific ACFs by the FLC increase in the multiplier by the same ratio that the booked expenses were reduced in making them forward looking. Consequently, we would eliminate the FLC adjustment to the ACFs and would direct that Verizon PA adjust its UNE rates accordingly. Generally, we accept the capital cost expense portion ACFs. See 7.1 Vcost Worksheet. However, we reject the direct expense ACFs because they are overstated due to Verizon PA's improper application of the FLC.²⁷ We direct Verizon PA to remove its application of the FLC factor in developing its ACFs and to rerun its cost study on that basis, consistent with the discussion contained in this Opinion and Order.

Based on the foregoing, we shall direct Verizon PA to adjust UNE rates due to our conclusion that Verizon PA's implementation of its .692 FLC factor to various ACFs has overstated estimated expenses. This action is without prejudice to Verizon PA's ability to more adequately justify the theoretical underpinning of the FLC, or an "FLC-like" adjustment in another proceeding.

E. Outputs as to Certain UNE Rates

As noted, we find the Verizon PA cost model has produced some large variances for certain UNEs, from existing rates. On review of the rates proposed in the December 4 filing, we observe that the output rates from Verizon PA's cost model have produced large unexplained fluctuations, especially increases in the rates, for certain UNEs. For example, certain new rates produced by the cost model computations are:

- 100% or more than existing rates for Digital 4 Wire Loops;
- 90 to 165% greater than the existing rates for Subloop Feeder - 4 Wire;

²⁷ The FLC adjustment should be removed from all ACFs to which it was applied, *e.g.*, the shared expense factor.

- 102 to 219% greater than the existing rates for Dark Fiber – IOF;
- 843 to 2028% greater than the existing rates for Unbundled EEL Testing;

We note that certain UNE rates show large decreases:

- 88.01% less than, to 77.54% greater than, existing rates for Unbundled Line Ports;
- 63.70% to 46.05% less than existing rates for Unbundled Dedicated Trunk Ports;
- 74.27% less than existing rates for Unbundled Individual Line Port Features;
- 98.5% to 32.98% less than existing rates for certain Centrex Features; and,
- 83.52% less than existing rates for Unbundled Tandem Switching (Tandem Switching MOU).

In the Commission’s judgment, these variances demonstrate some of the practical limits of a complex cost model, based on hypothetical forward-looking costs, that uses a series of company-wide, plant-specific and adjusted factors to develop individual UNE rates. In other words, these disparities reveal more about the practical limits of such cost studies than real world results.

The telecommunications industry continues to be characterized as a declining cost industry.²⁸ While we find this to be generally true, it is also true that the TELRIC methodology is imprecise and evolving. Therefore, it may not be surprising that in a case such as this, some rates will go up, and some will come down, but it is the magnitude of the

²⁸ See 93 PA PUC at 211; 215 (1999).

variation from current rates that is of concern. Such a substantial increase does not comport with the general industry trend of declining costs.²⁹

The Commission is not required to accept, without question, all outputs of this complex cost study without the application of its informed judgment and administrative expertise. As explained by Commonwealth Court in discussing rate structure:

Rate structure, which is an essential, integral component of rate-making, is not merely a mathematical exercise applying theoretical principles. Rate structure must be based on the hard economic facts of life and a complete and thorough knowledge and understanding of all the facts and circumstances which affect rates and services; and the rates must be designed to furnish the most efficient and satisfactory service at the lowest reasonable price for the greatest number of customers, *i.e.*, the public generally.

Phila. Suburban Transportation Co. v. Pa. PUC, 281 A.2d 179 (Pa. Cmwlth. 1971).

Likewise, we do not view the establishment of a rate structure for UNE rates as a mere mathematical exercise in which the Commission is bound to accept whatever rates are produced by the cost study computer program. Also, we note that TELRIC is not a specific formula, but rather, a collection of methodological principles. *See Sprint Communications Co. v. FCC*, 274 F.3d 549 (D.C. Cir. 2001).

It will be necessary for Verizon PA to rerun its cost model to arrive at TELRIC-compliant rates as established from this Final Opinion and Order. We shall address our concern relative to large variances in UNE rates by requiring Verizon PA, in its compliance filing to be made in response to this Final Opinion and Order, to provide a

²⁹ See recent National Regulatory Research Institute's (NRRI) study indicating a national decrease in UNE rates. *A Survey of Unbundled Network Element Prices in the United States* (Updated July 1, 2003) by Billy Jack Gregg.

specific, concise explanation and verifiable documentation for each specific UNE rate that varies by 50% or more, up or down, from the current rate.³⁰

Verizon PA should address, among other things, whether the increase or decrease³¹ is due to: (1) changes in the cost model (assumptions, allocation factors, or methodology); (2) changes in cost inputs (wages, benefits, equipment prices, taxes, etc); or (3) other factors. Other Parties may then comment on the rates and Verizon PA's explanation if they disagree with Verizon PA's calculation of the rates. The Parties are not foreclosed from commenting on any rate that they believe has been miscalculated, regardless of the magnitude in the change to the rate, however. The Commission would then evaluate all of this information when ruling on the compliance filing. The Commission reserves the right to reject any rate that is not properly justified and adjust the UNE rate in question. Verizon PA is directed to fully cooperate with Commission Staff during the compliance process as Staff or the Commission deems necessary.

Should this Commission find that Verizon PA has not met its burden to explain unjustified changes in existing rates, we shall, as noted, reserve our right to reject those proposed rates. We deem this approach to be reasonable given that the existing rates have previously been found to be TELRIC compliant both by this Commission and the FCC. *See Application of Verizon Pennsylvania Inc. . . . for Authorization to Provide In-Region, InterLATA Services in Pennsylvania*, Memorandum Opinion and Order, 16 FCC Rcd 17419 (September 19, 2001) (*PA § 271 Order*).

1. Cross-Connect Amortization Charge

³⁰ For purposes of this compliance filing requirement, the term “verifiable documentation” includes both documents in the record of this proceeding and presently existing documents that are properly authenticated by the company.

³¹ While it is generally true that the telecommunications industry is a declining cost industry, it is also true that the TELRIC methodology is imprecise and evolving. *See UNE NPRM*.

The CLECs have pointed out that Verizon PA has included a Cross-Connect Amortization, which appears as a \$.23, and \$.34 additive to loops. We can find no support or authorization for this charge and shall direct its removal. The “add-ons” are inconsistent with our determinations and conclusion regarding Verizon PA’s NRCM. *See* AT&T/MCI Jnt. Exc. at 6.

F. Requested Revisions to Tentative Order Assumptions

1. Maintenance and Repair Expense

(a) Positions of the Parties

AT&T/MCI, and other CLECs comment that, in addition to the FLC factor, the adoption of the 5% maintenance and repair expense reduction fails to address Verizon PA’s reliance on its embedded plant. These Parties advocated a 30% expense reduction adjustment. (*See* AT&T/MCI Cmnts. at 20-22).

