Before the
Federal Communications Commission
Washington, D.C. 20554

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

ORDER AND FURTHER NOTICE OF PROPOSED RULEMAKING

Adopted: May 15, 2006 **Released: May 16, 2006**

Comment Date: 90 days after publication in the Federal Register
Reply Comment Date: 180 days after publication in the Federal Register

By the Commission: Commissioners Copps and Tate issuing separate statements.

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Paragraph #

I. INTRODUCTION

1. In this Order and Further Notice of Proposed Rulemaking (Order and Further Notice), we address several pending issues related to the jurisdictional separations process by which incumbent local exchange carriers (incumbent LECs) apportion regulated costs between the intrastate and interstate jurisdictions.[1] First, we adopt an Order extending, on an interim basis, the current freeze of Part 36 category relationships and jurisdictional cost allocation factors, which would otherwise expire on June 30, 2006.[2] Extending the freeze will allow the Commission to provide stability for carriers that must comply with the Commission's separations rules while the Commission considers issues relating to comprehensive, permanent reform of the jurisdictional separations process. Second, we adopt a Further Notice seeking comment on issues relating to reform of the jurisdictional separations process, including several proposals submitted to the Commission since its adoption of the *2001 Separations Freeze Order*.

II. BACKGROUND

A. Jurisdictional Separations and the Separations Process

2. Jurisdictional separations is the process by which incumbent LECs apportion regulated costs between the intrastate and interstate jurisdictions.[3] Historically, one of the primary purposes of the separations process has been to prevent incumbent LECs from recovering the same costs in both the interstate and intrastate jurisdictions.[4]

3. Jurisdictional separations is the third step in a four-step regulatory process to establish rates for the incumbent LECs' interstate and intrastate regulated services. First, carriers record their costs, including investments and expenses, into various accounts in accordance with the Uniform System of Accounts (USOA) prescribed by Part 32 of the Commission's rules.[5] Second, carriers assign the costs in

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[1] 47 C.F.R. §§ 36.1-36.507.

[2] *Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, Report and Order, 16 FCC Rcd 11382 (2001) (*2001 Separations Freeze Order*).

[3] For purposes of section 251 of the Communications Act of 1934, as amended (the Act), a local exchange carrier (LEC) is regarded as an "incumbent local exchange carrier" (incumbent LEC) for a specific area if, on the date of enactment of the Telecommunications Act of 1996, Pub.L. 104-104, Feb. 8, 1996, 110 Stat. 56, codified at 47 U.S.C. § 151 *et seq.* (1996 Act), the carrier provided telephone exchange service in that area and was deemed to be a member of the National Exchange Carrier Association, Inc. (NECA), or if the carrier "became a successor or assign" of such a member on or after that date. 47 U.S.C. § 251(h)(1). Pursuant to section 69.601(b) of the Commission's rules, "[a]ll telephone companies that participate in the distribution of Carrier Common Line revenue requirement, pay long term support to association Common Line tariff participants, or receive payments from the transitional support fund administered by [NECA] shall be deemed to be members." 47 C.F.R. § 69.601(b). For purposes of this Order and Further Notice, the term "carriers" refers to incumbent LECs. We note that, unlike the incumbent LECs, competitive local exchange carriers (competitive LECs) are not subject to the requirements of Part 36. *See* 47 C.F.R. §§ 36.1 *et seq*.

[4] As the Supreme Court has recognized, procedures for the separation of intrastate and interstate property and expenses have been necessary for the appropriate recognition of authority between the interstate and intrastate jurisdictions. *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133, 148 (1930) (*Smith v. Illinois*). The Supreme Court added that "[w]hile the difficulty in making an exact apportionment of the property is apparent, and extreme nicety is not required, only reasonable measures being essential, it is quite another matter to ignore altogether the actual uses to which the property is put." *Id.* at 150-151. *See also MCI Telecommunications Corp. v. FCC*, 750 F.2d 135, 137 (D.C. Cir. 1984) (*MCI v. FCC*) (stating that "'[j]urisdictional separations is a procedure that determines what proportion of jointly used plant should be allocated to the interstate and intrastate jurisdictions for ratemaking purposes").

[5] 47 C.F.R. Part 32.

these accounts to regulated and nonregulated activities in accordance with Part 64 of the Commission's rules to ensure that the costs of non-regulated activities will not be recovered in regulated interstate service rates.[6] Third, carriers perform jurisdictional separations by apportioning the regulated costs in each category between the intrastate and interstate jurisdictions in accordance with the Commission's Part 36 separations rules.[7] Fourth, carriers apportion the interstate regulated costs among the interexchange services and rate elements that form the cost basis for their interstate access tariffs.[8] Carriers perform this apportionment in accordance with Part 69 of the Commission's rules.[9] The intrastate costs that result from application of the Part 36 rules form the foundation for determining carriers' intrastate rate base, expenses, and taxes.

4. The jurisdictional separations process itself has two parts. In the first step, carriers assign regulated costs to various categories of plant and expenses. In certain instances, costs are further disaggregated among service categories.[10] In the second step, the costs in each category are apportioned between the intrastate and interstate jurisdictions. These jurisdictional apportionments of categorized costs are based upon either a relative use factor, a fixed allocator, or, when specifically allowed in the Part 36 rules, by direct assignment.[11] For example, loop costs are allocated by a fixed allocator, which allocates 25% of the loop costs to the interstate jurisdiction and 75% of the costs to the intrastate jurisdiction.[12]

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[6] The Part 64 cost allocation rules are codified at 47 C.F.R. §§ 64.901-04. Non-regulated activities generally consist of activities that have never been subject to regulation under Title II; activities formerly subject to Title II regulation that the Commission has preemptively deregulated; and activities formerly subject to Title II regulation that have been deregulated at the interstate level, but not preemptively deregulated at the intrastate level, which the Commission decides should be classified as non-regulated activities for Title II accounting purposes. *See* 47 C.F.R. § 32.23(a); *Accounting Safeguards under the Telecommunications Act of 1996*, CC Docket No. 96-150, Report and Order, 11 FCC Rcd 17539, 17573 (1996), *recon. granted in part and denied in part*, Report and Order in CC Docket No. 98-81, First Order on Reconsideration in CC Docket No. 96-150, Fourth Memorandum Opinion and Order in AAD File No. 98-43, 14 FCC Rcd 11396 (1999) (granting petitions for reconsideration in part and adopting changes to section 274(f) reporting requirements), *recon. denied*, Second Order on Reconsideration in CC Docket No. 96-150, 15 FCC Rcd 1161 (2000) (rejecting petitions for reconsideration on the grounds that the petitions raised no new arguments). Similarly, state jurisdictions have the ability to remove the costs of state non-regulated activities so that those costs will not be recovered in regulated intrastate service rates.

[7] 47 C.F.R. Part 36.

[8] Part 61 of the Commission's rules prescribes the procedures for filing and updating interstate tariffs. *See* 47 C.F.R. Part 61.

[9] 47 C.F.R. Part 69.

[10] For example, central office equipment (COE) Category 1 is Operator Systems Equipment, Account 2220. The Operator Systems Equipment account is further disaggregated or classified according to the following arrangements: (i) separate toll boards; (ii) separate local manual boards; (iii) combined local manual boards; (iv) combined toll and DSA boards; (v) separate DSA and DSB boards; (vi) service observing boards; (vii) auxiliary service boards; and (viii) traffic service positions. *See* 47 C.F.R. § 36.123.

[11] Because some costs are directly assigned to a jurisdictionally pure service category, *i.e.* a category used exclusively for either intrastate or interstate communications, both steps are often effectively performed simultaneously. For example, the cost of private line service that is wholly intrastate in nature is assigned directly to the intrastate jurisdiction. *See* 47 C.F.R. § 36.154(a).

[12] *See* 47 C.F.R. § 36.154(c).

B. 2001 Separations Freeze Order

5. In 1997, the Commission initiated a proceeding seeking comment on the extent to which legislative changes, technological changes, and market changes warrant comprehensive reform of the separations process.[13] The Commission noted that the current network infrastructure is vastly different from the network and services used to define the cost categories appearing in the Commission's current Part 36 rules, and that the separations process codified in the current Part 36 rules was developed during a time when common carrier regulation presumed that interstate and intrastate telecommunications service must be provided through a regulated monopoly.[14] In addition, the Commission sought comment on several proposals previously submitted to the Commission.[15] The Commission also invited the State Members of the Federal-State Joint Board on Jurisdictional Separations (Joint Board) to develop a report that would identify additional issues that should be addressed by the Commission in its comprehensive separations reform effort.

6. On December 21, 1998, the State Members filed a report recommending that the Joint Board address certain additional issues in connection with the consideration of comprehensive separations reform.[16] The State Report proposed an interim jurisdictional separations freeze, among other things, to reduce the impact of changes in telephone usage patterns and resulting cost shifts from year to year.[17]

7. On July 21, 2000, the Joint Board issued its *2000 Separations Recommended Decision* for an interim freeze of the Part 36 category relationships and jurisdictional allocation factors.[18] The Joint Board recommended interim action to provide simplicity and stability to the separations process while the Commission and the Joint Board continue to review comprehensive reform in light of legislative, technological, and market changes. Accordingly, the Joint Board recommended that, until comprehensive reform can be achieved, the Commission should freeze Part 36 category relationships and jurisdictional

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[13] *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, Notice of Proposed Rulemaking, 12 FCC Rcd 22120, 22126-22131, paras. 9-19 (1997) (*1997 Separations Notice*).

[14] *Id.* at 22126, para. 9.

[15] For example, NYNEX proposed in its *Petition for Forbearance* that all costs be separated for each study area based on a single, frozen interstate allocation factor. *See New England Telephone and Telegraph Company and New York Telephone Company*, Petition for Forbearance from Jurisdictional Separations Rules, AAD 96-66 (filed May 2, 1996); *New England Telephone and Telegraph Company and New York Telephone Company*, Public Notice, AAD 96-66, 11 FCC Rcd 7139 (1996) (soliciting Comments on the NYNEX petition); *New England Telephone and Telegraph Company and New York Telephone Company*, Order, AAD 96-66, 12 FCC Rcd 2308 (1997) (denying the NYNEX petition and incorporating the issues raised by NYNEX into this proceeding).

[16] *See Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, State Members Report on Comprehensive Review of Separations (filed Dec. 21, 1998) (*State Report*).

[17] *See id.* at 15-16.

[18] *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, Recommended Decision, 15 FCC Rcd 13160 (2000) (*2000 Separations Recommended Decision*). The Commission sought public comment on the *2000 Separations Recommend Decision*. *See Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, Public Notice, 15 FCC Rcd 15054 (CCB 2000); Public Notice, 15 FCC Rcd (CCB 2000) (*2000 Separations Public Notice*). "Category relationships" are the percentage relationships of each Part 36 category to the total amount recorded in its corresponding Part 32 account(s). *See* 47 C.F.R. Part 32, Part 36. "Jurisdictional allocation factors" are the percentage relationships that allocate costs assigned to Part 32 accounts for jointly used plant between the interstate (federal) and intrastate (state) jurisdictions. *See 2000 Separations Recommended Decision*, 15 FCC Rcd at 13172, para. 20.

allocation factors for price cap carriers and allocation factors only for rate-of-return carriers.[19] The Joint Board further recommended that the Commission implement the freeze based on data from the twelve-month period immediately prior to the Commission's issuance of an order on the *2000 Separations Recommended Decision*.[20] Finally, the Joint Board recommended that the Commission continue to consider, in the context of comprehensive reform, other proposals in the record, such as the NYNEX single frozen factor proposal.[21]

8. In the *2001 Separations Freeze Order*, the Commission adopted the Joint Board's recommendation to impose an interim freeze of the Part 36 category relationships and jurisdictional cost allocation factors, pending comprehensive reform of the Part 36 separations rules.[22] The Commission concluded that this freeze would provide stability and regulatory certainty for carriers by minimizing any impacts on separations results that might occur as a result of circumstances not contemplated by the Commission's Part 36 rules, such as growth in local competition and new technologies.[23] Further, the Commission found that a freeze of the separations process would reduce regulatory burdens on carriers during the transition from a regulated monopoly to a deregulated, competitive environment in the local telecommunications marketplace.[24]

9. Accordingly, the Commission froze all Part 36 category relationships and allocation factors for price cap carriers and all allocation factors for rate-of-return carriers.[25] Under the freeze, price cap carriers calculate 1) the relationships between categories of investment and expenses within Part 32 accounts; and 2) the jurisdictional allocation factors, as of a specific point in time, and then lock or "freeze" those category relationships and allocation factors in place for a set period of time. The carriers use the "frozen" category relationships and allocation factors for their calculations of separations results and therefore are not required to conduct separations studies for the duration of the freeze. Rate-of-return carriers are only required to freeze their allocation factors, but had the option to freeze their category relationships at the outset of the freeze.

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[19] *2000 Separations Recommended Decision*, 15 FCC Rcd at 13172, para. 20.

[20] *Id.* at 13174, para. 25.

[21] *Id.* at 13167, para. 11; *see supra* note 15.

[22] *See 2001 Separations Freeze Order*, 16 FCC Rcd at 11387-88, para. 9.

[23] *Id.* at 11389-90, para. 12. Jurisdictional cost shifts in separations results generally are caused by changes in any of three areas: overall cost levels, categorization of costs (i.e., relative category assignments), or jurisdictional allocation factors. A carrier's increased overall cost level in a Part 32 account that has a high cost allocation to the interstate jurisdiction will cause shifts to the interstate jurisdiction for other investment and expense accounts whose jurisdictional allocations are dependent on that account. Increasing investment in specific categories (e.g., interexchange cable and wire facilities (C&WF)) may also contribute to jurisdictional shifts in the final results. Likewise, changes in customer calling patterns (e.g., increased interstate calling) will cause shifts in the jurisdictional allocation factors, many of which are based on usage. These factors allocate a significant portion of a carrier's investment between the interstate and intrastate jurisdictions.

[24] Although incumbent carriers were required under Part 36 rules to perform separations studies, competitive carriers had no similar requirements. The Commission found that a freeze would further the Commission's goal of achieving greater competitive neutrality during the transition to a competitive marketplace by simplifying the separations process for those carriers subject to Part 36.

[25] The frozen category relationships and allocation factors are based on data from the carriers' calendar-year 2000 separations studies. *2001 Separations Freeze Order*, 16 FCC Rcd at 11387-88, para. 9.

10. The Commission ordered that the freeze would be in effect for a five-year period beginning July 1, 2001, or until the Commission completed comprehensive separations reform, whichever came first.[26] In addition, the Commission stated that prior to expiration of the separations freeze, the Commission would, in consultation with the Joint Board, determine whether the freeze period should be extended.[27] The Commission further stated that any decision to extend the freeze beyond the five year period in the *2001 Separations Freeze Order* would be based "upon whether, and to what extent, comprehensive reform of separations has been undertaken by that time."[28]

C. Subsequent Filings and Commission Actions

11. Following the adoption of the *2001 Separations Freeze Order*, on December 18, 2001, the State Members of the Joint Board filed the *Glide Path Paper*, outlining seven options for comprehensive separations reform upon expiration of the freeze.[29] In particular, the *Glide Path Paper* proposed: (1) extending the separations freeze; (2) using fixed allocators to separate traffic sensitive costs; (3) having the Commission set rates for interstate services, and allowing states to apply "residual" ratemaking methods when setting intrastate rates; (4) establishing a new accounting and separations system that is based on separating switched circuits from packet circuits, and that recognizes the existence of broader categories of unregulated service, packet switching, distributed network architecture, and increasing sales of unregulated services; (5) simplifying separations procedures by directly assigning all telecommunications equipment to either the state or the federal jurisdiction; (6) eliminating separations by assigning regulation to a single jurisdiction, either the FCC or the states; or (7) eliminating separations by ending cost-based rate regulation in all jurisdictions where the incumbent carrier faces effective competition.[30] Subsequently, on December 20, 2001, the Wireline Competition Bureau sought comment on the *Glide Path Paper* in a Public Notice.[31] In addition, on February 5, 2002, the Joint Board held an en banc hearing to discuss options for comprehensive separations reform that were proposed in the *Glide Path Paper*.[32]

12. On May 27, 2004, the Separations Joint Board State Members filed a letter with the Federal Members of the Joint Board requesting that a data request be issued to carriers to better analyze

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[26] *See id.* at 11387-88, para. 9

[27] *See id.* at 11397, para. 29.

[28] *Id.* at 11397, para. 29. The Commission also agreed with the Joint Board's request in the Recommended Decision that the Commission commit itself to addressing separations treatment of new technologies (*e.g.*, digital subscriber lines) during the freeze and seek comment on the impact of the freeze prior to its expiration. *See id.* at 11397-98, paras. 31-33.

[29] Letter from David J. Lynch, Iowa Utilities Board, to Magalie Roman Salas, FCC, filed Dec. 17, 2001 (attaching "Options for Separations: A Paper Prepared by the State Members of the Separations Joint Board" (*Glide Path Paper*) (attached as Appendix A hereto)).

[30] *See Glide Path Paper* at 8-26.

[31] *See Common Carrier Bureau Seeks Comment on "Glide Path" Policy Paper Filed by State Members of the Federal-State Joint Board on Jurisdictional Separations*, CC Docket No. 80-286, Public Notice, 16 FCC Rcd 22551 (CCB 2001). The Wireline Competition Bureau was formerly known as the Common Carrier Bureau.

[32] *See Federal-State Joint Board on Jurisdictional Separations to Hold En Banc Hearing on Compreshensive Separations Reform*, CC Docket No. 80-286, Public Notice, 17 FCC Rcd 2179 (2002) (*Glide Path Hearing Public Notice*).

the impact of the separations freeze on carriers.[33] In October 2004, the State Members of the Joint Board also filed comments in the IP-Enabled Services proceeding proposing, among other suggestions, that the Commission issue a Notice of Proposed Rulemaking seeking comment on action to be taken upon expiration of the separations freeze, and include with it a data collection that could be used to compile information related to the freeze and the impact on separations of its termination.[34] Following these filings, pursuant to the Paperwork Reduction Act, in March 2005, the Commission published a notice in the Federal Register seeking comment regarding the estimated burdens of responding to a data request related to separations and the separations freeze.[35]

13. More recently, on October 25, 2005, the Separations Joint Board State Members prepared an update to the *Glide Path Paper*.[36] The *Glide Path II Paper* proposes six options – many of them the same as those presented in the original – for a separations policy following the end of the freeze on June 30, 2006. These options include: (1) allowing the freeze to expire; (2) extending the freeze; (3) separating traffic-sensitive costs with fixed allocators; (4) having the Commission set rates for interstate services, and allowing states to apply "residual" ratemaking methods when setting intrastate rates; (5) coordinating separations changes with universal service and intercarrier compensation changes; or (6) abolishing separations altogether.

14. Finally, on December 12, 2005, the United States Telecom Association (USTelecom) filed a White Paper advocating that the Commission extend the separations freeze on an interim basis from July 1, 2006 until a permanent rule retaining, modifying, or terminating the separations freeze takes effect.[37] USTelecom argues that the looming expiration of the freeze is causing significant uncertainty in the industry and forcing carriers to consider making substantial – but potentially unnecessary – investments in an effort to permit compliance with separations study requirements if the freeze is not extended.[38]

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[33] *See* Letter from Paul Kjellander, State Chair of Federal-State Joint Board on Separations and President, Idaho Public Utilities Commission, Diane Munns, Chair, Iowa Utilities Board, Judith Ripley, Commissioner, Indiana Utility Regulatory Commission, and John Burke, Board Member, Vermont Public Services Board, to Michael Powell, Chairman, Michael Copps, Commissioner, and Kevin Martin, Commissioner, FCC, dated May 27, 2004 (*State Members May 2004 Letter*). The State Members of the Joint Board also requested that the Commission issue a referral to the Separations Joint Board concerning how to address expiration of the freeze no later than July 2005, and release an order addressing expiration of the freeze no later than March 2006. *Id.*

[34] *See IP-Enabled Services; Vonage Holdings Corporation Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission*, WC Docket Nos. 04-36 and 03-211, Late-Filed Comments by State Members of Separations Joint Board (filed Oct. 26, 2004) (*State Members IP-Enabled Services Comments*).

[35] *See* Federal Communications Commission, Notice of Public Information Collection(s) Being Reviewed by the Federal Communications Commission, Comments Requested, 70 Fed. Reg. 11971 (March 10, 2005) (*Separations Data Request FR Notice*).

[36] *See* Letter from James Bradford Ramsay, General Counsel, National Association of Regulatory Utility Commissioners (NARUC), to Marlene H. Dortch, Secretary, Federal Communications Commission, CC Docket No. 80-286 (filed May 1, 2006) (*NARUC May 1, 2006 Letter*), Att., "Post-Freeze Options for Separations: A Paper Prepared by the State Members of the Joint Board," dated Oct. 25, 2005 (signed by Paul Kjellander, Commissioner, Idaho Public Utilities Commission; John Burke, Board Member, Vermont Public Services Board; and Mark Johnson, Commissioner, Regulatory Commission of Alaska) (*Glide Path II Paper*).

[37] *See* Letter from James W. Olson, USTelecom, to Marlene H. Dortch, FCC, filed Dec. 15, 2005 (attaching USTelecom White Paper, "Paving the Way for Jurisdictional Separations Reform" (*USTelecom White Paper*)).

[38] *See USTelecom White Paper* at 1-4.

III. ORDER

15. In this Order, we extend, on an interim basis, the freeze on Part 36 category relationships and jurisdictional cost allocation factors that the Commission adopted in the *2001 Separations Freeze Order*, because we conclude that extending the freeze will provide stability to carriers that must comply with the Commission's jurisdictional separations rules pending further Commission action to reform the Part 36 rules.

16. We find that more time is needed to study comprehensive reform, including the recent filings by the Joint Board's State Members and USTelecom.[39] Accordingly, as discussed further below,[40] we extend the separations freeze on an interim basis to allow the Commission and Joint Board to complete comprehensive reform of the jurisdictional separations process. The duration of such extension shall be no longer than three years from the initial date of this extension or until such comprehensive reform can be completed, whichever is sooner.

17. We continue to agree with the Joint Board's earlier recommendation that, as part of their efforts to comprehensively reform jurisdictional separations, the Joint Board and the Commission should address the appropriate separations treatment of (1) unbundled network elements, (2) digital subscriber line services, (3) private lines, and (4) Internet traffic.[41] Because these issues remain pending, we seek comment on these issues in the attached Further Notice.[42] An extension will allow additional time to study the interrelationships between these issues with comprehensive reform.

18. In the *2001 Separations Freeze Order*, the Commission concluded that it had the authority to adopt an interim separations freeze to preserve the status quo pending reform and provide for a reasonable allocation of costs.[43] The analysis performed there remains applicable here.[44] In this

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[39] Despite a number of filings by USTelecom and the Joint Board State Members disagreeing on procedural matters with regard to extending the separations freeze, on April 18, 2006, the full membership of the Joint Board filed a "letter recommending that the Commission extend the current separations freeze rules for an additional three-year period in order to allow an opportunity to seek comment on and conclude comprehensive separations [reform]." Letter from Deborah Taylor Tate, Chair, Federal-State Joint Board on Separations and Paul Kjellander, State Chair, Federal-State Joint Board on Separations, to Marlene H. Dortch, Secretary, FCC, at 1 (filed April 18, 2006) (*Letter of Joint Board Chairs*). In this letter, which resulted from extensive and meaningful consultation and cooperation amongst state and federal Joint Board members and staff, the Joint Board expressed its intent "to schedule several substantive working meetings, some of which will include all state and federal members of the board." *Id.* at 2. Further, to assist the Commission as it considers separations reform, NARUC, on behalf of the Joint Board State Members, filed the *Glide Path II Paper*, which expresses the State Members' views on possible directions for post-freeze separations reform. *See NARUC May 1, 2006 Letter*. In the Further Notice, we seek comment on the *Glide Path II Paper*. *See infra* paras. 29-30.

[40] *See infra* paras. 25-38.

[41] *See 2001 Separations Freeze Order*, 16 FCC Rcd at 11397-98, para. 31.

[42] *See infra* para. 33. For example, in the IP-Enabled Services proceeding, the State Members of the Joint Board emphasized the need to study the impact of Commission action in that proceeding on separations reform. *State Members IP-Enabled Services Comments*. In addition, more recently the State Members of the Joint Board proposed, in their *Glide Path II Paper*, that intercarrier compensation and high-cost universal service for rural carriers have a significant impact on separations. *Glide Path II Paper*, at 12-13. *See also Developing A Unified Intercarrier Compensation Regime*, CC Docket No. 01-92, Further Notice of Proposed Rulemaking, 20 FCC Rcd 4685 (2005); *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Order, 19 FCC Rcd 11538 (2004) (asking the Federal-State Joint Board on Universal Service to review the Commission's rules relating to the high-cost universal service support mechanisms for rural carriers).

[43] *2001 Separations Freeze Order*, 16 FCC Rcd at 11392-93, para. 17.

instance, the facts support maintaining the status quo through an interim extension of the separations freeze. Allowing the separations process to revert to the pre-freeze rules would create undue instability and administrative burdens while the Commission is considering comprehensive separations reform.[45] Moreover, a comprehensive source of data to assess alternatives to a freeze is not currently available. Taking those concerns into account, on balance, we find that extending the jurisdictional separations freeze on an interim basis is a reasonable measure to apportion costs.

19. Under the Administrative Procedure Act, an administrative agency may implement a rule without public notice and comment "when the agency for good cause finds . . . that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest."[46] We find that good cause exists in this instance. The Commission adopted the original separations freeze based on an extensive record, which has been supplemented since that time in several filings by the State Members of the Joint Board and interested parties.[47] Extending the freeze will prevent the wasteful expenditure of significant resources by carriers to develop the ability to perform separations in a manner that likely would only be relevant for a relatively short time while the Commission considers comprehensive separations reform.

20. We also find that an interim extension of the separations freeze without public notice and comment is consistent with *Mid-Tex Electric Cooperative, Inc. v. FERC*.[48] Here, too, the interim extension of the separations freeze is limited, and the concurrent adoption of the attached Further Notice should allow for a timely resolution of the underlying issues.[49]

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[44] The Supreme Court found in *Smith v. Illinois* that "extreme nicety is not required [in apportioning costs for jurisdictional separations], only reasonable measures being essential . . ." *Smith v. Illinois*, 282 U.S. at 150. As the D.C. Circuit explained in *MCI v. FCC*, "*Smith* compels 'only reasonable measures', because the '[a]llocation of costs is not a matter for the slide-rule,' but 'involves judgment on a myriad of facts.'" *MCI v. FCC*, 750 F.2d at 141 (citing *Smith*, 282 U.S. at 150; *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 589 (1945)). The court further explained that:

> Substantial deference must be accorded to an agency when it acts to maintain the status quo so that the objectives of a pending rulemaking proceeding will not be frustrated. What needs to be shown to uphold the FCC is that "existing, possibly inadequate rules" had to be frozen to avoid "compounding present difficulties."

MCI v. FCC, 750 F.2d at 141.

[45] *See infra* paras. 22-23.

[46] 5 U.S.C. § 553(b)(3)(B).

[47] *See Glide Path Paper*; *State Members IP-Enabled Services Comments*; *Glide Path II Paper*; *USTelecom White Paper*.

[48] *Mid-Tex Elec. Co-op., Inc. v. FERC*, 822 F.2d 1123 (D.C. Cir. 1987). There, the court found good cause for the agency to adopt interim rules without public comment, placing great weight on the interim nature of the rules: "[W]e have consistently recognized that a rule's temporally limited scope is among the key considerations in evaluating an agency's 'good cause' claim." *Id.* at 1132.

[49] *See id.* (assessing FERC's good faith intent to address permanent rulemaking in a timely manner). The *Mid-Tex* court further cited additional factors contributing to the finding of good cause that are similar to the factors supporting our finding of good cause here. The court credited FERC's "context-specific concerns regarding 'regulatory confusion' and 'irremedial financial consequences.'" *Id.* at 1133. Similarly, we have noted our concerns regarding the financial consequences and administrative burdens of allowing the separations rules to revert to the pre-freeze rules. Much like FERC in *Mid-Tex*, we have the benefit of the record from an earlier public notice

(continued….)

21. In addition, we find that the interim extension of the separations freeze does not require a referral to the Joint Board because it is temporary in scope and because the issue of extension was within the scope of the Joint Board's earlier recommended decision.[50] We have continued to receive valuable comments, analysis and expertise from the Joint Board on this matter during the current separations freeze.[51]

22. We believe that extending the freeze at this time will provide significant stability to the jurisdictional separations process. We find, as did the Commission in the *2001 Separations Freeze Order*, that avoiding a sudden cost shift will provide regulatory certainty that offsets the concern that there may be a temporary misallocation of costs between the jurisdictions.[52] Maintaining the stability and regulatory certainty of the freeze will allow carriers to make investment decisions without fear that a reversion to the earlier rules would create radically different cost recovery requirements than they would currently expect.

23. Further, extending the freeze will avoid the imposition of undue administrative burdens on carriers. The Commission described the significant burdens associated with the jurisdictional separations process in the *2001 Separations Freeze Order*.[53] If the Commission did not extend the separations freeze, and instead allowed the earlier separations rules to return to force, carriers would be required to reinstitute their separations processes. As noted in the *USTelecom White Paper*, Verizon alone devoted "at least 60 employees and 11 major computer systems" to the separations process at the time of the freeze.[54] As the *USTelecom White Paper* further notes, many carriers no longer have the necessary employees and systems in place to comply with the old jurisdictional separations process.[55] Carriers, therefore, likely would have to hire or reassign and train employees and redevelop systems for collecting and analyzing the data necessary to perform separations. Because the Commission may ultimately adopt comprehensive separations reform, these efforts might have very short useful lives. It would be unduly burdensome for carriers to commit the resources necessary to perform separations consistent with our prior rules when there is a significant likelihood that there would be no lasting benefit to doing so.

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and comment process, as well as other, subsequent filings. The existing record provides us a sufficient basis for considering whether to extend the freeze. *See id.* at 1132-33.

[50] As we explain above, our finding of good cause permits us to extend the freeze on an interim basis without notice and comment, so no referral is required.

[51] *See Glide Path Paper*; *State Members IP-Enabled Services Comments*; *Glide Path II Paper.*

[52] We stress that, under the principles of *Smith v. Illinois*, extreme precision is not required in the separations process. *Smith v. Illinois*, 282 U.S. at 150-51.

[53] *2001 Separations Freeze Order*, 16 FCC Rcd at 11390-91, para. 14.

[54] *USTelecom White Paper* at 1 and n.1 (citing *Federal-State Joint Board on Jurisdictional Separations to Hold En Banc Hearing on Comprehensive Separations Reform*, CC Docket No. 80-286, Verizon Comments at 2 (filed Sept. 25, 2000)). *See also* Letter from Joe A. Douglas, Vice President Government Relations & Corporate Communications, NECA, to Marlene H. Dortch, Secretary, Federal Communications Commission, CC Docket No. 80-286 (filed Mar. 2, 2006), Att. at 2 (stating that the burdens imposed on smaller rate of return carriers are proportionately as significant) (letter filed on behalf of NECA, Eastern Rural Telephone Association, the Independent Telephone & Telecommunications Alliance, National Telecommunications Cooperative Association, Organization for the Protection and Advancement of Small Telecommunications Companies, and Western Telecommunications Alliance).

[55] *Id.* at 2.

24. As indicated in the attached Further Notice, we remain committed to reforming the separations process. Until that occurs, however, we find it is appropriate to extend the freeze on an interim basis.[56] The extended freeze will be implemented as described in the *2001 Separations Freeze Order*.[57] Specifically, price-cap carriers will use the same relationships between categories of investment and expenses within Part 32 accounts and the same jurisdictional allocation factors that have been in place since the inception of the current freeze on July 1, 2001. Rate-of-return carriers will use the same frozen jurisdictional allocation factors, and will use the same frozen category relationships if they had opted previously to freeze those as well.