(b) Disposition

On consideration of the Comments, we disagree that the 5% adjustment for maintenance and repair expense substantially understates the efficiencies and expense reductions achievable in the forward-looking network which TELRIC assumes. While the 5% adjustment appears modest in relation to the 30% advocated by the CLECs, we are not persuaded to increase it based on the record in this proceeding. We affirm our prior reasoning on this issue.

2. Fill Factor Utilization

(a) Positions of the Parties

In the Tentative Order, we adopted Verizon PA's proposed conduit utilization factor. (Tentative Order at 114). AT&T/MCI and FSN/ATX comment that the Conduit Utilization Fill Factor adjustment suffers from the same, inappropriate reliance on Verizon PA's embedded network as does the assumption relating to maintenance and repair expense. These parties generally assert that the decision to base this calculation on the number of conduit feet contained in Verizon PA's existing network, results in an excessive recognition of spare capacity that would not be experienced in a forward-looking network. *See* AT&T/MCI Cmmt. at 23; FSN/ATX Cmmts./Exc. at 26.

In reply, Verizon PA states that it demonstrated that the network design requirement, which calls for digging spare trench capacity during initial installations will not change in a forward-looking environment.

(b) Disposition

On consideration of the Comments, we decline to reconsider our conclusion on this issue. We affirm our prior reasoning on this issue.

3. Port Rate and Features

(a) Positions of the Parties

AT&T/MCI and FSN/ATX point out that the current Verizon PA port rate and structure differs from that established in the *Global Order*. (AT&T/MCI Cmnts. at 4; FSN/ATX Cmnts. at 30). The *Global Order* established a structure whereby the CLEC could choose between two options: (1) a full featured port at a rate of \$2.67 per month; or (2) limited port rate of \$1.90 per month which, however, included all but four features – Three-Way calling, Custom Ringing, Centrex Intercom, and Calling Number Delivery, which features are available for purchase on an *a la carte* basis. See FSN/ATX Cmnts. at 30.

The change in Verizon PA’s port rate, structure, and feature availability is summarized from the Comments of FSN/ATX:

Rather than remaining consistent with the rate structure embodied in the Commission’s precedent in the *Global Order*, Verizon proposed a full featured port rate of \$8.96 per month and a stripped port rate that required many popular features to be purchased separately and, as stated by the ALJ, contained “minimal included features.” Unfortunately, the TO’s modifications provide no relief. The full featured port rate would increase from \$2.67/month to \$4.74/month – an increase of approximately 77% over the current rates. Even worse, CLECs seeking to replicate the features package included in the current limited port rate of \$1.90 would suffer an increase of about \$2.62/month for a total limited port rate of \$4.52/month. This new rate would constitute an approximate 138% increase over the current, *Global Order* rate.

(FSN/ATX Cmnts. at 31) (Note omitted; emphasis original).

Features excluded from the new, limited port include Call Waiting, Remote Call Forwarding, and Caller Identification with Name Identification. *Id.*, n. 81.

In reply, Verizon PA maintains that the objection to the switching port rate is procedurally defective because it is raised too late. Apart from Verizon PA's procedural objection, it responds that the initial cost studies contained the same proposals that are in the "compliance" studies and that the features included in the two port options have never changed during the course of these proceedings. (VZ R. Cmnts. at 26). Verizon PA further contends that the port rate structure is based on the AT&T position expressed by AT&T witness Baranowski in the *Global Order* proceeding. Thus, Verizon PA states that the port rate structure proposed in this case is consistent with the AT&T position in the *Global Order*, which was adopted by the Commission.

(b) Disposition

We conclude that the issuance of the November 4, 2002 Order in Tentative Form moots Verizon PA's claims of timeliness. On consideration of the Comments of the CLECs, we shall direct Verizon PA to retain the port rate structure and availability of features which were directed in our *Global Order* for a full featured port as well as for the limited featured port. As noted, in the *Global Order*, we directed Verizon PA to offer two port rate options, full featured port and limited port, which would include different port structures and rates.

To the extent Verizon PA's full featured rate shows a dramatic and unjustified variance or more than 50%, up or down, upon review of the compliance filing, we shall require Verizon PA to provide an explanation consistent with this Final Opinion and Order.

The CLECs also pointed out the exclusion of certain vertical features previously included in the limited port, which would, under Verizon PA's proposed change,

have to be purchased separately. (See AT&T Comments at 7-8, n. 13). Verizon PA attributes its proposal to a reading of the *Global Order* whereby it distinguishes the limited port and full-featured ports based on vertical features which have “hardware requirements” which, generally, are purchased *a la carte* from Verizon PA, and those vertical features which do not. Based on the state of the record, we find these claims to be unsupported.

We note that the limited port rate has decreased to \$1.14, down from the prior \$1.90. Verizon PA represents that this port option is consistent with the port rate structure established in the *Global Order* for a limited port offering. The Commission has not modified or otherwise changed the structure or features required for a limited port rate offering as established in the *Global Order*. Moreover, Verizon PA has not requested that the Commission modify the port structures or relieve it from the port offering obligations set forth in the *Global Order*. If Verizon PA is attempting to offer a “stripped” port rate, as argued by the CLECs, that action is without authorization and is expressly rejected in view of Verizon PA’s continuing obligation under the *Global Order* to offer two port rate options. As such, Verizon PA is required to provide a limited port offering which contains the features and structure established in the *Global Order*.

4. Rate for Calling Name and Number Delivery Features

(a) Positions of the Parties

AT&T/MCI discovered an error with regard to the monthly charge for a stand-alone calling feature identified as “Calling Name and Number Delivery” – a feature that is essential for CLECs that want to offer Caller ID services in competition with Verizon PA. The issue was not raised in the “compliance” phase of the remand proceedings before ALJ Schnierle because, according to AT&T/MCI, the matter did not technically appear to involve a failure to comply with the Tentative Order. Rather, the issue involves a computational

error. (AT&T/MCI Cmnts. at 28). These Parties maintained that Verizon PA's charge was based on a computational error.

Verizon PA conceded its computational error. Verizon PA's proposed rate for this feature was \$2.67, approximately the same amount (for a single feature) as Verizon PA charges a CLEC to purchase the full-featured port. (AT&T/MCI Cmnts. at 28). AT&T/MCI's application of the proper cost factors to derive this charge resulted in a charge of \$.75, a result they asserted was more in line with the results for this charge which Verizon PA has proposed for this feature in Maryland (\$0.60 per month) and the District of Columbia (\$0.43 cents per month). Verizon PA recalculated this charge to \$.76.

(b) Disposition

On consideration of the positions of the parties, we direct that the charge, as corrected by Verizon PA, be adjusted to reflect the proper application of the FLC adjustment, as directed herein. The end result shall be set forth in the compliance filing to this Final Opinion and Order.