IV. FURTHER NOTICE OF PROPOSED RULEMAKING

25. In this Further Notice, we seek comment on proposals relating to comprehensive separations reform.[58]

A. Separations Reform Proposals

26. In the *1997 Separations Notice*, the Commission noted that the network infrastructure was vastly different from the network and services used to define the cost categories appearing in the Commission's Part 36 rules. The Commission further noted that the separations process codified in Part 36 was developed during a time when common carrier regulation presumed that interstate and intrastate telecommunications service must be provided through a regulated monopoly.[59] The technological and market landscape of the telecommunications industry has continued to evolve since the adoption of the *1997 Separations Notice*. Thus, below, we seek comment on the effects on our separations rules of increased market adoption of IP-enabled services such as voice over IP (VoIP) services, among other technological and market changes. In addition, because of the time that has passed and changes that have occurred since the *1997 Separations Notice*, we ask that commenters refresh the record on the *1997 Separations Notice*. We also seek comment on specific proposals for comprehensive separations reform advanced by the State Members of the Joint Board, as well as a draft data request prepared by the State Members that is intended to elicit data that may be helpful in formulating a reformed separations process.

1. Refreshing the Record on the *1997 Separations Notice*

27. In the *1997 Separations Notice*, the Commission sought comment on the extent to which legislative changes, technological changes, and market changes warrant comprehensive reform of the separations process.[60] Because over eight years have elapsed since the closing of the comment cycle on the *1997 Separations Notice*, and the industry has experienced substantial changes during that time, we ask that commenters, in their comments on this Further Notice, refresh the record on the issues set forth in the *1997 Separations Notice*.

28. For instance, we seek guidance on whether competitive neutrality, administrative simplicity, and principles of cost causation still should be the primary criteria for evaluating proposals for reform of the separations rules,[61] or whether other criteria should be balanced in addition to or in place of

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[56] *See Letter of Joint Board Chairs* at 1.

[57] *2001 Separations Freeze Order*, 16 FCC Rcd at 11393-408, paras. 18-55 (describing the components of the freeze in detail).

[58] *See Letter of Joint Board Chairs* at 1-2.

[59] *1997 Separations Notice*, 12 FCC Rcd at 22126, para. 9.

[60] *Id.* at 22126-22131, paras. 9-19.

[61] *See id.* at 22132-36, paras. 22-31.

these criteria. In addition, we solicit updated analysis of whether the Supreme Court's holding in *Smith v. Illinois* is still applicable in light of competitive market conditions.[62] Furthermore, we seek comment on whether there is a continued need to prescribe separations rules for either price cap or rate-of-return incumbent LECs.[63] Commenters should address the Commission's existing separations procedures -- including the definition of "study areas," Part 36 cost categories, and apportionment of costs among Part 36 cost categories and between jurisdictions.[64] Have the Commission's Part 36 separations rules become obsolete?[65] Where commenters advocate reform of the separations rules, we request that they submit with specificity proposed separations rules, identifying amendments or deletions to the Commission's existing separations rules that would be necessary if their proposals were adopted.[66] These proposals should include an analysis of how such proposals would affect prices paid by consumers, the way costs are recovered in the intrastate and interstate jurisdictions, and a jurisdictional shift in revenue requirements.[67] Commenters also should consider how costly and burdensome any proposed changes to the Commission's separations rules would be for small carriers, and whether such changes would disproportionately affect specific types of carriers or ratepayers.

2. *Glide Path* Papers

29. On December 19, 2001, following adoption of the *2001 Separations Freeze Order*, the State Members of the Joint Board filed the *Glide Path Paper*, outlining seven options for comprehensive separations reform, including the advantages and disadvantages of each option.[68] The *Glide Path II Paper*, prepared by the State Members of the Joint Board in late October 2005, proposes six options for comprehensive separations reform.[69] The *Glide Path Paper* and *Glide Path II Paper* propose options for a transition path from the current frozen Part 36 regime to a mechanism that reflects a telecommunications environment that has experienced significant technological, economic, and legal changes. In both papers, the State Members of the Joint Board express concern about avoiding unwanted consequences when transitioning to a new separations system. Both papers also outline several goals for

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[62] *See id.* at 22136-38, paras. 32-37 (interpreting and analyzing *Smith v. Illinois*). In that decision, the Court stated that "proper regulation of rates can be had only by maintaining the limits of state and federal jurisdiction" to determine whether rates are confiscatory. The Court held that when distinct jurisdictional limits exist as to the determination of reasonable rates, some form of jurisdictional separations must occur. In light of this holding of the Court, the Commission sought comment on whether some form of allocation of costs is necessary when there are distinct jurisdictional limits to ensure that regulated rates are not confiscatory or excessive. *See id.* at 22136-37, para. 33 (quoting *Smith v. Illinois*, 282 U.S. at 149).

[63] *See 1997 Separations Notice*, 12 FCC Rcd at 22138-41, paras. 38-42. *See also Petition of BellSouth Telecommunications, Inc. For Forbearance Under 47 U.S.C. § 160 From Enforcement of Certain of the Commission's Cost Assignment Rules*, WC Docket No. 05-342, Petition for Forbearance, at 43 (filed Dec. 6, 2005) (*BellSouth Cost Assignment Forbearance Petition*) (arguing that the original purpose of separations, to prevent incumbent LECs from recovering the same costs in both the interstate and intrastate jurisdictions, was "only valid under rate-of-return regulation where costs could have a direct impact on rates. For [BellSouth], the need for a separations process evaporated when both federal and state regulators moved to pure price cap regulation").

[64] *See 1997 Separations Notice*, 12 FCC Rcd at 22145-59, paras. 51-83.

[65] *See id.* at 22131, para. 21.

[66] *See id.*

[67] *See id.* at 22159-60, paras. 84-87.

[68] *See supra* para. 11.

[69] Some of these options overlap with the seven proposed in the original *Glide Path Paper*. *See supra* para. 13.

comprehensive separations reform, including the principles that separations should be simpler, separations should be compatible with new technologies and competitive markets, and cost responsibilities should follow jurisdictional responsibilities.

30. We ask commenters to refresh the record on the *Glide Path Paper,*[70] and, as requested by the State Members of the Joint Board,[71] we seek comment on all of the proposals in the *Glide Path II Paper*.[72] Specifically, we seek comment on how these proposals account for technological, market, legislative, and other regulatory changes in the telecommunications industry over the last 15 years. In addition, we solicit comment on the State Members' enunciated goals for and principles underlying comprehensive separations reform. How do these comport with the proposed criteria for evaluating separations reform proposals, as described by the Commission in the *1997 Separations Notice*?[73] Moreover, what are the merits of the proposals advanced in the *Glide Path Paper* and *Glide Path II Paper* in light of the criteria described by the Commission in the *1997 Separations Notice,* as well as the goals and principles for reform enunciated by the State Members of the Joint Board? We also ask commenters to address the impact of the State Members' proposals on other proceedings before the Commission. Finally, we ask that commenters specifically comment on how these proposals would affect small carriers, including rural incumbent LECs.

3. Draft Data Request

31. In the *State Members May 2004 Letter,* the State Members of the Joint Board suggested that the Joint Board "issue a data request to find out what the carriers are doing under the freeze – *e.g.,* to find out how carriers are allocating certain costs and expenses and where they are recording or booking certain costs, expenses, and revenues – and to determine what is, and is not, working."[74] In soliciting comment on the potential burdens associated with a data request, the Commission stated that it contemplated "a one-time data collection designed to assist the Commission in evaluating whether to modify its rules pertaining to jurisdictional separations, specifically, the Part 36 category relationships and jurisdictional cost allocation factors."[75] We continue to believe that the information derived from such a data request will be useful in assisting the Commission as it contemplates comprehensive separations reform. Appendix C of this Order and Further Notice contains the draft data request. We

[70] As a starting point for comprehensive separations reform, the Common Carrier Bureau solicited comment on the *Glide Path Paper* shortly after it was filed in late 2001. *See Glide Path Paper Public Notice.* Soon thereafter, in February 2002, the Joint Board held an en banc hearing on the *Glide Path Paper. See Glide Path Hearing Public Notice.*

[71] *See State Members May 2004 Letter* at 2 (requesting that the Commission publish an updated version of the *Glide Path Paper* for public comment).

[72] Appendices A and B of this Order and Further Notice contain the *Glide Path Paper* and *Glide Path II Paper*, respectively, in their entireties.

[73] *Cf. 1997 Separations Notice,* 12 FCC Rcd at 22132-36, paras. 22-31 (suggesting that competitive neutrality, administrative simplicity, and principles of cost causation should be the primary criteria for evaluating separations reform proposals).

[74] *State Members May 2004 Letter* at 2.

[75] *Separations Data Request FR Notice,* 70 Fed. Reg. at 11972. The Commission added: "To assist the Federal-State Joint Board on Separations and the Commission in this regard, carriers will be requested to identify and explain the way in which specific categories of costs and revenues are recorded for accounting and jurisdictional purposes." *Id.* Though the Commission, in March 2005, published a Federal Register notice seeking comment on the burdens associated with a proposed data request, the Commission did not attach the actual proposed data request at that time. *See id.*

seek comment generally on its utility in assisting separations reform efforts, and on whether, as currently drafted, it will help the Commission to elicit useful information towards that end. We also seek comment on whether there are alternatives to a data request to help the Commission educe the desired information.

32. In addition, we seek comment on whether the questions in the appended data request are appropriate as drafted. For instance, in the *Separations Data Request FR Notice*, the Commission expressed that, among other things, "the data will allow the Federal-State Joint Board and the Commission to study the impact of the Internet and the growth in local minutes during the interim freeze."[76] Do the questions as drafted accomplish this purpose? Because LECs already retain most of the requested information pursuant to Parts 32, 36, 64, and 69 of the Commission's rules, we believe that the request should not be unduly burdensome. Nevertheless, we seek input on whether there is any way to streamline the draft data request without sacrificing its utility. We also particularly seek comment on the burdens of the draft data request on small carriers.

4. Separations of the Costs Associated with Emergence of New Technologies and Local Competition

33. Though the proposals formulated by the State Members of the Joint Board in the *Glide Path Paper* and *Glide Path II Paper* cast a fairly wide net -- considering carefully the effects of separations reform on other Commission proceedings, and likewise the effect of other Commission proceedings on separations reform -- there are a few issues and other proceedings on which we will particularly focus in this section, in order to ensure that we derive as complete a record as possible on them. In the *2001 Separations Freeze Order*, the Commission agreed with the Joint Board's recommendation that the Commission commit itself to addressing the separations ramifications of issues associated with the emergence of new technologies and local exchange service competition. These issues include the appropriate separations treatment of: (1) UNEs;[77] (2) DSL services;[78] (3) private lines;[79] and (4) Internet traffic.[80] In accord with the Commission's commitment, we seek comment on the separations ramifications of these four specified issues. We also seek comment on how the market adoption and

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[76] *Id*.

[77] *See 1997 Separations Notice*, 12 FCC Rcd at 22162, para. 91.

[78] *See 2001 Separations Freeze Order*, 16 FCC Rcd at 11398, para. 31. *See generally Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, Universal Service Obligations of Broadband Providers*, CC Docket No. 02-33, Report and Order and Notice of Proposed Rulemaking, 20 FCC Rcd 14853 (2005) (classifying wireline broadband Internet access service, including DSL Internet access service, as an information service).

[79] *See 1997 Separations Notice*, 12 FCC Rcd at 22128-29, para. 13, 22149, para. 60.

[80] *2001 Separations Freeze Order*, 16 FCC Rcd at 11398, paras. 31, 33 (citing *2000 Separations Recommended Decision*, 15 FCC Rcd at 13175, para. 27). With the substantial growth in broadband adoption over the last five years, we seek comment on its effect on the ISP-bound traffic issue and the question of whether to adjust the local DEM factor. *2001 Separations Freeze Order*, 16 FCC Rcd at 11402-03, paras. 39-40, 42. For example, the State Members of the Joint Board have proposed that frozen separations usage factors should be changed by transferring 33 percent of each company's current local DEM to the interstate jurisdiction and recalculating separations factors accordingly, while assigning 100 percent of a carrier's investment to interstate where the carrier has converted completely its network to IP Format. *See State Members IP-Enabled Services Comments* at 21-22. We seek comment on this proposal. We encourage commenters to support their views on this issue with specific, reliable data that will allow the Commission to quantify with reasonable certainty the portion of local usage that can be attributed to Internet usage, and thus establish a reasonable amount, if any, of local DEM reduction that should be applied on an across-the-board, nationwide basis.

regulatory treatment of IP-enabled services,[81] and other issues and proceedings before the Commission, may affect, or be affected by, comprehensive separations reform.[82]

34. *Local Competition*. In the *2001 Separations Freeze Order*, the Commission expressed that a freeze of the separations process would reduce regulatory burdens on carriers during the transition from a regulated monopoly to a deregulated, competitive environment in the local telecommunications marketplace. The Commission also stated that, because incumbent LECs are required under part 36 to perform separations studies, while competitive LECs have no similar requirements, a freeze would further the Commission's stated goal in the *1997 Separations Notice* of achieving greater competitive neutrality during the transition to a competitive marketplace, by simplifying the separations process for incumbent LECs.[83] We seek comment on what effect competitive changes in the local telecommunications marketplace since passage of the 1996 Act should have on comprehensive reform of the Commission's separations rules.[84]

35. *Universal Service*. The State Members of the Joint Board maintain that separations procedures were never adjusted to reflect the obligations of the Commission, with respect to interstate services, and the States, with respect to intrastate services, under section 254(k) of the 1996 Act to "establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."[85] In addition, the State Members suggest that any adjustment to separations factors could require parallel adjustments to the assumptions and parameters used in calculating high-cost universal service support.[86] We seek comment on these issues raised by the State Members, and on the general interaction of our separations rules with our universal service rules.

36. *Special Access*. In an Order and Notice of Proposed Rulemaking adopted over a year ago, the Commission sought comment generally on whether accounting rates of return are meaningful

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[81] For instance, in the *2001 Separations Freeze Order*, the Commission suggested that the part 36 rules do not appropriately address the allocation methods for newer technologies such as packet switching. *2001 Separations Freeze Order*, 16 FCC Rcd at 11390, para. 12 & n.32. Insofar as IP-enabled services rely on packet switching, *see generally IP-Enabled Services*, WC Docket No. 04-36, Notice of Proposed Rulemaking, 19 FCC Rcd 4863, 4869-70, para. 8 (2004), how, if at all, could the Commission's separations rules be modified to account for the irrelevance of usage-based separations procedures as applied to such services?

[82] *See, e.g.*, Letter from Douglas Meredith, Director – Economics & Policy, John Staurulakis, Inc., to Marlene H. Dortch, Secretary, Federal Communications Commission, CC Docket No. 80-286 (filed Mar. 30, 2006) (urging Commission to account for line count declines in revised separations rules); Letter from Douglas Meredith, Director – Economics & Policy, John Staurulakis, Inc., to Marlene H. Dortch, Secretary, Federal Communications Commission, CC Docket No. 80-286 (filed Apr. 26, 2006).

[83] *See 2001 Separations Freeze Order*, 16 FCC Rcd at 11390, para. 13.

[84] For instance, Verizon has argued: "In a market where all services – interstate, intrastate, wireline, wireless, local, long distance, basic, and enhanced – are competitively disciplined, regulatory cost allocation requirements such as the separations rules are not only unnecessary to protect ratepayers, but destructive of true competition." *BellSouth Cost Assignment Forbearance Petition*, WC Docket No. 05-342, Verizon Comments at 6-7 (filed Jan. 23, 2006) (*Verizon Cost Assignment Forbearance Petition Comments*).

[85] *Glide Path II Paper* at 8 (quoting 47 U.S.C. § 254(k)). The State Members of the Joint Board provide as an example that Part 64 of the Commission's rules, "as applied," concentrates primarily on expense accounts and not investment accounts. *Glide Path II Paper* at 8.

[86] *See State Members IP-Enabled Services Comments* at 22.

statistics for evaluating the reasonableness of price cap special access rates.[87] The Commission suggested that its cost allocation rules and factors such as the separations freeze may undermine the usefulness of examining rates of return derived from ARMIS data, but it asked for input on what factors may affect the relevance of ARMIS data to the Commission's examination of special access rates. The Commission further noted that some parties claim that accounting rates of return for services such as interstate special access are meaningless, because these returns reflect arbitrary allocations of fixed costs between regulated and nonregulated services, between interstate and intrastate jurisdictions, and among interstate services.[88] We seek comment on the effects that separations reform would have on evaluation of special access rates.

37. *BellSouth Cost Assignment Forbearance Petition*. In a recent petition for forbearance, BellSouth argues that the increase in competitiveness of the telecommunications marketplace since the Commission adopted the *2001 Separations Freeze Order*, combined with a "full-fledged" rollout of IP-enabled services and BellSouth's subjection to price cap regulation, warrants the Commission's grant of its request for forbearance from the separations rules.[89] Though we solicit comment in other parts of this Further Notice on the effect on comprehensive separations reform of the factors cited by BellSouth to support its petition, we also specifically seek comment on the effect of a Commission grant or denial of the *BellSouth Cost Assignment Forbearance Petition* on comprehensive separations reform, and vice-versa.

B. Reallocation of Investment Categories

38. While the Commission froze the separations category relationships and the jurisdictional cost allocation factors in the *2001 Separations Freeze Order*, the Commission also required that categories or portions of categories that had been directly assigned prior to the separations freeze would continue to be directly assigned to each jurisdiction.[90] The Commission's rules provide that direct assignments shall be updated annually.[91] There has been some disagreement, however, between state commissions and carriers regarding the application of this direct assignment requirement. For instance, at its February 2006 Winter Meetings, the NARUC Board of Directors adopted a resolution stating that the Commission "should clarify that all carriers must continue to directly assign all private lines and special access circuits based on existing line counts."[92] Conversely, USTelecom requests that the Commission

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[87] *Special Access Rates for Price Cap Local Exchange Carriers; AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, WC Docket No. 05-25, RM-10593, Order and Notice of Proposed Rulemaking, 20 FCC Rcd 1994, 2015, para. 61 (2005).

[88] *See id.* at 2006, para. 29 & n.93, 2015, para. 61.

[89] *See BellSouth Cost Assignment Forbearance Petition* at 43-45.

[90] *See 2001 Separations Freeze Order*, 16 FCC Rcd at 11395, para. 23. The Commission explained that

> the frozen factors shall not have an effect on the direct assignment of costs for categories, or portions of categories, that are directly assigned. Since those portions of facilities that are utilized exclusively for services within the state or interstate jurisdiction are readily identifiable, we believe that the continuation of direct assignment of costs will not be a burden on carriers, nor will it adversely impact the stability of separations throughout the freeze."

Id. [internal footnote omitted].

[91] *See, e.g.*, 47 C.F.R. § 36.3(a) ("Direct assignment of private line service costs between jurisdictions shall be updated annually. Other direct assignment of investment, expenses, revenues or taxes between jurisdictions shall be updated annually.").

[92] *Resolution Relating to Separations Reform*, NARUC (Feb. 15, 2006), http://www.naruc.org/associations/1773/files/TCOM-2SeparationsReform.pdf. In a supporting white paper,

(continued….)

"reaffirm" that, under the *2001 Separations Freeze Order*, state regulators may not compel LECs to reallocate categories of investment from the intrastate to the interstate jurisdiction while the freeze remains in effect.[93] USTelecom asserts that the direct assignment provision "is narrow and does not require investment studies," but that some state regulators are attempting to compel carriers to demonstrate that costs are directly assigned in the proper manner.[94] We seek comment on the clarifications sought by NARUC and by USTelecom.

V. PROCEDURAL MATTERS

A. Final Regulatory Flexibility Certification.

39. The Regulatory Flexibility Act of 1980, as amended (RFA),[95] requires that an RFA analysis be prepared for rulemaking proceedings, unless the agency certifies that "the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities."[96] The RFA certification is in Appendix D. The Commission will send a copy of the Order, including the final certification, in a report to Congress and the Government Accountability Office pursuant to the Congressional Review Act.[97] In addition, the Commission will send a copy of the Order, including this final certification, to the Chief Counsel for Advocacy of the Small Business Administration. A copy of the Order and final certification (or summaries thereof) also will be published in the Federal Register.[98]

B. Paperwork Reduction Act Analysis

40. This Order and Further Notice does not contain new, modified, or proposed information collections subject to the Paperwork Reduction Act of 1995 (PRA), Public Law 104-13. In addition, therefore, it does not contain any new, modified, or proposed "information collection burden for small

(Continued from previous page)
NARUC maintains that when the Joint Board recommended a freeze in 2000, the Joint Board relied on the updating of direct assignments to offset the effect of increased sales of interstate private lines and special access services, but that "at least some carriers are not performing these annual adjustments." *Whitepaper on Separations Resolution*, NARUC, http://www.naruc.org/associations/1773/files/TCOM-2aWhitepaperonSeparationsResolution.pdf (last visited Mar. 20, 2006).

[93] *See USTelecom White Paper* at 10-12 (citing proceedings in Vermont and Maine). Similarly, in comments on the *BellSouth Cost Assignment Forbearance Petition*, Verizon argues that permitting states to engage in such reallocation "would undermine not only the freeze, but the entire concept of a unified national approach to jurisdictional separations." *Verizon Cost Assignment Forbearance Petition Comments* at 6 (citing *Crockett Tel Co. v. FCC*, 963 F.2d 1564, 1567, 1573 (D.C. Cir. 1992), and *Hawaiian Tel. Co. v. Public Utilities Commission of Hawaii*, 827 F.2d 1264, 1275-76 (9th Cir. 1987)). Thus, Verizon urges that the Commission "confirm" that the freeze precludes states from imposing inconsistent separations requirements, and that the Commission not create or tolerate a situation where the same investment is split between two different jurisdictions in two different ways. *See Verizon Cost Assignment Forbearance Petition Comments* at 1, 4.

[94] *USTelecom White Paper* at 11 (citing *2001 Separations Freeze Order*, 16 FCC Rcd at 11390, para. 14, 11395, paras. 22-23); *see also* Letter from Linda S. Vandeloop, Director, AT&T Services, Inc., to Marlene H. Dortch, Secretary, Federal Communications Commission, CC Docket No. 80-286 (filed Apr. 6, 2006) (asserting that "[n]ot all companies currently directly assign special access and private line costs").

[95] *See* 5 U.S.C. § 603. The RFA, *see* 5 U.S.C. §§ 601-12, has been amended by the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

[96] 5 U.S.C. § 605(b).

[97] *See* 5 U.S.C. § 801(a)(1)(A).

[98] *See* 5 U.S.C. § 604(b).

business concerns with fewer than 25 employees," pursuant to the Small Business Paperwork Relief Act of 2002, Public Law 107-198, *see* 44 U.S.C. § 3506(c)(4).

C. Congressional Review Act

41. The Commission will send a copy of this Order in a report to be sent to Congress and the Government Accountability Office pursuant to the Congressional Review Act, *see* 5 U.S.C. 801(a)(1)(A).

D. Initial Regulatory Flexibility Act Analysis

42. As required by the Regulatory Flexibility Act of 1980, as amended, *see* 5 U.S.C. § 603, the Commission has prepared an Initial Regulatory Flexibility Analysis (IRFA) for this Further Notice, of the possible significant economic impact on a substantial number of small entities by the policies and rules proposed in this Further Notice. The IRFA is in Appendix E. Written public comments are requested on this IRFA. Comments must be identified as responses to the IRFA and must be filed by the deadlines for comments on the Further Notice. The Commission will send a copy of the Further Notice, including this IRFA, to the Chief Counsel for Advocacy of the SBA.[99] In addition, the Further Notice and IRFA (or summaries thereof) will be published in the Federal Register.[100]

E. Ex Parte Presentations

43. These matters shall be treated as a "permit-but-disclose" proceeding in accordance with the Commission's *ex parte* rules.[101] Persons making oral *ex parte* presentations are reminded that memoranda summarizing the presentations must contain summaries of the substance of the presentations and not merely a listing of the subjects discussed. More than a one or two sentence description of the views and arguments presented is generally required.[102] Other requirements pertaining to oral and written presentations are set forth in section 1.1206(b) of the Commission's rules.[103]

F. Comment Filing Procedures

44. Pursuant to sections 1.415 and 1.419 of the Commission's rules, 47 C.F.R. §§ 1.415, 1.419, interested parties may file comments and reply comments on or before the dates indicated on the first page of this document. Comments may be filed using: (1) the Commission's Electronic Comment Filing System (ECFS), (2) the Federal Government's eRulemaking Portal, or (3) by filing paper copies. *See Electronic Filing of Documents in Rulemaking Proceedings*, 63 Fed. Reg. 24121 (1998).

- Electronic Filers: Comments may be filed electronically using the Internet by accessing the ECFS: http://www.fcc.gov/cgb/ecfs/ or the Federal eRulemaking Portal: http://www.regulations.gov. Filers should follow the instructions provided on the website for submitting comments.
    - For ECFS filers, if multiple docket or rulemaking numbers appear in the caption of this proceeding, filers must transmit one electronic copy of the comments for each docket or rulemaking number referenced in the caption. In completing the transmittal screen, filers

[99] *See* 5 U.S.C. § 603(a).

[100] *Id.*

[101] 47 C.F.R. §§ 1.1200-1.1216.

[102] 47 C.F.R. § 1.1206(b)(2).

[103] 47 C.F.R. § 1.1206(b).

should include their full name, U.S. Postal Service mailing address, and the applicable docket or rulemaking number. Parties may also submit an electronic comment by Internet e-mail. To get filing instructions, filers should send an e-mail to ecfs@fcc.gov, and include the following words in the body of the message, "get form." A sample form and directions will be sent in response.

- Paper Filers: Parties who choose to file by paper must file an original and four copies of each filing. If more than one docket or rulemaking number appears in the caption of this proceeding, filers must submit two additional copies for each additional docket or rulemaking number.

  Filings can be sent by hand or messenger delivery, by commercial overnight courier, or by first-class or overnight U.S. Postal Service mail (although we continue to experience delays in receiving U.S. Postal Service mail). All filings must be addressed to the Commission's Secretary, Office of the Secretary, Federal Communications Commission.

  - The Commission's contractor will receive hand-delivered or messenger-delivered paper filings for the Commission's Secretary at 236 Massachusetts Avenue, NE, Suite 110, Washington, DC 20002. The filing hours at this location are 8:00 a.m. to 7:00 p.m. All hand deliveries must be held together with rubber bands or fasteners. Any envelopes must be disposed of before entering the building.

  - Commercial overnight mail (other than U.S. Postal Service Express Mail and Priority Mail) must be sent to 9300 East Hampton Drive, Capitol Heights, MD 20743.

  - U.S. Postal Service first-class, Express, and Priority mail should be addressed to 445 12th Street, SW, Washington, DC 20554.

People with Disabilities: To request materials in accessible formats for people with disabilities (braille, large print, electronic files, audio format), send an e-mail to fcc504@fcc.gov or call the Consumer & Governmental Affairs Bureau at 202-418-0530 (voice), 202-418-0432 (tty).

45. In addition, one copy of each pleading must be sent to the Commission's duplicating contractor, Best Copy and Printing, Inc, 445 12th Street, SW, Room CY-B402, Washington, DC 20554; website: www.bcpiweb.com; phone: 1-800-378-3160. Furthermore, three copies of each pleading must be sent to Antoinette Stevens, Telecommunications Access Policy Division, Wireline Competition Bureau, 445 12th Street, SW, Room 5-B521, Washington, DC 20554; e-mail: antoinette.stevens@fcc.gov.

46. Filings and comments are also available for public inspection and copying during regular business hours at the FCC Reference Information Center, Portals II, 445 12th Street, S.W., Room CY-A257, Washington, D.C., 20554. Copies may also be purchased from the Commission's duplicating contractor, BCPI, 445 12th Street, S.W., Room CY-B402, Washington, D.C. 20554. Customers may contact BCPI through its website: www.bcpiweb.com, by e-mail at fcc@bcpiweb.com, by telephone at (202) 488-5300 or (800) 378-3160 (voice), (202) 488-5562 (tty), or by facsimile at (202) 488-5563.

47. For further information regarding this proceeding, contact Ted Burmeister, Attorney Advisor, Telecommunications Access Policy Division, Wireline Competition Bureau at (202) 418-7389, or theodore.burmeister@fcc.gov, or Michael Jacobs, Telecommunications Access Policy Division, Wireline Competition Bureau, (202) 418-2859, or michael.jacobs@fcc.gov.

VI. ORDERING CLAUSES

48. Accordingly, IT IS ORDERED that, pursuant to sections 1, 2, 4, 201-205, 215, 218, 220, 229, 254, and 410 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151, 152, 154, 201-205, 215, 218, 220, 229, 254 and 410, this Order IS ADOPTED.

49. IT IS FURTHER ORDERED that, pursuant to the authority contained in sections 1, 2, 4, 201-205, 215, 218, 220, 229, 254, and 410 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151, 152, 154, 201-205, 215, 218, 220, 229, 254 and 410, this Further Notice of Proposed Rulemaking IS ADOPTED.

50. IT IS FURTHER ORDERED that the Commission's Consumer and Governmental Affairs Bureau, Reference Information Center, SHALL SEND a copy of this Order and Further Notice of Proposed Rulemaking, including the Final Regulatory Flexibility Certification and Initial Regulatory Flexibility Analysis, to the Chief Counsel for Advocacy of the Small Business Administration.

51. IT IS FURTHER ORDERED that this Order shall be effective thirty days after publication in the Federal Register.

FEDERAL COMMUNICATIONS COMMISSION

Marlene H. Dortch
Secretary

APPENDIX A

Separations Joint Board State Members' *Glide Path Paper*

Options for Separations

A Paper Prepared by the State Members of the Separations Joint Board

Approved: December 17, 2001

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Introduction

The state members of the Separations Joint Board believe that the five year freeze adopted by the Commission[1] provides an opportunity to examine, and redefine if warranted, the jurisdictional division between state and federal authority over telecommunications services. The "glide path" developed here is an attempt to frame the debate by articulating various jurisdictional alternatives, and assessing their various strengths and weaknesses. We encourage all interested members of the public and the industry to provide their insights and concerns on this issue, and similarly encourage our federal colleagues to seek comment and bring their own expertise and perspectives.

Three years ago, the state members of the Joint Board stated their concern that the then-existing separations process was cumbersome, pretended to accuracy it could not achieve, and was fundamentally disconnected from pricing decisions. We said:

> In 1986, the Commission required some costs assigned to the interstate jurisdiction to be recovered from end users through the SLC. For all practical purposes, the SLC became part of the basic monthly charge. This means that, since at least 1986, there has been no direct relationship between the level of costs assigned to either jurisdiction and the level of basic monthly charges paid by customers. The separations process may once have provided a forum for addressing the fundamental rate design issue of flat versus usage based charges. In its current form, separations no longer provides that forum.[2]

Our view has not changed. Separations as we have known it, even as frozen, provides little benefit to our constituents. Based on our experience, customers care little whether the charges on their bills are the result of federal or state action; indeed, the most frequent complaint is not against one jurisdiction or the other but about the confusion engendered by multiple charges and surcharges for what, to the customer, seems a single service. Aside from the overall level of their bills, customers care most about the relationship between charges imposed on a flat rate basis (i.e., a fixed monthly charge) and charges that vary with usage. In its early history, separations provided a basis, in rough terms, for deciding how much of a customer's bill would be fixed and how much variable. Costs allocated by separations to the interstate jurisdiction were recovered almost entirely through usage-based toll charges. The states had sole control over the level of fixed monthly charges. Some states recovered intrastate costs through high fixed charges. Others relied more on intrastate toll and access revenue to keep fixed

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[1] *Jurisdictional Separations Reform And Referral To The Federal-State Joint Board*, CC Docket No. 80-286, "Report and Order," FCC 01-162 (rel. May 22, 2001).

[2] "State Members' Report On Comprehensive Review Of Separations" at page 11, filed in CC Docket No. 80-286 on December 21, 1998 (the 1998 Report). The 1998 Report was the subject of a public notice released by the FCC on February 26, 1999, DA 99-414.

charges low).[3] Nevertheless, by varying the level of interstate cost assignment, separations policymakers could, within fairly narrow boundaries, determine the relationship between fixed and variable charges to customers.