5. Cost of Capital

(a) Background

In the Tentative Order, we directed Verizon PA to use an overall cost of capital of 9.83% in determining UNE rates. (Tentative Order at 39). Three Parties presented cost of capital positions in the proceeding, Verizon PA, AT&T/MCI, and the OTS. Our conclusion to adopt an overall cost of capital of 9.83% was based, in large part, on the analysis sponsored by the OTS.

The cost of capital recommendations of the Parties are summarized, below:

Verizon PA (1)

<u>Capital Structure</u>	<u>Ratio</u>	<u>Cost Rate</u>	<u>Weighted Cost Rate</u>
	(%)	(%)	(%)
Long-term Debt	25.00	7.55	1.89
Common Equity	<u>75.00</u>	14.75	<u>11.06</u>
Total	<u>100.00</u>		<u>12.95</u>

AT&T/WCOM(2)

<u>Capital Structure</u>	<u>Ratio</u>	<u>Cost Rate</u>	<u>Weighted Cost Rate</u>
	(%)	(%)	(%)
Long-term Debt	34.50	7.86	2.71
Common Equity	<u>65.50</u>	10.42	<u>6.83</u>
Total	<u>100.00</u>		<u>9.54</u>

OTS (3)

<u>Capital Structure</u>	<u>Ratio</u>	<u>Cost Rate</u>	<u>Weighted Cost Rate</u>
	(%)	(%)	(%)
Long-term Debt	49.00	6.42	3.15
Common Equity	<u>51.00</u>	12.25	<u>6.25</u>
Total	<u>100.00</u>		<u>9.40</u>

See (1) Verizon PA St. 4.0, p.47, Table 2; (2) AT&T/WCOM, M.B. at 49-50; (3) OTS Exhibit No. 1-SR Schedule No. 1 at 1.

Thus, AT&T/WCOM recommended a cost of capital of 9.54% -- the midpoint of an overall range of 9.17% to 9.91% (AT&T/WCOM Stmt. 6.0 at 51-52); the OTS recommended a cost of capital of 9.40% (OTS Exh. 1-SR);³² and Verizon PA recommended a cost of capital of 12.95%.

Since the issuance of the Tentative Order, the *FCC TRO* has provided additional guidance regarding the types of risk that should be reflected in a TELRIC cost of capital. The FCC concluded that a TELRIC-based cost of capital should reflect the risks of a competitive market and also reflect any unique risks associated with new services that might be provided over certain types of facilities. *See FCC TRO* para. 680; 683.

In recognition that the FCC has given clarification that a cost of capital that is TELRIC-based, should reflect the risks of a competitive market that is assumed by the TELRIC methodology and that states should establish a cost of capital that reflects the competitive risks associated with participating in the type of market TELRIC assumes, we shall modify our cost of capital determination.³³

We also note that the FCC endorsed, but did not mandate, the use of different costs of capital for different UNEs, particularly those UNEs reflecting unique risks usually associated with new (advanced) services. (*FCC TRO* para. 684). The FCC has acknowledged the possibility for an ILEC to argue for multiple costs of capital since its *Local Competition Order*, para. 702. No party has advocated the use of different costs of capital for various UNEs in this proceeding. *See UNE NPRM*, para. 90.

³² Despite its recommendation of an overall cost of capital of 9.40%, the OTS, in Replies to Exceptions, supported the 9.83% recommendation of the presiding ALJ.

(b) Positions of the Parties

In Comments to the Tentative Order, Verizon PA requests that we revisit the cost of capital determination. Verizon PA contends that our adoption of a 9.83% overall cost of capital is the result of an improper view of the type of risk that must be assumed for a TELRIC cost of capital. (VZ Cmnts. at 8). Consequently, Verizon PA maintains that the OTS analysis, on which the Tentative Order was based, does not adequately reflect the much more significant risks associated with providing UNEs to competitors in a fully competitive market. Verizon PA also points to the cost of capital which AT&T and MCI admittedly use to evaluate their investments in the local exchange market as persuasive of its position. (VZ Cmnts. at 11). The focal point of Verizon PA's criticism of the OTS analysis is the OTS' use of a book rather than a market capital structure. *Id.*

In response to Verizon PA's position, the OTS notes that its witness' original analysis, using a 49% debt/ 51% equity ratio capital structure, produced a 12.25% cost of equity and a 9.40% overall cost of capital. Thus, argues the OTS, the Commission's overall determination of 9.83% which is comprised of the adoption of the same capital structure with a 6.42% cost of debt would presume a 13.10% equity cost rate. This rate, argues the OTS, exceeds the 12.25% market-derived cost of equity by 85 basis points and is, therefore, generous to Verizon PA in that it compensates the company for investment risks. (OTS R. Cmnts. at 10-11). The OTS points out that capital cost rates have declined significantly since the 9.83% cost of capital was found reasonable in the *Global Order*. Thus, assuming a debt cost rate of 6%, which may be more in line with today's rates, the 9.83% overall cost of capital would amount to a 13.50% return on equity, with all other inputs remaining as set forth in the Tentative Order. (R.Cmnts. at 11). Based on the

³³ The market which is assumed by a TELRIC-based cost of capital would consider the risk to the LEC of losing customers to other facilities-based carriers. (*FCC TRO* at para. 680).

foregoing, the OTS responds that the overall capital cost rate adequately compensates Verizon PA for competitive market risks.

AT&T/MCI, in their Reply Comments, assert that the overall cost of capital position of Verizon PA is excessive and has been rejected by the state commissions of Delaware, Maryland, and New Jersey. (R.Cmnts. at 12-13). However, AT&T/MCI also advocate that the dispute on this issue comes down to the appropriate capital structure to use when determining a cost of capital. (R.Cmnts. at 14).

AT&T/MCI, rely upon the *Local Competition Order, Bluefield Water Works Improvement Co. v. PSC*, 262 U.S. 679 (1923), and *FPC v. Hope Natural Gas Co.*, to advance their position that there is no inconsistency in seeking to replicate the costs of an effectively competitive market while, at the same time, limiting returns to the levels needed to compensate the regulated firm for the risk it actually faces. (R.Cmnts. at 17).

(c) Disposition

On consideration of the clarification advanced in the *FCC TRO* with regard to the appropriate competitive market risk to be considered in evaluation cost of capital, we shall reconsider our Tentative Order conclusion in this area. The record in this proceeding contains expert testimony regarding the appropriate cost of capital that ranges from a low of 9.40% presented by OTS to a high of 12.95% presented by Verizon. Determination of the appropriate cost of capital for Verizon PA in the type of competitive market assumed by TELRIC must consider a variety of underlying factors and inputs, including capital structure, cost of debt and cost of equity. Because of the many variables involved, the cost of capital is “basically a matter of judgment governed by the evidence presented and the regulatory agency’s expertise.” *Lower Paxton Twp. v. Pa. PUC*, 317 A2d 917 (Pa. Cmwlth 1974); *West Penn Power Co. v. Pa. PUC*, 607 A2d 1132 (Pa. Cmwlth. 1992).