This relationship between separations and fixed charges was first weakened by federal access charge policy and soon will be severed entirely, at least for non-traffic sensitive costs. Because the Commission has exercised its authority to recover many interstate costs through fixed monthly charges, a separations shift from one jurisdiction to the other may make no difference to the consumer's telephone bill. A dollar of cost "sent" to the interstate jurisdiction through separations may be "sent" right back to the customer in the form of an increase in the subscriber line charge.

The state members of the separations joint board believe that, in light of the disappearance of the historical justification (or at least the predominant political basis) for separations, we should now look critically at the way in which jurisdictional responsibility is assigned for pricing in telecommunications. It may be, as the glide path suggests, that some entirely new formulation may better serve customers and industry alike. Any change of this magnitude, of course, would require a careful and thoughtful review of many legal, technical, and policy issues. We have prepared the glide path to help define those issues and to begin and to stimulate the debate that, we hope, will lead to a jurisdictional structure that is consistent with the evolving telecommunications world and enhances rather than constrains both consumer welfare and market development.

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[3] As we said in the 1998 Report,

> Separations has, throughout its history, been viewed as a way to help keep basic service rates low by assigning costs to the interstate jurisdiction, where those costs would b recovered through (usage-based) interstate toll charges. The debates about how close SPF should be to SLU, for example, were largely focused on how much cost should be recovered through interstate usage charges as opposed to local rates. Indeed, the "policy compromise" (the 25% gross allocator) described above was, at its center, a compromise between those who favored recovering relatively more costs through basic rates and those who favored recovering less.

1998 Report at page 11.

I. The Changing Environment

A. Technology changes

1. Declining Cost. Costs of transport and switching have declined dramatically, the former due to greater use of fiber optics, and the latter due to decreasing prices for all computer equipment.

2. Distributed Intelligence. The intelligence of the public switched network is becoming more distributed.

a) Some of that intelligence is moving into the periphery. Dumb concentrators are being replaced by smart remote switches. More electronics are migrating out of central offices, moving the switching function closer to the end user.

b) Conversely, some network intelligence is becoming more concentrated. SS7 networks use signal control points in faraway locations. Databases also provide more services, such as E-911, from remote locations, even from other states. The expected deployment of soft switches will provide for integrated routing and switching functions with full network intelligence at the Class 5 office level and will blur the boundaries between circuit switched and packet traffic.

c) The concept of "local calling" is less technologically meaningful. Local calls, particularly "EAS calls" now sometimes involve use of tandems that are tens or hundreds of miles away. Even short-haul calls can involve use of remote SS7 signal control points and faraway databases. Some wireless carriers offer plans that do not distinguish between local and toll calls.

3. Packet networks. The existence of new packet networks challenge separations, which was designed solely for the circuit switched environment. Significant voice and data traffic now travel on these packet networks. No generally accepted method exists to develop usage factors that reflect both packet traffic and switched usage. The separations manual was originally designed to accommodate packet networks or fiber technology.

4. Bypass risk. Bypass and tariff arbitrage of the switched network are more likely. Telephone companies traditionally have provided the sole last-mile access to the network. Now, competition is arriving from the wireless, cable and satellite industries, and competition may even arrive from electric companies. Arbitrage and bypass are also possible for toll services, as consumers continue to change how they complete long distance voice calls, increasing usage of packet networks through Voice Over the Internet protocols.

B. Economic Changes

1. Competitors. Since separations was last substantially revised, local exchange competition has been authorized by Congress. More telecommunications services are now being provided by companies not subject to separations. Incumbent carriers are more reluctant to incur the cost of complying with separations regulations.

2. Regulated Monopolies. Separations continues to assume that most of the operations of regulated companies are regulated monopolies. More services now have in fact become competitive, however, creating new questions about what portions of the property and expenses of local exchange carriers should be subject to separations.

C. Legal Changes

1. Price Caps. Some LEC carriers are today under price cap regulation in both jurisdictions. Such carriers have little incentive to spend resources conducting separations studies since the results of the studies have little or no effect on company revenues. Many incumbent LECs have reduced their staffs and lost expertise to perform separations studies. Similarly, regulators in states using price cap regulation may be indifferent to separations results.

2. Fixed Charges. The Subscriber Line Charge (SLC) has been in existence for 15 years and for all practical purposes has become part of the basic monthly charge. As a result, there is little if any connection between interstate toll usage and support for the monthly fixed charges for basic service. The SLC has increased as the FCC changes its access charge policies, and it could further increase if the FCC moves toward a bill-and-keep approach for all payments resulting from interconnection of telecommunications networks.[4]

3. Joint and Common Costs. Under the 1996 Act, the FCC and states are required to "establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service

[4] *Developing A Unified Intercarrier Compensation Regime*, CC Docket No. 01-92, FCC 01-132, "Notice of Proposed Rulemaking" (issued April 27, 2001).

bear no more than a reasonable share of the joint and common costs of facilities used to provide those services." 47 U.S.C. § 254(k). As competitive services emerge, it has become more difficult to ensure that non-competitive services are paying only a fair and reasonable share of common costs. Current jurisdictional separations procedures do not recognize the increase in competitive services, nor have separations procedures been adjusted in recognition of the safeguard requirements of the Act. Part 64, as applied, concentrates primarily upon expense accounts not investment accounts, and thus may not provide useful information to ensure compliance with § 254(k).

4. Freeze in effect. A five-year freeze is in effect.[5] The existing freeze will make it harder to return to the pre-2001 system. LECs will be increasingly unwilling to expend the resources necessary to operate a complex separations system. Also, when the freeze expires, LECs face the possibility of large shifts in their separations factors and cost results.

D. Jurisdictional Changes

1. DSL. The FCC has asserted jurisdiction over DSL loops, although these loops provide both intrastate and interstate services. Thus, for the first time, loops used to provide local services are tariffed in the interstate jurisdiction. No additional costs are assigned to the interstate jurisdiction because of this use.

2. ISP Calls. The FCC found Internet Service Provider bound communications to be interstate services.[6] This traffic, however, is ordinarily treated for nearly all purposes as local calling. It is difficult for carriers to ascertain which local calls are in reality ISP-bound traffic. Thus an unidentified (and possibly unidentifiable) portion of local calling is now jurisdictionally interstate.

3. Unbundled Network Elements. UNE pricing is a new kind of jurisdictional blend. While the FCC sets general guidelines and methodologies for rate development, states must implement those requirements and review the actual UNE rates.

E. Political Changes.

1. Preemption. Congress has shown itself more willing to preempt state jurisdiction. Examples include cable television and wireless communications where Congress has significantly limited state authority, particularly over economic regulation.

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[5] *Jurisdictional Separations Reform And Referral To The Federal-State Joint Board*, CC Docket No. 80-286, "Report And Order," FCC 01-162 (rel. May 22, 2001).

[6] "Order On Remand And Report And Order," FCC 01-131, CC Docket Nos. 96-98 and 99-68 (released April 27, 2001).

2. New Concerns. Congress has seemingly become less interested in traditional concerns such as the regulation of "natural monopolies," and more concerned about a different set of issues, including promoting competition and the deployment of broadband services.

II. Broad Questions

A. What's Next?

1. We seek comment on the best transition path or "*glide path*" that will take separations from the current regime under the freeze to whatever systems are needed in the new environment.

2. Several broad questions need to be addressed.

a) Can Separations be abolished altogether? If so, what other things would need to change, if any?

b) If Separations is to remain after the freeze, what changes should be made to it?

c) What methods can be used to arrive at the next phase of Separations without creating unwanted consequences, such as large transition costs or customer dissatisfaction?

B. Broad Goals

1. We suggest the following broad goals will guide the development of answers to these questions.

a) Separations should have some meaningful relationship to how prices are actually set: i.e., it should, if perpetuated, actually make a difference to consumers.

b) Separations should be simpler.

(1) Simpler and easier to administer and audit.

(2) Lower overhead cost.

(3) Reasonable accuracy of result still important if separations continues.

c) Separations should be capable of addressing new architectures and technologies.

d) Separations should evolve with competitive markets.

e) Cost responsibility should follow jurisdictional responsibility.

2. We also suggest that the following goals are of reduced importance:

a) Accuracy of cost allocations.

b) Obtaining contribution to loop costs from interstate services.

3. Proposals.

a) Below are presented a series of seven proposals for a "glide path" to a post-freeze system. We seek comment on these proposals.

III. Option #1 – Extend The Freeze

A. Background

1. The FCC has adopted a five-year interim separations freeze. Some category relationships and all allocation factors are now frozen for a period of five years or until comprehensive separations reform can be completed. With limited exceptions, no adjustments to the frozen category relationships and allocation factors will be allowed during the freeze. The freeze is intended to stabilize and simplify the Part 36 separations process pending comprehensive reform, of which this paper is the first step.

B. Proposal

1. For price cap companies, continue to freeze categories and usage factors based on the most recent twelve month period prior to the freeze.

2. For rate-of-return (ROR) companies, continue to freeze usage factors based on the most recent twelve month period prior to the freeze. ROR companies may elect to freeze categories as well.

C. Advantages

1. Eliminates the need for basic studies and traffic studies.

2. Prevents further misallocation of costs associated with dial-up Internet traffic to the state jurisdiction, assuming this traffic continues to grow.

3. Recognizes the disconnect between separations and pricing.

D. Disadvantages

1. Does not reflect increased interstate usage which could offset or mitigate the effects of the dial-up internet effect.

2. Fails to correct any existing misallocation problems.

3. Fails to reflect the impact of new technologies.

4. When all measurements are lost, we will be unable to know or measure, in the future, the impacts of moving to other options.

E. Questions

1. How long should the freeze remain in place?

2. Should there be any rule changes during the freeze period?

3. Should waivers be granted during the freeze period?

4. Does a freeze prohibit adoption of any other option and stay in place until there is no need for separations?

IV. Option #2 - Separate Traffic Sensitive Costs With Fixed Allocators

A. Background

1. Currently non-traffic sensitive ("NTS") costs are separated using a fixed allocator, which assigns 25% of the costs to the interstate jurisdiction in all cases where the plant is mixed-use in nature. Traffic sensitive ("TS") costs, however, are separated based upon factors like DEM and SLU that are derived from network usage. It may be desirable to apply one or more fixed allocators to TS costs.

B. Proposal

1. All TS costs would be separated based upon fixed allocators. The separations allocator(s) could be set nationally, regionally, or by study area.

C. Advantages

1. Eliminates traffic studies.

2. Simplifies audit and review of separations practices.

3. If the factor were set statewide or nationally, it would simplify separations issues surrounding sale of exchanges.

4. Recognizes disconnect between separations and pricing.

D. Disadvantages

1. General loss of accuracy in separations. This proposal essentially eliminates the link between a utility's use and assignment of plant and associated costs. A substantial portion of plant costs may be assigned to the state jurisdiction even though the plant had only minimal or incidental state use.

2. Separations may be slower to respond to changes in the way the network is used.

3. Variations in network usage among different carriers may not be reflected in separations, i.e., some or all carriers would be using the same TS separations factors even if their network usage was different.

4. The transition from usage-based separations factors to fixed TS allocators could result in significant jurisdictional cost shifts for carriers that have usage-based TS allocators that are different from the new fixed allocators.

5. Without usage studies, it may be difficult or impossible to determine whether plant and facilities were used for non-regulated activities and, if they were, whether a proper allocation of costs was assigned to the non-regulated activities. Similarly, once the new system was in place, carriers would likely no longer keep the usage records needed to allow for knowledgeable update of the fixed TS factors.

E. Questions

1. Factual question: What is the range of TS allocators now? What is the average?

2. What is the appropriate scale for a fixed allocator: National, state, or study area?

a) If the scale is national, would a decision to ignore state-by-state and company-by-company differences for TS costs be so unjust as to justify immediate rejection? Would a national fixed allocator be opposed by those who today benefit from today's variations? Would it be practical to base it upon some sampling of minutes and packets, conducted on a nationwide basis? Should the national fixed TS allocator be set equal to the NTS fixed allocator? Would there be inappropriate division of costs in some cases, leading to an undue competitive advantage, incorrect assignment of costs to monopoly services, or implicit cross-subsidy?

b) Is anything gained by setting the factor at the regional or state level? Is there a correlation between separations factors like DEM and readily-available figures such as population or area? Could some other figure be used as a proxy?

c) If the appropriate geographic scale for the separations factor is the study area, should the factor be simply equal to historic TS allocators, and thus amount to a perpetual freeze? Could the factor be revenue-based, or would this introduce inappropriate circularity into separations? What procedure should be used to select the fixed allocator(s) and how should updates be handled?

d) How often should the fixed allocator(s) be adjusted?

e) What conditions, if any, should be imposed if a carrier uses fixed allocators? Should the carrier be required to report network usage data? What consumer protection measures would be useful?

f) Will any adjustment to the universal service mechanism be needed to reflect the new fixed allocator.

g) Should concurrence by state commissions be a prerequisite?

V.Option #3 - Total Company Revenue Requirement

A. Background

1. Not all incumbent local exchange carriers separate their costs according to the detailed procedures of Part 36. Due to their size and limited resources, many small carriers were allowed to become "average schedule" companies. In place of performing a jurisdictional cost study, an average schedule company determines its interstate revenue requirement based on a simplified formula. The interstate average schedule formula is derived from the characteristics of cost companies and is reviewed by the FCC.

2. Some average schedule companies do not conduct separations studies, and their state commissions set intrastate revenue requirements on a residual basis.[7] In other words, federal receipts are an offset to a total "unseparated" revenue requirement, and all the rest of that revenue requirement must be recovered from intrastate rates. State rates thus are set on a "residual" revenue requirement.

B. Proposal

[7] *See Crockett Tel. Co. v. Federal Communications Commission*, 963 F.2d 1564 (D.C.Cir., 1991).

1. Under this proposal, states would set rates for all incumbent carriers based upon the "residual" method. The FCC would set rates for interstate services, and carriers would record the resulting interstate revenues. States would then set intrastate rates so that all of the company's unseparated revenues (including its interstate revenues) are sufficient to meet its unseparated revenue requirement for regulated services. The carrier would not report any embedded costs to the FCC, nor would it perform any traditional separations studies.

2. Critical to this proposal is an acceptable method for the FCC to set interstate rates. Two possibilities may warrant consideration:

a) Set rates based upon the output of a cost model ("cost model"), such as the existing "average schedule" formula or an extension of the Hybrid Cost Proxy Model that has been used for universal service purposes.

b) Set rates based upon a price cap mechanism by which existing rates are adjusted only incrementally, and existing pooling mechanisms continue to operate.

C. Advantages

1. Eliminates individual company separations studies and reporting, and thus is much simpler.

2. The averaged schedule mechanism has been in existence for a number of years and is well understood by the industry.

3. If interstate revenues are greater than expected (possibly due to increased demand), the state gains the ability to lower state rates.

4. Avoids having costs assigned to one jurisdiction but revenues assigned to the other jurisdiction.

5. Some state commissions, including Maine and Utah, currently set state rates or set universal service funding levels on a residual basis, thereby demonstrating that this general approach is workable.

D. Disadvantages

1. If a cost model is used to set federal rates:

a) Developing that cost model may be controversial and time consuming.

b) It may be difficult to maintain a cost model. If no companies are under a "cost based" system for their interstate revenue requirement, data reporting will decrease. The separations freeze will also reduce the currency of some data that might be used to update a model.

c) Given the differences in size and characteristics of companies across the country, it may be necessary to develop more then one cost model.

d) If the cost model determines the federal "revenue requirement" based on a forward looking methodology, then states would become solely responsible for the recovery of any difference between legacy costs and costs developed by the model.

2. Safeguards may be needed to prevent carriers from carrying into rates imprudent capital costs and excessive expenses.

3. If a change in FCC policy or a change in other conditions (e.g., demand) reduced interstate revenues, then state rates would probably be liable for the difference. Also, states may need to take a more proactive approach to how interstate policy changes might affect state revenue requirements.

4. It may be difficult to allocate liability for any confiscation claim presented by a carrier. State liability may increase.

E. Questions

1. Is there a way to calculate interstate rates that will protect both state and federal interests?

2. If rates are set using a cost model:

a) How can the model best be developed and maintained?

b) Should it be based on historical costs, forward looking costs, or some other methodology?

c) Can the existing average schedule formula be used or adapted?

d) If a forward looking cost model is chosen, can the HCPM model be adapted?

e) How can a cost model address the differences among companies in their network configuration, services, and usage patterns?

f) At what scale should the cost model be applied? Company, study area, exchange, or some other area?

g) How should a cost model account for the sale of Unbundled Network Elements?

3. Can this system deal adequately with jurisdictionally-complex services like DSL where the same loop is used for interstate and intrastate purposes?

4. Is there a way to ensure that states will not be left with unclaimed or unallocated interstate embedded costs as a result of this approach? If a forward looking model is used, will this lead to excessive litigation over confiscation rights?

5. Can this system meet the requirements of the constitution, and in particular *Smith v. Illinois Bell*[8] and following cases?

6. Will state commissions willingly accept an obligation to set state revenue requirements on a residual basis?

7. Do any state statutes make residual ratemaking either impractical or unworkable? If this proposal were put into effect today, would all states have the jurisdictional authority to require appropriate adjustments to state rates?

VI. Option #4 - Redesign Separations to Account for Packets and Competition.

A. Background

1. A new high capacity packet-switched data network parallels the switched network and is almost entirely unregulated. Packet switching is a technology, not a service, and is highly efficient. It is likely to grow in the future.

2. The switched network carries an ever-smaller proportion of total traffic, and the network model that underlies separations is therefore increasingly inadequate as a description of telecommunications, even of voice traffic. It is not necessarily true that usage of the packet network is the same as the usage of the switched network. For example, DEM factors based upon switched traffic usage are sometimes used to separate packet switching equipment. Some customers directly interact with the packet network, bypassing Class 5 switches. Packets have also changed the peak usage characteristics of the switched networks.

3. Electronic equipment has appeared at unexpected places in the network. Splitters allow packet data (including digital voice) to be stripped off telephone wires before it enters a traditional switch at all. DSLAMs now shunt data off the switched network. Remote switches can complete local calls without any direct support from a class 5 switch. Some line concentrators are actually traffic sensitive. CLEC access to the network has moved out of the central office to the concentrator panel.

4. An increasing set of services are being provided on an unregulated basis. This casts doubt on the adequacy of the existing Part 64 rules, which apply to a relatively narrow set of services. The risk is that captive ratepayers may wind up with liabilities created by unregulated activities or an inappropriately large portion of fixed costs.

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[8] 282 U.S. 133 (1930)

B. Proposal

1. Undertake a project to establish a new accounting and separations system that is based upon separating switched circuits from packet circuits and that recognizes the existence of broader categories of unregulated service, packet switching, distributed network architecture, and increasing sales of unregulated services.

C. Advantages

1. If separations cannot be eliminated, it may be necessary to redesign separations to reflect more accurately the way the network is used.

2. Creating separations procedures that properly account for packet and non-packet services may lead to more accurate cost allocations, reducing implicit subsidies, increasing fair pricing of services, and improving the likelihood that effective competition will develop.

D. Disadvantages

1. Any system of this nature will likely be complex and controversial to develop. The more complex, the system, the more costly it will be to maintain and audit.

2. Unless there is a direct link to pricing, the greater degree of "accuracy" achieved here will be irrelevant for customers.

E. Questions

1. Is there a practical way to blend packets and switching minutes into an overall separations factor?

2. Is the new equipment easily classified as packet v. non-packet?

3. What about traditional "in-network" packet services such as frame relay?

4. How should new categories of unregulated services be treated for separations?

5. Should states have options to declare service unregulated and to allocate costs?

VII. Option #5 – Facilities-Based Separations

A. Background

1. Incumbent LECs must follow the FCC's separations procedures. They must divide between the state and federal jurisdictions the costs and expenses of

equipment and facilities that are used for both state and federal purposes. Three basic methods are used:

a) Facility investments and expenses are directly assigned to one jurisdiction when the facility is used solely to provide services in that jurisdiction. Similarly, some facilities are directly assigned entirely to the federal jurisdiction when they are used for "mixed" intrastate and interstate use but the intrastate use is not consequential.

b) Some commonly shared facilities are separated using fixed factors. In particular, loop costs are separated with 75% of costs going to the state jurisdiction.

c) Other commonly shared facilities are separated based upon usage. Usage factors generally apply to switches and trunks. Usage-based separation is a complex task. Carriers must collect a large amount of data and follow detailed procedures and formulas. New technology and new services have made the system even more complex.

B. The Proposal

1. Simplify separations procedures by directly assigning all telecommunications equipment to either the state or the federal jurisdiction.. The proposal also includes some significant limitations on the ratemaking discretion of the FCC and of state commissions. The proposal consists of three interdependent elements: 1) separations and jurisdiction; 2) limitation on rate designs; and 3) universal service.

2. Separations and Jurisdiction

a) The key boundary in this proposal is the area served by "access tandem" switches. Tandems are the switches that LECs use to provide access for interexchange carriers. For each tandem, the LEC will define the area subtended by the tandem ("tandem service area"). Historically, each "LATA" has a single access tandem, and so a tandem service area is never smaller than a LATA.

b) All telecommunications equipment will be directly assigned, and the assignment will be based upon the location of the equipment in the network. Generally, equipment will be directly assigned to the federal jurisdiction if it is "above" the tandem in the network hierarchy (where the customer is visualized at the bottom of the hierarchy). All equipment that is not "above the tandem" will be directly assigned to the state jurisdiction. Here is how that system will work on particular network components:

(1) Loops: All shared-use customer loops will be directly assigned to the state jurisdiction. This will end the 75-25 split that today

applies to shared-use loops. States will also be assigned all "private line" loops and DSL loops, most of which are today directly assigned to the federal jurisdiction. Circuit control equipment, concentrators, digital loop carriers and DSLAMs will be assigned to the state jurisdiction.

(2) Trunks: Trunks will be assigned to the federal jurisdiction if they: 1) connect any ILEC tandem with any other carrier's Point of Presence ("POP trunks"); or 2) connect two tandem switches of the ILEC ("tandem trunks"). All other trunks will be directly assigned to the state jurisdiction. Therefore, all "umbilical trunks" that serve remote switches will be assigned to the state jurisdiction, as will dedicated interoffice trunks that connect two local switches or that connect a local switch and a tandem. All tandem-to-tandem trunks will be assigned to the federal, even if they do not cross state lines.

(3) Switches: Local (host and remote) and tandem switches will be assigned to the state jurisdiction. However, any separate switching equipment exclusively connected to interstate trunks will be assigned to the federal jurisdiction.

(4) Other Plant: Other plant, such as buildings, general purpose computers, and vehicles, will be assigned using a fixed allocator, with 75% of cost assigned to the state jurisdiction and 25% assigned to the federal jurisdiction.

(5) Expenses: All expenses will be apportioned between the jurisdictions according to a single ratio equal to the total plant separation factor.

c) LEC revenues will continue to be assigned to each jurisdiction in the current rules. That is, revenues will be separated as follows:

(1) State commissions will set rates for use of state-separated equipment, and revenues from the sale of these services will be separated to the state jurisdiction. This will include all revenue from retail customers and all UNE revenue from CLECs. UNE rates will be subject to the FCC's existing rulemaking authority under the Telecommunications Act of 1996.

(2) The FCC will set rates for use of federal-separated equipment, and revenues from the sale of these services will be separated to the federal jurisdiction. These rates will include wholesale rates for IXCs that use POP trunks and retail rates for LEC customers who make calls across tandem service areas.

d) Each state commission will have discretion to select a rate design that includes the state's own best mixture of fixed and variable payments, as state conditions may require. Some commissions might rely heavily upon fixed charges. Other states might rely upon per-minute usage charges or per-call usage charges on originating customers. It is even possible (but unlikely) that some state commissions might establish per-minute usage charges for terminating traffic. Some state-separated costs will also be covered by universal service support generated by the FCC and distributed by USAC.

3. Rate Design Limitations. Three limitations would be imposed on rate designs. Two limitations would apply to state rate designs, and one would apply to federal rate designs.

a) State rate designs must give interstate traffic a "most favored retail customer" benefit. That is, states have considerable freedom in setting rate designs, but they may not charge an interstate customer on a per-minute basis more than is charged to an intrastate customer under the most favorable circumstances. This would be measured through equivalent intrastate rates, including local measured service retail rates and intrastate access and reciprocal compensation rates. UNE rates would not be included because they are wholesale rates and are not all set on a per-minute basis. For example:

(1) If a particular ILEC has flat-rated calling for retail service, it could not charge IXCs anything to terminate calls.

(2) If a different ILEC has a local measured service charge of 1 cent per minute for local service, and if it has a terminating access rate of four cents a minute for intrastate toll, it can charge an IXC one cent per minute to terminate calls.

b) LECs may charge other carriers to use their federal-separated plant, such as inter-tandem trunks, at rates set by the FCC. Some interexchange carriers will not have a Point of Presence at the LEC's tandem. In that case the IXC may rely on additional LEC trunks to interconnect with the LEC, and the IXC will have to pay for that extra service. As noted above, the costs of these "POP trunks" will be separated to the federal jurisdiction, and the FCC will set wholesale "access" or "transport" rates to recover their cost. Also, the LEC may use tandem trunks for its own traffic that crosses tandem service area boundaries, and the FCC would set rates for those calls.

c) Charges for use of property separated to the federal jurisdiction will be presumed traffic sensitive, and will be based upon usage. No per-month charges may be imposed by the FCC.

4. Universal Service. The final essential element in this proposal is universal service. Currently, the FCC collects and distributes approximately $3.0 billion per year for the support of facilities in high cost areas. This money is distributed through a wide variety of programs, some of which are aimed at the federal costs of LECs and some of which are aimed at their state costs. Under this proposal, all facilities that create a need for universal service support will be within the state jurisdiction. Much of the cost of such facilities is now separated to the federal jurisdiction. We propose, therefore, that approximately the same amount of support that currently defrays the costs of providing telephone service in high cost areas continue to be devoted to that same purpose, including programs that currently support federal-separated costs. The actual mechanism for that support should be decided by the FCC after referring the question to the Universal Service Joint Board.

5. Examples. Some examples may help illustrate the proposal.

a) Example 1: Suppose states A and B each decide to establish fixed subscriber rates at $20 per month, but with no per-minute charges. Each state has decided, in other words, to recover all costs of state-separated property through fixed charges. Suppose now that customer a in state A calls customer b in state B using an IXC. Under the proposal, customer a's IXC does not pay any charge to originate this interstate toll call. Similarly, the IXC pays nothing to customer b's LEC. Thus from the IXC's point of view, originating and terminating access will be zero. All of the costs of state-separated property will be recovered by fixed charges in States A and B, and the IXC will have to recover from its customer only for its own internal costs of transporting the call from a's LEC to b's LEC.

b) Example 2: Suppose states C and D, in order to keep fixed charges low, establish a fixed monthly charge of $10 and a usage charge of $0.01

for each originating minute of use. Suppose now that customer c in state C calls customer d in state D using an IXC. Here the originating customer will pay its ILEC $0.01 per minute for the call. The customer must also pay the IXC whatever the IXC charges, but since the IXC's costs are the same as in Example 1, its rate will presumably be the same. As a result, customer c pays less in fixed charges and more in usage charges that customer a from Example 1. Customer d who receives the call will pay nothing beyond the $10 per month for telephone service in state D.

c) Example3: Suppose state E, in order to further reduce fixed charges, establishes a fixed monthly charge of $5, a usage charge of $0.01 for each originating minute of use and a usage charge of $0.005 for each terminating minute of use. Suppose now that customer c from state C above calls customer e in state E using an IXC. Here the originating customer will still pay its ILEC $0.01 per minute for the call, as in example 2. Customer c must also pay the usual IXC rate as well. As a result, customer c pays the same as in Example 2. Customer e, however, receives the benefit of a smaller fixed charge of $5 per month, but must pay $0.005 per minute to its LEC, which terminates the call.

C. Advantages and Concerns

1. Advantages:

a) It simplifies separations and provides an inexpensive method for incumbent LECs to continue to operate in a dual jurisdictional environment. Some separations activities will remain, such as for expenses, but these can also be simplified.

b) It simplifies customer billing. It will eliminate the need for a "Subscriber Line Charge" to recover the federal portion of loop costs. It also eliminates the need for a separate universal service charge on SLC revenue.

c) It increases the ability of state commissions to adjust the mix between fixed and variable charges to match local conditions.

d) It eliminates access discrimination. It prohibits states and LECs from discriminating against interstate traffic in setting rates.

e) By redrawing jurisdiction lines, Option 5 would largely eliminate the distinction between intrastate and interstate calling. That is, an IXC-carried call will be subject to the same rules whether it terminates in the same or a different state. At the same time, there is an opportunity to eliminate entirely the increasingly artificial distinction between toll calls and local calls. If under the new system the IXC bills its retail customer for all but the originating facilities, it

doesn't really matter whether a call is "toll" or "local." What will matter more is whether a call is a one-carrier (ILEC only) call, or a multi-carrier call.

2. Concerns.

a) Universal service support. Is there political will to raise sufficient universal service support to keep rural rates reasonably comparable to those in urban areas? Will rural areas require advance guarantees of sufficient support? Will urban states take the risk that support might rise?

b) Universal service revenue. The FCC can collect universal service support only on "interstate" services. Does this proposal undercut the ability of the FCC to raise revenue for universal service?

c) Customer Acceptance.

(1) LEC charges will increase and IXC charges will decrease. Will this hurt any particular type of customer? Will it be acceptable?

(2) In some states, customers initiating inter-tandem calls may be required to pay two per-minute charges, one to the originating LEC for the state-separated facilities and another to the IXC for federal-separated facilities. Will this be acceptable?

d) Competitive issues.

(1) Will this plan create unexpected advantages or disadvantages for existing classes of carriers?

(2) How will this plan be implemented for competitive LECs? Will they be subject to the "no charge for state-separated property" rule?

e) Need for Legislation. Will this approach require statutory change, or can it be accomplished under existing statute?

(1) Must there be statutory change to give the FCC jurisdiction over intrastate inter-tandem facilities and calls?

(2) Is it statutorily permissible to assign all loop plant to the state jurisdiction?

(3) Should any of the four rate limitation rules be placed in statute?

(4) Can existing interconnection agreements that include reciprocal compensation payments be altered without legislation?

f) Constitutionality. Is it constitutionally permissible to assign all loop plant to the state jurisdiction? Do the constitutional requirements set forth in *Smith v. Illinois* still apply?

VIII. Option #6 - End of Separations - One Jurisdiction

A. Background

1. Maturing competition may replace regulation and make jurisdictional separations unnecessary, at least in some markets. However, it appears that so long as there are two jurisdictions and either jurisdiction sets a company's rates by any form of cost-based regulation, *Smith* requires that some form of separations continue. Therefore, it may be that separations can be totally eliminated only if all jointly-priced services are regulated by a single jurisdiction, that is, separations could end if all services subject to separations are tariffed only by the states or the FCC.

IX. Proposal 6A – One State Jurisdiction

A. Proposal.

1. Pricing policy, wholesale and retail, would be assigned to the states, subject to general FCC guidelines for all relevant areas similar to the jurisdictional split in authority currently applied to Unbundled Network elements (UNEs). States would be primarily responsible for consumer protection functions. All retail and wholesale tariffs and all interconnection agreements would be filed with the states, if the states so required. Costs would all be reported on a total state basis only, eliminating the need for any separations. Relevant prices would be set based on those total state costs, just as UNE rates are currently set. All end user rates would be subject to state ratemaking requirements. The End User Line charges and interstate access charges could be eliminated as separate charges. The FCC would no longer accept tariffs, but it might impose some limits or parameters for certain rates where there is a national network interest as well as a local interest. This might include limiting rates for terminating access and interconnection. National programs such as the Federal USF, NECA pools and Local Number Portability would remain under FCC jurisdiction.

B. Advantages

1. Federal-state separations would be eliminated.

a) Some cost allocations (separations) will still be required among states for multistate companies.

2. Lower regulatory cost.

3. Technology independent.

4. Single local and access rates - less confusing, easier to understand

5. Single point of contact for all pricing within each state.

6. States have historically been responsible for the majority of rate making, including intrastate access charges.

7. States would be in better positions to take into account different circumstances and implement policies that reflect those differences.