As more fully explained herein, based on our evaluation of the record as to each of the underlying components that make up the cost of capital, and in accordance with recent FCC determinations, we conclude that the overall cost of capital should be 12.37%, which adequately accounts for the competitive market risks that are assumed under TELRIC.

i. Capital Structure

The determination of a capital structure that appropriately reflects the competitive market environment which is assumed by the TELRIC methodology is perhaps the most elusive component of an appropriate cost of capital determination. As Verizon PA witness Vander Weide stated at VZ Stmt. 4.0, p. 32, “. . . there are no publicly-traded companies whose sole business is constructing and operating telecommunications networks for the purpose of offering UNEs.” Thus, according to Vander Weide, a capital structure recommendation that employs a proxy group of companies must be adjusted to reflect those risks associated with the theoretical risk, assumed by TELRIC, of investing in facilities to provide UNEs in a fully competitive environment. AT&T/MCI concede this concern in their Reply Comments, *supra*.

The exclusive use of Verizon PA’s current book value capital structure, as commonly utilized in the traditional rate of return-based regulation, may not be fully reflective of the competitive risks clarified in the *FCC TRO*. Traditionally, public utility companies, in an environment of “cost plus” regulation, have carried a greater level of debt capital than could otherwise be justified. Due to business risk differentials, utilities have been able to carry relatively higher levels of financial risk (degree of debt financing) than competitive firms. The *FCC TRO* clarifications discussed above indicate that historical perceptions of business risk (and therefore financial risk) may no longer be appropriate when evaluating a representative capital structure under TELRIC. It is apparent that any firm

wishing to enter the competitive market assumed by TELRIC would not be able to maintain the level of debt capital traditionally found in the regulated telecommunications market.

It is clear that the Commission should go beyond traditional regulatory methods to evaluate an appropriate capital structure in this case. To that end, the record contains an evaluation of capital structure based on both Verizon PA's and a barometer group of telephone holding companies' book value capitalization (arriving at a capital structure recommendation for both of 49 % debt and 51 % equity capital). The record also contains a market valuation model to estimate a TELRIC-compliant type of capital structure based on a competitive environment. The market value common equity ratio is calculated by multiplying the market price of a company's common stock by the number of shares outstanding. The resulting market-value related capital structure for Verizon PA is 26% debt and 74% common equity capital. The market-value capital structure for AT&T's barometer group companies is 20% debt and 80% equity, which resulted in a recommended capital structure appropriate to a TELRIC environment of 34.5 % debt and 65.5% equity capital. These ratios represent the mid-point of the extremes of the book-value and market-value capital structures. *See AT&T/MCI Stmt. 6.0 at 36-38.* The mid-point reflects our belief that the market-value capital structure of the barometer group companies understate the proportion of debt in the long run capital structure of a competitive company. We note that traditional telephone utilities are in transition from a traditionally regulated marketplace to a competitive environment. For this reason, we conclude that it is unreasonable to rely solely on current market value capital structure weights. On the contrary, the recommended capital structure in this proceeding should properly reflect the transition between Verizon's former regulated environment and the future competitive marketplace in which Verizon will participate.

We are reluctant to rely solely on a market-valued capital structure. *See Virginia Arbitration Order #2, para. 102.* Market valuation of Verizon PA's as well as the barometer group's equity (price x shares outstanding) is not the market's implied

capitalization of a competitive entity as envisioned in the TELRIC methodology. The market sets a price for Verizon PA's and the barometer group's stock based upon the investor's current expectations with regard to the future cash flows to be derived from these investments. Price is not a reflection of investor expectation with regard to how a Verizon PA competitor would capitalize. A capital structure derived from Verizon PA's (or the barometer group's) market price is in no way conclusive evidence of a competitive capital structure derived from the TELRIC parameters. We further observe that Verizon PA's UNE cost model, which we have adopted with modifications as the basis for the least-cost most efficient network, does not estimate costs in a purely competitive environment. Rather, it is a model that is, in the first instance, premised upon Verizon PA's current network which is updated with state-of-the-art equipment and otherwise adjusted. In essence, this model updates the current Verizon PA infrastructure and is not a "purely hypothetical" representation of a TELRIC entity.

For the above reasons, we find it advisable not to rely solely on either a book or market valuation to arrive at an appropriate TELRIC-related capital structure. We shall rely on the aforementioned capital structure analysis which results in 34.5% debt and 64.5% equity. We conclude that this approach balances the need to move away from a traditionally financed capital structure, to a capital structure that is forward looking as it attempts to estimate capitalization in the type of market TELRIC assumes.

ii. Cost of Debt

We find that the appropriate cost rate for debt to be applied to the debt portion of the capital structure discussed above is 7.86 %. This is the June 30, 2000 weighted average yield to maturity of the bonds of Bell Atlantic and GTE.

The yield to maturity is a forward-looking cost of debt that measures the rate that would be paid if bonds were issued at the measurement date, and reflects investor's

expectations regarding the future returns on these publicly-traded bonds. *See* AT&T/MCI Stmt. 6.0.

iii. Cost of Equity

The *FCC TRO* clarifications regarding the necessity to establish costs reflective of a competitive market, as discussed above, also apply to the appropriate cost of common equity capital. *See* para. 681. An appropriate common equity cost rate, in this case, should, therefore, reflect those risks associated with a firm engaged solely in a competitive market for facilities-based telecommunications service. To that end, Verizon PA has offered analysis of the S&P Industrial group as a proxy for the risks associated with investing in the facilities required to provide competitive services on a forward-looking basis. However, this group includes five traditional telecommunications companies; BellSouth Corp., Century Tel Inc., Sprint FON Group, SBC Communications Inc. and *Verizon Communications*. The cost of capital determination derived by Verizon PA from this group is, therefore, not a perfect reflection of a competitive market, but, rather, an amalgamation of entities, some of which reflect an historic regulated environment. Much like the capital structure determination discussed previously, our equity cost rate determination balances the need to reflect a TELRIC-style competitive market with the realities of the current market where “... there are no publicly-traded companies whose sole business is constructing and operating telecommunications networks for the purpose of offering UNEs.” (Verizon PA witness Vander Weide at VZ Stmt. 4.0, at 32) The Verizon PA cost of equity recommendation, like our capital structure determination, balances that need.

The Discounted Cash Flow (DCF)-derived cost of common equity capital is 14.75% for this group. Based on our review of the record in this case, we find the DCF approach more consistent with the goals of TELRIC in that it, inherently, considers the

investor perception related to the current financial environment.³⁴ We will adopt a 14.75% common equity cost rate applicable to a cost of capital determination based upon the parameters associated with a competitive entity and the attendant risks as clarified in the *FCC TRO*. This is consistent with the weighted cost of common equity position of Verizon PA. See Stmt. 4.0, Table 2.

The telecommunications industry is consistently evolving, and at this time the return associated with the S&P Industrials reflects the best proxy of the investment risk, and therefore, resulting return that a TELRIC-style competitive entity would experience.

Based on the foregoing, we conclude that a 12.37% overall cost of capital, explained below, is more reflective of a competitive market and clearly falls within the range established on the record. Our 12.37 % overall cost of capital determination is based on a common equity rate of 14.75 %, which reflects the risks that *FCC TRO* clarifies as consistent with the type of market TELRIC assumes. The following table summarizes our determination of Verizon PA's overall cost of capital:

³⁴ We observe that the FCC Staff, in the *VA Arbitration Order #2*, used the Capital Asset Pricing Model (CAPM) as opposed to the Discounted Cash Flow (DCF) Model to reach an overall capital determination in that proceeding. While both DCF and CAPM approaches have been, at various times, used to determine the risk adjusted cost of equity for a firm, CAPM is neither a company specific nor an industry specific financial modeling tool. On our record, we do not find the CAPM to be an appropriate tool for estimating the equity return of a single company, such as Verizon PA.

<u>Capital Structure</u>	<u>Ratio</u> (%)	<u>Cost Rate</u> (%)	<u>Weighted Cost Rate</u> (%)
Long-Term Debt	34.5	7.86	2.71
Common Equity	<u>65.5</u>	14.75	<u>9.66</u>
Total	<u>100.0</u>		<u>12.37</u>

Thus, the cost of equity adopted adequately compensates Verizon PA for those risks associated with TELRIC market conditions.

6. Depreciation

(a) Background

In the Tentative Order, we agreed with the position of AT&T/MCI, and departed from prior conclusions in *MFS III* and the *Global Order*, in electing to use FCC-prescribed depreciation lives in this proceeding. We stated “. . . we find that the FCC prescribed depreciation lives are more reflective of the forward-looking, economic criteria required by the FCC rules.” (Tentative Order, slip op. at 49).

The *FCC TRO* has, subsequently, clarified the depreciation factor for use in TELRIC. With regard to depreciation, the FCC rejected the use of financial reporting lives for use in establishing depreciation expense under TELRIC. State commissions continue to have discretion in this choice. (*FCC TRO*, para. 688). Use of financial reporting lives, a position advocated by the incumbent LECs, and advocated by Verizon PA in the instant proceeding, has been rejected. The FCC stated that use of “economic” lives is appropriate,

but clarified that a LEC may accelerate recovery of the initial capital outlay for an asset over its life to reflect any anticipated decline in value. (para. 690).

(b) Positions of the Parties

Verizon PA, in Comments, continues to argue against our Tentative Order conclusion to adopt the FCC-prescribed depreciation lives for use in these proceedings. *See* slip op. at 55. Verizon PA asserts that we provided no “legitimate” reason to depart from a prior acceptance of its economic lives and, *inter alia*, the longer asset lives adopted will present less chance that Verizon PA will recover the costs recognized in this proceeding. (VZ Cmnts. at 16-21).

In response, the CLECs, particularly AT&T/MCI, point out the reasoning of the Tentative Order as adequately supported by the record and appropriate TELRIC principles. *See* AT&T/MCI Cmnts. at 21-25. Two responses are worth highlighting.

First, in response to Verizon PA’s position that telephone companies have no incentive to understate depreciation lives because those lives are used for financial reporting, AT&T/MCI state:

Although adopting longer depreciation lives may increase a company’s *reported* earnings (at least in the short run), this accounting change does not increase a company’s *actual* earnings or cash flows by a penny: the “improved” earnings are purely an accounting artifact. In contrast, adoption of shorter financial lives *can* increase a company’s *actual* earnings: if regulatory commission thereby acquiesce in higher UNE prices, the carrier gains an increased barrier to competitive entry by CLECs, and therefore an increase ability to maintain supranormal returns.

(AT&T/MCI Cmnts. at 24) (Emphasis original).

Second, in response to Verizon PA's criticism of this Commission's reasoning that competition and technological change may actually increase asset lives, AT&T/MCI point out that this criticism is at odds with Verizon PA's advocacy in its Petition to Amend Network Modernization Plan, Docket No. P-00930715F0002. (AT&T/MCI Cmnts. at 25). In that proceeding, Verizon PA relies upon DSL as the technology to meet its network modernization obligations under Chapter 30, through 2007. *Id.*

(c) Disposition

We shall affirm our Tentative Order conclusion on depreciation. We find our reasoning adequate and Verizon PA has not convinced us that its economic lives are better suited to reflect the forward-looking, economic criteria required by the FCC rules. Also, we find no indication in the *FCC TRO*, *VA Arbitration #2*, or *UNE NPRM*, which counsel against our determination.

7. Loop Conditioning and Loop Qualification

(a) Positions of the Parties

Verizon PA Comments that we should reverse our decision in the Tentative Order to prohibit Verizon PA from recovering loop conditioning and loop qualification costs. (VZ Cmnts. at 29).

(b) Disposition

Verizon PA has provided no reasoning which causes us to reverse the Tentative Order conclusions on this issue. Our conclusion is affirmed.

8. Loop Issues

We adhere to and affirm the Tentative Order conclusions for appropriate line counts, DLC assumptions, fill factors, outside plant mix and pole investments. *See VZ Cmnts.* at 29-36.

9. Other Input Factors

We are not persuaded by the Comments of Verizon PA to revisit our determinations regarding Y2K Expenses, Merger Savings, and Advertising Expenses. We affirm our Tentative Order conclusions on these issues.

G. Switching Rates

1. Reliability of Switching Cost Study

Verizon PA's December 4 Filing in response to the Tentative Order did not fully implement the directives relative to switching costs. ALJ Schnierle concluded that Verizon PA did not comply with the Tentative Order in the following areas:

1. Verizon PA used the wrong number of PRI trunks to calculate Right-to-Use (RTU) costs.
2. Verizon PA used incorrect line counts to adjust costs missing from the SCIS model.
3. Verizon PA used incorrect investment levels for tandem and TOPS switching elements.
4. Verizon PA understated right-to-use (RTU) costs that the Commission authorized in its Tentative Order.

5. Verizon PA improperly accounted for “getting started” costs in its Switching Cost Study.

In addition, the Verizon PA Motion to Amend its Switching Cost Study (to correct some of these errors) has itself been assailed by AT&T/MCI as containing errors. The extent of these errors, which were not addressed in the Supp. R.D., and Verizon PA’s failure to comply with the Tentative Order, cause us to doubt the reliability of the December 4 Filing and reject its use for establishing switching UNE rates in this proceeding.

We note that the rates contained in Verizon PA’s December 4th filing resulting from reruns using the switching model reflected a decrease in almost all rates from the filing in response to the May 7, 200 Recommended Decision, except for switching rates. Those rates are as follows.