C. Disadvantages

1. Some method to protect users of interstate services will be needed.

2. Some state regulatory commissions may not have sufficient authority under state law to implement this option.

3. Individual state pricing policies could be inconsistent across the nation, potentially raising issues regarding (i) fair treatment of customers and carriers in different states and (ii) whether the overall networks between states will continue to be interconnected in an efficient and reasonable manner.

4. Policy variations among the states may make for a complex system that would be costly to maintain and audit.

5. The FCC may insist on more direct pricing jurisdiction.

D. Questions

1. Will it be politically tolerable to have all service rates set by state commissions?

2. Probably requires passage of legislation, at least altering section 152.

3. Can the FCC and the industry be given sufficient assurance that network operations won't be harmed?

X.Proposal 6B – One Federal Jurisdiction

A. Proposal.

1. This is the mirror image of Proposal 6A. Pricing policy, wholesale and retail, would be assigned to the FCC. The FCC would have the responsibility for setting all retail rates for services currently subject to separations.

B. Advantages

1. Consistent telecommunications and pricing policy throughout the nation.

C. Disadvantages.

1. The FCC would have to enormously scale up its rate review functions or the scope of rate review would be much more limited than at present.

2. It would be very difficult for the FCC to give proper weight to the myriad of cost and service differences between states and regions within states.

3. States may insist on more direct pricing jurisdiction.

XI. Option #7 - End of Separations - Competition Overtakes Regulation

A. Background

1. Given increasing competition in some telecommunications markets, it might be expected that a local exchange carrier may request exemption from rate regulation, and then from separations. Eventually, competition may develop to such an extent that it might be suggested that the separations system be eliminated entirely. A key issue will be the conditions under which that may happen.

B. Proposal

1. The FCC and the states would offer incumbent carriers that are facing effective competition for all regulated services the option of ending cost-based rate regulation in all jurisdictions. This includes some price caps, low-end adjustments, average schedule arrangements, and any other regulatory pricing systems based upon cost to serve. It requires the existence of sufficient competition to protect customers from uneconomic monopoly pricing, and to resolve any "provider of last resort" issues.

C. Advantages

1. Achieves competitive neutrality between ILECs and CLECs.
2. Eliminates separations studies and reporting.
3. Technology independent.

D. Disadvantages

1. Reduced ability to use regulated rates to pursue societal goals.
2. Determining the conditions under which a carrier may opt out of rate regulation will be controversial and time-consuming.
3. Requires a degree of competition that does not yet exist in the general telecommunications marketplace.

E. Questions

1. What minimum conditions should precede ending separations for a company?
   a) Permanent state price caps without resort to adjustments?
   b) Elimination of low-end adjustment on federal level?
   c) Waiving all confiscation claims in both jurisdictions?
   d) Deregulation at the federal or state levels (or both)?
2. Should there be certain tariffing or price list arrangements at state or federal levels?
3. How will ILECs continue to guarantee other obligations?
   a) Consumer protection?
   b) Universal service?
   c) Service quality?
   d) Emergency services?
   e) UNE and resale pricing?
4. Are federal-state jurisdictional separations required for the universal service fund? If so, what changes are needed if the separations process is eliminated?
5. There may remain some monopoly or near-monopoly services. For example, last-mile may remain a monopoly in many areas. Should this option be available only with concurrence by the state commission?

6. Should this option be LEC-initiated? Should state commissions be able to force an unwilling LEC into this option?

APPENDIX B

Separations Joint Board State Members' *Glide Path II Paper*

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Post-Freeze Options for Separations

State Members of the Separations Joint Board

The attached paper represents an update of the Glide Path paper that was originally published in 2001. Like the original Glide Path paper, this document is intended to promote discussion on the issues of instituting a post-freeze separations policy.

The five-year separations freeze now in effect is due to expire on June 30, 2006. If no action is taken, classical separations rules based on the Part 36, will be revived. This paper anticipates the end of the freeze and describes a number of legal, economic and technological changes to be considered. The paper further suggests some new options for separations that may better serve customers and industry alike. This list of options is not intended to make recommendations or draw conclusions as to what the ultimate course of action may be.

This paper is a product of the state members of the Separations Joint Board and should be read in that context. To the extent that positions are proffered and responses are requested, these come for the state members.

Some of the changes suggested in the paper are fundamental, and they require a careful analysis of the many associated legal, technical, and policy issues. We encourage all interested members of the public and the industry to provide their insights, concerns and recommendations on whether and how local exchange carrier revenues and costs should be jurisdictionally separated following expiration of the separations freeze.

Paul Kjellander - Commissioner

John Burke – Commissioner

Mark Johnson - Commissioner

Post-Freeze Options for Separations

A Paper Prepared by the State Members of the Separations Joint Board

Approved: October 25, 2005

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I. Introduction

A five-year interim separations freeze is in effect now. During the term of the freeze, cost separations factors are determined by network usage characteristics that were measured in 2000. For price cap companies, both factors and categories are frozen. For rate-of-return (ROR) companies, only factors are frozen. For these ROR companies, categories of property are not frozen although they can elect to freeze categories.

The freeze expires in June of 2006.[1] Unless some further action is taken, classical separations rules will then revive, based upon text still found in the FCC's Part 36 rules. The state members of the Separations Joint Board have prepared this paper to anticipate the end of the freeze. The paper describes a number of legal, economic and technological changes, most of which seem to reduce the desirability of reviving classical separations rules. The paper then suggests some new options for separations that may better serve customers and industry alike.

This paper is an update to the original "Glide Path" paper approved on December 17, 2001. It was prepared to help define those issues and to stimulate debate that, we hope, will lead to separations rules consistent with the evolving telecommunications world and that enhance rather than constrain consumer welfare and market development.

Some of the changes suggested below would be fundamental, and they require a careful analysis of the many associated legal, technical, and policy issues. We encourage all interested members of the public and the industry to provide their insights, concerns and recommendations on whether and how local exchange carrier revenues and costs should be jurisdictionally separated following expiration of the separations freeze.

II. Separations and the Modern Network

The telecommunications industry has continued to change dramatically, not only after the breakup of AT&T in the 1980's, but also since the separations freeze was instituted in 2001. Some of these changes seem likely to affect the most appropriate form for separations after the freeze. We summarize below some policy, technological, economic, and legal factors that we believe may affect the kinds of rules that should take effect in 2006 and thereafter.

A. Pre-Freeze Concerns

Even before the freeze, the separations system was frequently criticized. In 1998, the four state members then serving on the Separations Joint Board filed a paper stating, among other

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[1] *Jurisdictional Separations Reform And Referral To The Federal-State Joint Board*, CC Docket No. 80-286, "Report And Order," FCC 01-162 (rel. May 22, 2001).

things, that separations was cumbersome and "pretended to accuracy it could not achieve."[2] Usage-based factors control the separation of most switching and trunking costs, as well as associated expenses. But separations also relies on a "fixed factor" that applies to feeder and distribution networks and associated expenses.[3] For many companies, the fixed factor dominates cost separations because of the large proportion of costs tied up in distribution networks. Usage-based factors control a minority of costs while generating a majority of separations-related administrative expense. Despite its importance, the fixed factor was largely the result of a political judgment.

The 1998 paper also commented on the effect of the federal Subscriber Line Charge. It criticized separations for no longer providing a "forum for debate on the fundamental question of flat versus usage based charges."[4] The paper also asserted that separations is now "fundamentally disconnected from pricing decisions."[5]

Separations divides costs and revenues between the state and interstate jurisdictions, thereby distinctly allocating confiscation responsibility to the states and to the FCC. A second informal purpose, however, historically was to allocate network cost between fixed and variable charges. Before the 1980's, interstate costs had been chiefly recovered through per-minute usage charges imposed on the customers of AT&T's long-distance services. In contrast, state-separated costs were chiefly recovered through flat monthly charges set by state commissions. The effect was that an increase in interstate cost allocations allowed state commissions to reduce fixed monthly service rates. Later, a decrease in interstate allocations in some areas caused fixed rates to rise.

In 1983, however, the FCC established a fixed charge on telephone subscribers equal to interstate "non-traffic sensitive" costs.[6] On appeal, the court affirmed, holding that the FCC may require all telephone subscribers to pay, on a per-line basis, for "that portion of their necessarily-incurred local telephone plant costs assigned by separations to the interstate jurisdiction."[7] Originally, the "Subscriber line Charge" was limited to $3.50 per month for residential customers.

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[2] *State Members' Report On Comprehensive Review Of Separations*, filed in CC Docket No. 80-286 on December 21, 1998 (1998 Report) at 11. The 1998 Report was the subject of a public notice released by the FCC on February 26, 1999, DA 99-414.

[3] This factor allocates 25 percent to the interstate jurisdiction and 75 percent to the state jurisdiction.

[4] 1998 Report at 11.

[5] *Id.*

[6] *MTS & WATS Market Structure*, Third Report and Order, 93 F.C.C.2d 241 (1983), *aff'd, Nat'l Ass'n of Regulatory Utility Commissioners v. FCC*, 737 F.2d 1095, (D.C. Cir. 1984) (*NARUC v. FCC*).

[7] *NARUC v. FCC* at 1114.

In short, more than two decades ago the FCC adopted a fixed interstate charge that eliminated the primary informal purpose of separations. Today most end users pay two flat charges every month. The first is a state-set charge for state-separated costs, usually in the form of a "basic service" charge.[8] The second is a Subscriber Line Charge set by the FCC to recover a portion of interstate-separated costs, and that charge is now as much as $6.50 for residential customers. As a result, while a separations change may change the balance between the fixed federal charge and the fixed state charge, it is unlikely to significantly alter the total amount of fixed charges.

The freeze has not eliminated this concern. In 2001, shortly after the freeze had begun, the state members of the Separations Joint Board issued a "Glide Path" paper reiterating the same concerns.[9] In that paper, they asserted that, even as frozen, classical separations provided little benefit to end users. They stated that customers care little whether the charges on their bills are the result of federal or state action, but that they do care about the relationship between flat rated and usage-based charges. They also noted that customers are confused by "multiple charges and surcharges for what, to the customer, seems a single service."[10]

In its 2001 Freeze Order, the FCC stated that a comprehensive review of the separations process would continue during the freeze. The FCC committed itself to continuing during the freeze to work with the Joint Board on four issues: 1) Unbundled network elements; 2) Digital subscriber line (DSL) services; 3) Private lines; and 4) Internet traffic.[11] The FCC also committed itself to working with the Joint Board on a continuing basis to address the impact of the Internet and the resulting growth in local minutes.[12] Each of these issues could affect the kind of separations regime that should follow the end of the freeze.

B. Technology Changes

A number of technological developments might bear on what kinds of separations regime should follow the freeze.

Classical separations was based on the architecture of a circuit-switched network. It distinguished between central office equipment, the trunks that connect central offices, and the loops that connect customers to central offices. This was an appropriate design when network

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[8] Some states also impose a separate Subscriber Line Charge.

[9] "Options for Separations: A Paper Prepared by the State Members of the Separations Joint Board," CC Docket No. 80-286, filed December 18, 2001.

[10] *Id.* at 2.

[11] *Jurisdictional Separations Reform And Referral To The Federal-State Joint Board*, CC Docket No. 80-286, "Report and Order," FCC 01-162 (rel. May 22, 2001) ("*Freeze Order*"), para. 33.

[12] *Id.*, para. 42.

intelligence resided solely in switches found at central offices and when switches made a clear distinction between "line side" connections and "trunk side" connections.

The architecture of the modern network is evolving and becoming more complex. For example, the distinction between "line side" and "trunk side" ports is less clear. Some end users today purchase "trunk side" ports, and some communications providers purchase "line side" ports.

In addition, intelligence in the modern switched network is becoming more widely distributed. The network periphery has greater capabilities. For example, some remote platforms today are able to perform limited switching functions. Conversely, SS-7 switched networks can use signal control points hundreds of miles away to establish calling circuits. Even local or nearby calls can require access to regional and national databases, such as E-911 databases and number portability lookup tables. These network architecture changes suggest a need to review the assumptions underlying both separations measurement and cost allocation.

Consistent with the structure of federal law, separations also distinguishes between "local" and toll traffic. In some cases this distinction has little relation to technological reality. For example, in some states, "Extended Area Service" calls are rated as local calls, but they are routed as toll calls. These "local" calls can be routed through tandem switches dozens or hundreds of miles away from the end users, making them "local" in name only.

A significant portion of voice traffic today travels on packet networks, including Internet Protocol (IP) networks. IP networks do not even switch traffic in the classical sense of establishing a fixed path for a "call." Instead, IP networks use multiple routers, and related packets may travel over different paths. It may not be possible to develop a generally accepted method for measuring traffic on a network that is partly circuit-switched and partly packet-switched. Even if successful, such a system might impose unacceptable measurement costs.

During the freeze, telecommunications providers have sold increasing numbers of "special access" circuits. These lines are often used as backbones for other kinds of communications. Examples include providing links for wireless, private, and CLEC networks. Under existing separations rules, if the traffic on certain special access circuits is "contaminated" with as little as ten percent interstate usage, it becomes an interstate service. Under existing Part 36 rules, narrowband facilities dedicated to such lines should be directly assigned to interstate, and should not be retained in "common line" counts used for both intrastate and interstate services. For other special access circuits, the separations factors were based on usage factors that have been frozen since 2000 even though the nature of the traffic placed on these lines may well have changed (or may change as a result of intercarrier compensation reform). Following the freeze, the large number of these "special access" circuits suggests that their separations treatment should be carefully defined and monitored.

C. Economic Changes

A number of economic changes might bear on the most appropriate kinds of separations rules to follow the freeze.

Some telephone network costs have declined significantly over the past decades. Transport cost has decreased with the introduction of digital fiber trunks. Dramatically cheaper chips and computers have also reduced switching costs. Under classical separations rules, transport and switching usage was carefully measured; yet today these traffic sensitive costs often form a small (and still shrinking) share of a local exchange carriers' total cost. The cost of reinstituting usage measurements may not be justified by the incremental benefit.

Many telecommunications carriers today offer a variety of competitive and semi-competitive services. Separations applies only to costs that are not excluded under Part 64 of FCC rules, but those rules have not been revised since before Congress mandated local exchange competition. This may suggest that new rules are needed to exclude from separations some new classes of competitive facilities, expenses and revenues.

It may be desirable to reduce dependence on costly measurement techniques. Competitive LECs are not subject to separations. Incumbent LECs therefore may view separations costs as creating competitive disadvantage. Moreover, many ILECs have lost staff expertise needed for separations studies.

Telecommunications marketing has also changed significantly. Wireless carriers have been offering bundled packages for years that include local and toll calling. Now similar packages are widely available from wireline carriers as well. These packages typically make little or nothing of classical distinctions between toll and local traffic and between interstate and intrastate traffic. It may be desirable to avoid requiring measurements or defining categories of services that do not otherwise exist for business purposes. At the same time distinguishing between state and federal revenues may remain relevant for determination of assessment of state and federal universal service fund mechanisms, and in some cases, state tax assessments.

D. Legal Changes

A number of legal changes might bear on what kinds of separations regime should follow the freeze.

Some LEC carriers are today under price cap regulation in both the state and federal jurisdictions. In these states, separations results have little or no effect on rates or company revenues. In such states neither regulators nor LECs may have an incentive to expend resources on complying with strict separations rules. Of course, depending on the facts, a state or the FCC may still have a confiscation liability that, if asserted by the LEC, can still require the separation of costs and revenues.

Before the freeze, the FCC had found Internet Service Provider-bound communications to be an interstate service.[13] More recently, the FCC has found VoIP service to be interstate.[14] The first decision declared a local call terminating at an ISP to be jurisdictionally interstate. The second decision reached the same conclusion for a local call originating at an ISP. Neither decision included any separations changes. Classically, separations recorded all local traffic as intrastate even if it were IP related. Now, however, a substantial proportion of apparently local traffic is interstate. Following expiration of the freeze, it is not clear whether traffic measurement would or could address this new environment nor what adjustment to fixed or traffic sensitive factors would be appropriate to reflect the shift of jurisdiction of what formerly were intrastate services.

These two Internet decisions allow a new interstate service to serve as a functional substitute for intrastate toll services. This could erode intrastate toll and access revenues and change usage and cost characteristics of traditional local services such as business lines and Centrex lines. Either of these factors might justify a separations change following the freeze.