Unbundled Switching-per MOU

	<u>May</u>	<u>December</u>	<u>Increase</u>
Originating Local switching	\$0.0001019	\$0.001606	57%
Termination Local Switching	\$0.000859	\$0.001378	60%
Tandem Switching MOU	\$0.000057	\$0.000131	129%

On review of the switching cost rates in the December 4 Filing, we note that the above rates have substantially increased over and above the levels resulting from the May 7, 2002 Recommended Decision of ALJ Schnierle. The increase, we believe, is attributable, in part, to both Verizon PA’s application of the FLC and, in part, to the lack of compliance with the directives of the Tentative Order. We are also cognizant of the fact that the non-transparent nature of Verizon PA’s cost studies makes it difficult to identify the reason for such an anomalous result.

Based on the foregoing, we shall direct Verizon PA to rerun its SCIS and related switching cost studies as follows. First Verizon PA shall implement the five (5) adjustments found by ALJ Schnierle to be mandated by our Tentative Order. This shall include the use of the appropriate methodology to implement the “melded” new switch/growth switch discount proposed by AT&T/MCI, which was estimated to produce a 20% reduction from the December 4 Filing. Second, the rerun of the switching cost study shall also include the Commission’s adoption of a 12.37% cost of capital. Finally, Verizon PA’s rerun shall also fully implement the directives concerning the rejection of Verizon PA’s application of the FLC in this proceeding and direction as to the proper application of the FLC in this proceeding. Verizon PA shall provide all work papers to demonstrate its compliance with these directives.

H. Non-recurring Costs

1. Positions of the Parties

AT&T and MCI acknowledged that Verizon PA’s December 4, 2002 submission includes rates that correctly reflect the output of AT&T/MCI’s NRCM. These Parties advise that the Commission can fully and finally resolve the portion of this case devoted to non-recurring costs by adopting the rates produced by the AT&T/MCI NRCM that Verizon PA presented in Attachment 4 to Verizon PA’s letter of December 4, 2002.

AT&T/MCI cited two Verizon PA submissions which, they argued, should be rejected as inconsistent with the Tentative Order.

First, AT&T/MCI opposed Verizon PA’s adjustment of its recurring cost inputs and assumptions to account for those costs which AT&T/MCI’s NRCM, but not Verizon PA’s NRCM, assumes as recurring costs. AT&T/MCI argued that the Verizon PA recurring cost model originally included these costs consistent with the assumptions

underlying the AT&T/MCI models and it was Verizon PA that inappropriately reduced its 1999 operating expenses by “the amount of non-recurring provisioning revenue it received in 1999 in an effort to avoid recovering those costs both as part of the recurring rates and again as part of the nonrecurring rates.” The correct treatment of these costs was, according to AT&T/MCI witnesses, to reverse Verizon PA’s removal of non-recurring provisioning revenues from its 1999 expense. Thus, they assert that the adjustments which Verizon PA proposes, purportedly based upon the list in its Attachment 3, should be rejected.

Also, AT&T/MCI assert that Verizon PA has not supplied any cost support for the “add ons” that it has submitted. Verizon PA has not adequately explained the connection between the list of activities in Attachment 3 and its calculation of the “add on” rates that it proposes. In short, they state that Verizon PA has not provided any evidentiary basis upon which these additional rates could be adopted. *See* AT&T/MCI R.Cmnts. at 34.

Second, AT&T/MCI refute Verizon PA’s position that their NRCM failed to account for many of the UNEs that Verizon PA must offer. These Parties take the position that the Commission explicitly rejected in their entirety most of the rate elements that Verizon PA refers to in this argument, as follows:

Elements of Verizon PA's NRCM rejected by Tentative Order

Element Number	Verizon PA's NRCM	Commission Rejection
65	Manual Loop Qualification	Tentative Order at 202
66	Engineering Query	Tentative Order at 198
67	Engineering Work Order	Tentative Order at 198
68	Aerial Bridged Tap Removal – One Occurrence	Tentative Order at 198
69	Aerial Bridged Tap Removal – Multiple Occurrence	Tentative Order at 198
70	Aerial Load Coil Removal – 21 K Ft	Tentative Order at 198
71	Aerial Load Coil Removal – 27 K Ft	Tentative Order at 198
72	Underground Bridged Tap Removal – One Occurrence	Tentative Order at 198
73	Underground Bridged Tap Removal – Multiple Occurrence	Tentative Order at 198
74	Underground Load Coil Removal – 21 K Ft	Tentative Order at 198
75	Underground Load Coil Removal – 27 K Ft	Tentative Order at 198
76	Cooperative Testing	Tentative Order at 193
80	Line and Station Transfer	Tentative Order at 189
123	Line Sharing Initial (see Note 5)	Tentative Order at 195
124	Line Sharing Additional (see Note 5)	

Moreover, explains AT&T/MCI, to the extent additional rates need to be developed, the burden is on Verizon PA to avail itself of the opportunity offered to it by the Commission to develop a new model based upon time and motion studies with all of the TELRIC assumptions required by the Tentative Order. Thus, AT&T/MCI object to the submission made by Verizon PA in Attachment 6 as failing to meet these requirements. These Parties state that Verizon PA should not be permitted to propose additional rates based on its model which was rejected. *See* Joint Exc. at 6-9.

Cavalier, in its Comments, also argued that the Commission should ignore the December 4 Filing to the extent Verizon PA continues to proffer its own NRCM results.

Verizon PA responds that its recurring model does not include the recurring costs it proposed since Verizon PA proposed to recover those costs through its non-recurring model, which was rejected. Thus, Verizon PA explains, neither Verizon PA's recurring cost model nor AT&T/MCI's non-recurring cost model include this set of costs. Verizon PA takes the position there is no reasonable basis for denying it any recovery of these costs that even AT&T/MCI admit are legitimately incurred -- the only disagreement being whether they are recurring or nonrecurring.

Verizon PA also opposed the AT&T/MCI suggestion regarding the proper way to include these costs. *See* AT&T/MCI Joint Exceptions at 6-7. Verizon PA objects to this proposal and argues that it would be deprived of recovery of a significant portion of these costs because AT&T/MCI would attribute a portion of these CLEC-caused costs to facilities used to serve Verizon PA retail customers. Thus, these costs would be placed in a position where no one would pay for them. Verizon PA adjusts the base-year expenses included in the calculation of the Wholesale Marketing and Network ACFs to exclude non-recurring revenues related to provisioning, customer interfacing, and other regulated activities. *See* VZ St. 1.0 (Recurring Panel Direct) at 9, 26-27. This is done, explains Verizon, to ensure that Verizon PA does not include any nonrecurring costs in its recurring rates. Consequently, simply putting these revenues back into the expense factors, however, does not remedy the cost recovery problem and is inconsistent with cost causation principles. In particular, this approach would spread these costs across all investments in Verizon PA's entire network and in essence assume that all customers, including Verizon PA's retail customers, should pay a portion of costs incurred on behalf of the CLEC. Verizon PA's proposal, by contrast, moves the non-recurring costs that are excluded from AT&T/MCI's non-recurring model directly to the cost-causers ? the CLECs ? by adding them to recurring rates charged only to CLECs. Thus, it advocated that its proposed recurring rates should be adopted.

Verizon PA also argued that, although the CLECs claim that the Commission has already rejected Verizon PA's argument that AT&T/MCI's model fails to account for many UNEs, AT&T/MCI Joint Exceptions at 8, it has done no such thing. Contrary to the CLECs' claims, Verizon PA states that the Commission has never rejected these critical missing costs, such as costs associated with various types of hot cuts, subloops, many varieties of ports, multiplexing, AIN development, and others — none of which appear on AT&T's list of allegedly rejected costs.

Verizon PA also states that there is no merit to Cavalier's claim that Verizon PA's proposed additional nonrecurring costs "have already been properly accounted for as recurring costs." (Cavalier Comments at 5). Verizon PA argues that it did *not* include these costs in its recurring cost models because they are properly treated as non-recurring costs and were, therefore, included in Verizon PA's non-recurring cost model. Verizon PA concludes that its compliance filing properly addresses these gaps left by the Commission's mismatch of models. (VZ R.Cmnts. at 4-7).

2. ALJ Recommendation

On consideration of the positions of the Parties, ALJ Schnierle concluded that the first issue presented was whether the AT&T/MCI NRCM model should be used in lieu of Verizon PA's. He bifurcated this issue. The first sub-issue was explained as whether the Commission should reconsider its directive to Verizon PA to use AT&T/MCI's NRCM. The ALJ did not make a recommendation on this issue as it was the subject of Verizon PA's Petition to the Commission for reconsideration or clarification. The second-sub issue was whether the Tentative Order allowed Verizon PA to use its NRCM to develop rates for those non-recurring activities that are not modeled by the AT&T NRCM. On this question, the ALJ concluded that the Tentative Order does not allow Verizon PA to use its NRCM for this purpose. (Supp. R.D. at 20). The ALJ noted that the Commission ruled that the Verizon PA NRCM cannot be used to produce TELRIC compliant rates. Therefore, it

obviously cannot be used to produce TELRIC compliant rates for those non-recurring activities for which the AT&T NRCM simply does not produce rates. *Id.*

3. Disposition

Consistent with our discussion relative to Verizon PA's Petition for Reconsideration, we make final the Tentative Order conclusion to adopt the AT&T/MCI proposed NRCM. Parenthetically, we observe that this is a result supported by the analysis of the FCC Staff who considered Verizon VA's non-recurring cost model, using an approach substantially the same as that in Pennsylvania, and rejected Verizon VA's proposal in favor of the AT&T/MCI model, stating "[i]n contrast, Verizon's [VA] model is not based on an optimization constrained only by current switching locations. Rather, it is tied to existing processes and the existing network." (*VA Arbitration #2*, para. 567).

We shall direct Verizon PA to file non-recurring rates in compliance with the discussion and implementing the modifications contained in this Final Opinion and Order.

For the recurring costs, we note the December 4 Filing includes Verizon PA's modifications to account for those recurring costs Verizon PA assumed were not addressed by virtue of our adoption of the AT&T/MCI NRCM. Consistent with our disposition of Verizon PA's Petition for Reconsideration, we direct that in compliance, no further adjustment of the NRCM or recurring costs is warranted, other than conformance to the FLC and cost of capital inputs.

I. Verizon PA's Motion to Amend Its Switching Cost Study

After submitting the December 4 Filing, Verizon PA discovered an error in its switching study that understated right-to-use (RTU) costs that the Commission authorized in its Tentative Order. On January 13, 2003, Verizon PA filed a motion to correct its switching cost study with respect to this error, as well as three errors that were identified by AT&T/MCI in their Joint Exceptions (specifically, the wrong number of PRI trunks to calculate RTU costs, incorrect line counts to adjust costs missing from the SCIS model, and, incorrect investment levels for tandem and TOPS switching elements).

The Motion to Amend Switching Cost Study is denied, consistent with our discussion of switching costs rates, above.

V. Disparate Rate Impact of Density Cell Structure

A. Introduction

We initially quote from the pertinent language of the Tentative Order to establish the appropriate context in which we directed that this issue be considered:

Section 51.507(f) of the FCC's rules, 47 CFR §51.507(f), require state commission to establish different rates for unbundled network elements in at least three defined geographic areas within the state to reflect geographic cost differences. This Section allows state commissions to use existing density-related zone pricing plans, or other such cost-related zone plans established pursuant to state law as long as they are consistent with the density-related zone pricing plans described in Section 69.123 of the FCC's regulations, 47 CFR §69.123. In Pennsylvania, we have permitted Verizon to price its UNE loops based on four density cells, which is consistent with the number of density cells Verizon has traditionally used to calculate the prices for its retail dial tone lines.

We find that the geographical areas associated with Verizon's Density Cell 4 are the most rural, and thus, highest cost areas in which to provide local service. As a result, these rural areas are generally the last to experience local competition. CLECs generally argue that this is because the rates established for UNE loops in Density Cell 4 are too expensive and Verizon's retail rates in Density Cell 4 are less than the UNE loop rates. As a result, it may be beneficial for rural local exchange competition if Verizon consolidated its density cells for UNE pricing from four density cells to three density cells across the state. Therefore, we will require the Parties to address this alternative approach to density cells in Pennsylvania in a Technical Conference. It is our opinion that this matter will be best addressed in the context of a separate

technical conference after the conclusion of this proceeding, rather than in the context of the remanded proceedings before the OALJ.

(Tentative Order, slip op. at 204-205) (Notes omitted; emphasis supplied).

Based upon the manner in which our inquiry was phrased, it appears that the Parties, particularly Verizon PA, interpreted the above discussion to mean that this Commission was suggesting a consolidation of Density Cells #3 and #4 as the primary approach for consideration to ameliorate the disproportionate impact of UNE rates in different density cells. Thus, the discussion and commentary necessarily focused on consolidating Density Cells #3 and #4.

Further, Verizon PA states that the consolidation of Density Cells #3 and #4 was an idea “initially broached” by this Commission. *See* VZ R.Exc. at 2, n. 2; also at 3. This is not accurate. We did not direct, nor should our language have been interpreted as endorsing with particularity, the consolidation of Density Cells #3 and #4 as the sole means to address a disproportionate UNE rate impact between Verizon PA’s four density cells.³⁵ What the above-quoted language from the Tentative Order was intended to communicate, is that this Commission observed that federal rules required that there be a minimum of three geographically defined rate areas in a state. 47 CFR § 51.507(f). These areas are required to reflect geographic cost differences. We have permitted Verizon PA to implement four rate areas, *i.e.* density zones or cells, which were based on distinctions approved for retail rate purposes. These density cells were approved prior to the enactment of TA-96. It was our intent that the entire retail density cell structure of Verizon PA be reviewed in the TA-96 wholesale environment. We anticipated that a “fresh look” be taken at Verizon PA’s existing density cell structure and its impact on UNE rates be considered.

³⁵ The OCA proposed the consolidation of Verizon PA’s density cells from four to three density cells.

B. Positions of the Parties

Verizon PA supports the consolidation of its Density Cells #3 and #4 to ameliorate density cell disparities. In its December 4 Filing, Verizon PA demonstrated that the Tentative Order inputs to its cost model resulted in a proposed \$13.12 two-wire loop rate in Density Cell #3 and a \$23.76 two-wire loop rate in Density Cell #4. Its proposed consolidation would result in a “blended” rate of \$16.71. (VZ R. Exc. at 4). Verizon PA states that this method would achieve the result contemplated by the Tentative Order in the least disruptive manner possible and be relatively inexpensive to implement from an administrative perspective, and would preserve the current “connection” between retail and wholesale density zones. (VZ R.Exc. at 4).

The OCA, and CLECs, vigorously oppose the consolidation of Density Cells #3 and #4, as proposed by Verizon PA. Generally, they attack this proposal as anti-competitive, as the gains for Density Cell #4 are minimal, as compared to the increase, argued to be prohibitive, for Density Cell #3 customers.

C. Disposition

On consideration of the evidence in this proceeding, we conclude that the record is insufficient to permit us to direct a revision to the organization of Verizon PA’s density cells, at this time. Also, the claims of witness Johnson are not verifiable based on the record. We shall, consistent with our observations in the Tentative Order, direct that this issue be addressed in a separate Technical Conference, in accordance with the relevant Ordering Paragraph in this Opinion and Order.

VI. Retail Revenue Comparison

As previously stated, ALJ Schnierle, *sua sponte*, raised the question of whether it was possible to check the rates generated by the TELRIC studies against some less abstract figures in order to obtain some sense of their general level. This matter was not directed by the Commission for consideration on remand, and ALJ Schnierle observed that a retail revenue comparison cannot be used to set UNE rates. (Supp. R.D. at 41). Therefore, we reject the retail revenue comparison since it has no merit in this proceeding.

VII. Conclusion and Order

This Opinion and Order is issued in Final Form and addresses those matters identified in our Tentative Opinion and Order previously issued herein. Verizon PA is directed to file a tariff or tariff supplement which conforms to the modifications and directives contained in this Final Opinion and Order; **THEREFORE,**

IT IS ORDERED:

1. That the March 19, 2003 Supplemental Recommended Decision of Administrative Law Judge Michael C. Schnierle is adopted, to the extent consistent with the discussion in this Final Opinion and Order.
2. That Exceptions are granted and denied, to the extent consistent with this Final Opinion and Order.
3. That the Tentative Order conclusions and reasoning are either affirmed and adopted, or otherwise modified, to the extent consistent with the discussion contained in this Final Opinion and Order.
4. That Verizon Pennsylvania Inc. shall file a tariff or tariff supplement, and supporting data and documentation, implementing revisions to the UNE rates in its Tariff Pa. P.U.C. No. 216, and any related tariffs or tariff amendments, which conform to and are in compliance with the modifications and directives set forth in this Final Opinion and Order (Compliance Filing), within forty-five (45) days of the entry date of this Final Opinion and Order.

- (a) Regarding the cost model inputs and assumptions used to develop UNE rates, Verizon Pennsylvania Inc. shall rerun its cost model using the input values and methodologies specified in the body of this Order. Verizon Pennsylvania Inc. is expressly directed to file UNE rates that reflect our rejection of Verizon Pennsylvania's application of the FLC in this proceeding, consistent with the discussion contained in this Final Opinion; Verizon Pennsylvania Inc. is expressly directed to rerun its cost studies incorporating an overall cost of capital of 12.37%; Verizon Pennsylvania Inc. is directed to file UNE switching rates consistent with the discussion contained in this Final Opinion and Order.
- (b) Verizon Pennsylvania Inc. shall file final rates for non-recurring costs consistent with this Final Opinion and Order.
- (c) The cost model rerun and its output values shall be filed with the Commission and shall be accompanied by such documentation as may be necessary to demonstrate compliance with this Final Opinion and Order, including all pertinent work papers demonstrating Verizon Pennsylvania Inc.'s compliance.

5. That Verizon Pennsylvania Inc., in its Compliance Filing, shall provide a specific, concise explanation and verifiable documentation for each specific UNE rate that varies by 50% or more, up or down, from the current rate. Verizon Pennsylvania Inc. shall address, among other things, whether the increase or decrease is due to: (1) changes in the cost model (assumptions, allocation factors, or methodology); (2) changes in cost inputs (wages, benefits, equipment prices, taxes, etc.); or (3) other factors.

6. That the Parties shall have thirty (30) days after the Compliance Filing to file Exceptions and Comments to said Compliance Filing. The Parties may comment on the rates and Verizon Pennsylvania Inc.'s explanation if they disagree with Verizon Pennsylvania Inc.'s calculation of the rates. Further, the Parties are not foreclosed from commenting on any rate that they believe has been miscalculated, regardless of the magnitude in the change to the rate, however. Replies to the Exceptions and Comments of the Parties shall be expressly permitted and filed within ten (10) days after the date such Exceptions and Comments are due.

7. The Commission shall evaluate Verizon Pennsylvania Inc.'s Compliance Filing and all supporting information when ruling on the Compliance Filing. Upon review of the Exceptions and Reply Exceptions, the Commission reserves the right to reject any rate that is not properly justified and adjust the UNE rate in question. Verizon Pennsylvania Inc. is directed to fully cooperate with Commission Staff during the compliance process as Staff or the Commission deems necessary.

8. Verizon Pennsylvania Inc. shall be directed to rerun its cost study incorporating the directives in this Order, and to provide an output for all of the UNEs currently contained in the effective Tariff No. 216. Further, Verizon Pennsylvania Inc.'s Compliance Filing shall identify those UNEs, if any, that Verizon Pennsylvania Inc. believes should be removed from Tariff No. 216 as a result of the *FCC TRO*.

9. That Verizon Pennsylvania Inc. shall offer a port rate structure consistent with that established in this Commission's *Global Order*, including those features directed for a limited port option and full-featured port option, and other directives contained in this Final Opinion and Order.

10. That the modification of density cells shall be addressed in a separate Technical Conference, to be convened within sixty (60) days of the entry of this Final

Opinion and Order. The Office of Executive Director shall coordinate and designate those bureaus responsible for conducting the Technical Conference.

11. That Verizon Pennsylvania Inc.'s Petition for Reconsideration and Clarification of the November 4, 2002 Tentative Order is denied, consistent with the discussion contained in this Final Opinion and Order.

12. That Verizon Pennsylvania Inc.'s Motion to Amend its Switching Cost Study is denied, consistent with the discussion contained in this Final Opinion and Order.

BY THE COMMISSION,

James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: November 13, 2003

ORDER ENTERED: December 11, 2003