The two Internet decisions also suggest that the FCC may claim that an IP based network is solely within the federal jurisdiction. If an ILEC were to install a "soft switch" and convert its network to IP packets, its local traffic would be IP-based from end to end, and the FCC might view this traffic as interstate. Any post-freeze separations system may need to define rules for cost separations in this situation.

The FCC indicated in March of 2004 that it might impose some kind of access-like regime for termination of VoIP calls.[15] If this occurs, it would create a new class of revenue that would presumably be interstate. That could unbalance cost separations by exacerbating jurisdictional revenue-cost mismatches that already exist or by creating new mismatches. For example, intrastate toll revenues lost in the conversion to VoIP might not be replaced, and incremental state-separated costs arising from VoIP traffic might not be recoverable from VoIP customers.

Unbundled Network Element pricing occurs under a new hybrid form of jurisdictional structure. While the FCC sets general guidelines and methodologies for rate development, states must implement those requirements and must review the actual UNE rates. It is not clear whether LECs currently are directly assigning costs associated with such facilities to one jurisdiction or the other. It is also unclear whether they are directly assigning UNE revenues to

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[13] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, *Intercarrier Compensation for ISP-Bound Traffic*, CC Docket No. 99-68, Order On Remand And Report And Order, FCC 01-131 (rel. Apr. 27, 2001).

[14] *Vonage Holdings Corporation Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission*, WC Docket No. 03-211, Memorandum Opinion and Order, FCC 04-267, rel. Nov. 12, 2004.

[15] *Matter of IP Enabled Services*, WC Docket No. 04-36, FCC 04-38, released Mar. 10, 2004, para. 61.

the same jurisdiction as they are assigning costs. Any post-freeze separations system should probably clarify the acceptable practice in this area.

Other portions of the Telecommunications Act of 1996 may also affect, or be affected by, the separations process or rules. For example, Section 254(k) of the 1996 Act establishes a duty for the FCC and the states. It states:

> The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.[16]

Separations procedures were never adjusted to reflect these obligations. For example, Part 64, as applied, concentrates primarily on expense accounts and not investment accounts. This may not provide enough useful information to ensure compliance. Post-freeze separations rules may need to define a new approach to compliance with subsection 254(k).

The FCC has classified several services as "information services" under "Title I" since TA96. It is unclear whether costs of services classified as information service can legally be allocated or assigned to either the interstate or the intrastate jurisdiction, as the FCC's Part 36 jurisdictional separations rules are currently promulgated under Title II. If revenues are treated under Title I then associated costs should be removed from under Title II. It is unclear whether appropriated accounting treatment of these changes has been implemented.

E. Transition Issues

On June 30, 2006, the last day of the freeze, cost separations will still be based on traffic measurements made in calendar 2000. Any new substitute form of separations might also lead to substantially different factors. Even if current rules remain in force, 2006 traffic measurements might lead to considerably different separations factors. In either case a phase-in period might be useful.

During the freeze, LECs and state commissions have adjusted their staffing patterns. Anecdotally, it appears that most large ILECs have reduced or eliminated dedicated separations staff. Undoubtedly there has been a significant loss of separations expertise within the industry. Even when augmented by consultants, it may be difficult for these companies to pick up measuring traffic in 2006 where they left off in 2000.

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[16] 47 U.S.C. § 254(k).

III. Broad Questions

We seek comment on the best transition path or "*glide path*" that will take separations from the current regime under the freeze to whatever systems are needed in the new environment. Several questions need to be addressed. Most broadly, can Separations be abolished altogether? If so, what elements of separations, or other regulatory mechanisms would also need to change, if any?

We suggest here some broad goals that might guide the development of answers to these questions.

1. So long as there remain two jurisdictions, cost assignment should at least roughly follow jurisdictional authority and revenue assignment.
2. Separations should have a meaningful relationship to how costs are actually incurred.
3. Separations should be simpler and easier to administer and audit. It should have a lower overhead cost, but should retain a reasonable accuracy for any quantities that are still measured.
4. Separations should be capable of addressing new architectures and technologies and should respond suitably to the presence of competitive markets.
5. Part 32 accounting requirements and separations data collection requirements should be considered at the same time.

If separations procedures are reinstituted after the freeze expires, methods will be needed to avoid large transition costs or customer dissatisfaction. We seek comment on those methods.

IV. Post-Freeze Options

A. Option #1 – Allow The Freeze to Expire

The first proposal is to do nothing, thereby allowing the freeze to expire. This would revive all the requirements of Part 36 Rules, including the requirement that traffic be measured and that separations studies calculate various plant categories.

This option could better align the separation of costs and revenues with current operations. Continuing the freeze could exacerbate existing jurisdictional revenue-cost mismatches could create new ones.

A disadvantage of this approach is that it may substantially increase the administrative costs of ILECs. This could create a competitive disadvantage when compared to CLECs that are not subject to separations. It may also create implementation difficulties because of the loss of separations expertise during the freeze.

If network usage measurements are revived, rule changes might be desirable. These might include a way to address Internet-based traffic that is jurisdictionally interstate but is recorded as local intrastate traffic. Changes to Part 64 might also be needed, or another way needs to be found to exclude from the regulated operation of both jurisdictions the costs of nonregulated or non-Title II activities.

We seek comment on whether the freeze should be allowed to expire without extension. We also seek comment on any rule changes that should be made upon expiration of the freeze.

B. Option #2 – Extend The Freeze

The second proposal is to extend the freeze beyond June 30, 2006. This would allow ILECs to continue to avoid performing Part 36 separations studies. It would also avoid any possible cost dislocations that might follow from new usage factors. It also would delay any additional misallocation of costs that might arise from new measurements that misreport interstate Internet-related traffic as local-intrastate traffic.

A disadvantage of continuing the freeze is that the frozen factors, being based on 2000 usage, fail to reflect the effects of new or expanding technologies such as the Internet. Also, since no usage data are collected or reported under the freeze, policy-makers would continue to lack information about trends in network usage.

Continuing the freeze may not be legally valid. The courts afford substantial deference to an agency when it acts to maintain the status quo so that the objectives of a pending rulemaking proceeding will not be frustrated.[17] However, having already frozen separations for five years, the courts might not allow an indefinite freeze extension that is not subordinated to an active process for broader change. If the freeze is extended further, it may be necessary to describe now the outlines of a new post-freeze separations regime. A minimum extension would be preferable and probably should not exceed two years.

If the freeze is extended, some adjustments to existing factors may still be possible. A change could be made, for example, to fixed factors to account for new jurisdictional decisions and national usage changes.

It may be desirable to extend the freeze for a short period only, such as one year, anticipating restoration of traffic measurement. During this period, carriers would collect usage data that would provide a more accurate basis for new separations factors.

We seek comment on whether the freeze should be extended, and if so, for how long. We also seek comment on whether any rule changes should be made in conjunction with the extension, and in particular whether fixed factors should be adjusted to account for jurisdictional

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[17] *MCI Telecommunications Corp. v. Federal Communications Commission*, 750 F.2d 135, 141 (D.C. Cir. 1984).

or usage changes. We also seek comment on whether it is permissible to further extend the freeze for an additional period without otherwise defining what kinds of separations procedures would follow.

C. Option #3 – Use Fixed Factors

As noted above, many costs currently are separated using a fixed allocator, which assigns 25% of the costs to the interstate jurisdiction. Traffic sensitive costs, such as switching and trunking, are separated based upon factors like DEM and SLU that are derived from network usage. A third option is to apply one or more fixed allocators to traffic sensitive costs.

This third option eliminates traffic studies and simplifies audit and review of separations practices. If the factor were set statewide or nationally, that would simplify separations issues surrounding sale of exchanges.

Possible disadvantages include a loss of accuracy in separations factors. Separations may also be slower to respond to usage changes and to company-specific variations. A phase-in or transitional period might also be required.

We seek comment on the existing range and average of usage-based separations factors. We also seek comment on whether it would be advantageous to set factors at a scale smaller than the entire nation and whether generally accepted demographic factors could serve as proxy inputs to calculate fixed separations factors. We also seek comment on what conditions, if any, should be imposed if a carrier uses fixed factors. Finally, we seek comment on adjustments, if any, that should be made to universal service mechanisms.

D. Option # 4 – Use Fixed Rates and Residual Ratemaking

Not all incumbent local exchange carriers separate their costs according to the detailed procedures of Part 36. Many small carriers have been permitted to become "average schedule" companies. In place of performing a jurisdictional cost study, an average schedule company determines its interstate revenue requirement based on a simplified formula reviewed by the FCC. The courts have upheld this method of performing jurisdictional separations.[18]

In some states, the intrastate revenue requirements of average schedule companies are set using a "residual" or "total company" methodology. Such states consider all company costs, on an unseparated basis, and all revenues, including interstate revenues. Intrastate rates are set to allow the total company the opportunity to earn a reasonable return on its unseparated plant and expenses.

Under the fourth separations option, carriers would not report any embedded costs to the FCC, nor would they perform any traditional separations studies. Instead, the FCC would set

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[18] *See Crockett Tel. Co. v. Federal Communications Commission*, 963 F.2d 1564 (D.C.Cir., 1991).

rates for interstate services, and carriers would record the resulting interstate revenues from all sales. States could, if they wished, apply "residual" or "total company" ratemaking methods when setting intrastate rates.

A critical prerequisite for such a system is the ability of the FCC to develop just and reasonable rates. Without an interstate rate floor, the residual ratemaking system could create an incentive to reduce interstate rates and transfer all costs to the state jurisdiction.

It is a challenge to design an interstate rate floor when there is no interstate revenue requirement derived from separations. One possibility is to set rates based upon the output of a cost model such as the existing "average schedule" formula or an extension of the Hybrid Cost Proxy Model that has been used for universal service. Another possibility is to set rates based upon a price cap mechanism by which existing rates are adjusted incrementally. A third possibility would be some kind of collaborative state-federal rate-setting process.

The residual ratemaking option would eliminate individual company separations studies and reporting. The treatment of "average schedule" companies is similar, and it is well understood by the industry. This option also could avoid cost-revenue mismatches because all services over which the FCC sets rates would produce revenues, and intrastate services would pick up residual revenue requirements.

Under residual ratemaking, state commissions would have the opportunity to set rates, and any that did so would need adequate data, accounting, and cost allocation mechanisms. The FCC might need to change Part 32 rules or establish other minimum requirements on carriers. For example, a number of "state" or "interstate" accounts or subaccounts might be needed. Section 254(k)'s requirements limiting the allocation of joint and common facilities costs to universal service might also affect how costs are allocated.

The residual ratemaking option also has some disadvantages. If a cost model is used to set federal rates, that model may be controversial. Also, interstate rates might be too low to carry a fair share of the burden of supporting the network. The state jurisdiction could also become responsible for cost recovery of both state and interstate embedded legacy costs if the interstate jurisdictional cost assignment was based on a forward looking model.

We seek comment on whether a residual ratemaking methodology would be a suitable method of performing jurisdictional separations after June, 2006. We also seek comment on methods of calculating interstate rates that would protect both state and federal interests. If rates were set using a cost model, we seek comment on how that model best can be developed and maintained. We also seek comment on what changes the FCC would need to make to its data collection, accounting, and cost allocation requirements.

E. Option # 5 – Coordinate Separations Changes With Universal Service and Intercarrier Compensation Changes

Separations rules are related to at least two major policy areas currently being examined by the Commission. First, the FCC has sought and received comment has been sought on

revising the existing system of intercarrier compensation.[19] This proceeding raises significant federalism issues, not least because some commenters have encouraged the FCC to preempt the states from setting intrastate access rates. If any significant unification of intercarrier compensation does occur, it likely would strongly affect both existing separations rules and existing universal service rules.[20]

Second, the Universal Service Joint Board is currently considering whether and how to extend the existing rules for support of rural telecommunications carriers.[21] In addition, in early 2005 a federal court remanded for the second time the Commission's system of support for nonrural carriers.[22] These events, combined with other political forces in the Congress, conceivably could lead to substantial reforms of universal service systems.

It may not be possible to find an acceptable solution in any of these three policy areas, intercarrier compensation, universal service, and separations, without also solving the other two. Therefore, in deciding what should follow the separations freeze, one option is to work with the universal service joint board and other interest groups (including the NARUC Intercarrier Compensation Task Force) in developing a comprehensive solution to two, or ideally three, of these issue areas. One way to do this would be to use a joint conference.[23]

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[19] *See In the Matter of Developing a Unified Intercarrier Compensation Regime*, CC Docket No. 01-92, Further Notice of Proposed Rulemaking, FCC 05-33, released Mar. 3, 2005. The expiration date of the current freeze, June 30, 2006, is also the announced expiration date of the universal service system for rural carriers established in 2001 following the "Rural Task Force" report.

[20] For example, the National Association of Regulatory Utility Commissioners has filed a proposal with the Commission that would provide additional federal support to some carriers for a transitional period. That plan would in some ways blend intrastate and interstate jurisdictional revenue requirements, such as by allowing carriers to offset some intrastate revenue losses with Subscriber Line Charge increases.

[21] *In the Matter of Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Order, FCC 04-125, released June 28, 2004; Public Notice, FCC 04J-2, released August 16, 2004.

[22] *Qwest Comm. Intl. Inc. v. FCC*, 398 F.3d 1222, (10th Cir. Feb. 23, 2005).

[23] *See* 47 C.F.R. §, Appendix A to Part 1. The Rule states:

> Whenever there shall be instituted before the Federal Commission any proceeding involving the rates of any telephone or telegraph carrier, the State commissions of the States affected thereby will be notified immediately thereof by the Federal Commission, and each notice given a State commission will advise such commission that, if it deems the proceeding one which should be considered under the cooperative provisions of the Act, it should either directly or through the National Association of Railroad and Utilities Commissioners, notify the Federal Commission as to the nature of its interest in said matter and request a conference, the creation of a joint board, or a joint hearing as may be desired, indicating its preference and the reasons therefor. Upon receipt of such request the Federal Commission will consider the same and may confer with the commission making the request and with other interested commission, or with representatives of the National Association of Railroad and Utilities Commissioners, in such manner as may be most suitable; and if cooperation shall appear to be practicable and desirable, shall so advise each

F. Option # 6 – Eliminate Separations

Many commenters previously have advocated the end of separations while others argue that eliminating separations would be premature. The comments seeking the elimination of separations, however, have not always been clear about how this should be achieved. Absent statutory change, we tentatively conclude that the requirements of *Smith v. Illinois Bell* continue in effect.[24] In that 1930 case, the United State Supreme Court held that some form of jurisdictional separations is required. Subsequently, the courts have not agreed about whether that holding was based on the constitution. Regardless, some form of separations is clearly required under the jurisdictional structure established by the 1934 Communications Act.[25]

One scenario to eliminate separation is to recognize that competition has overtaken regulation, allowing separations to wither away. Although this scenario is appealing, the necessary pre-conditions seem quite demanding. At the least, permanent economic deregulation would seem to be a prerequisite. Both federal and state regulators would have to agree that there is no longer any need for the results of a jurisdictional separation process. Such a conclusion might apply broadly throughout a state or more narrowly in a smaller market, an urban core, for example.

Companies on price caps regimes are obvious candidates to be exempted from separations because of competition. However, price cap plans often include features such as periodic review based on earnings and low-earnings adjustments that presuppose the continued availability of separations results. Also, states may need separations data for other purposes, such as to operate universal service plans or for rate design purposes.

Constitutional issues also should be considered. Before separations could be abolished in an area, it may be necessary to determine formally that the affected carrier waives any potential confiscation claim. Concurrent consent by a state commission may also be desirable. There may also be a need for a triggering mechanism that clearly identifies when a carrier or an area served has passed beyond the need for, or the applicability of, some type of jurisdictional separations mechanism. For example, it is unclear whether the existence of a price cap plan or other "alternative regulation" plan in which rates are either deregulated or regulated less, will remove the possibility of a successful confiscation claim by an ILEC.

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interested State commission, directly, when such cooperation will be by joint conference or by reference to a joint board appointed under said sec. 410 (a), and, as hereinafter provided, when such cooperation will be by a joint hearing under said sec. 410(b).

[24] 282 U.S. 133 (1930)

[25] *Crockett*, above, 963 F.2d at 1571 (*Smith v. Illinois Bell* recognized a constitutional necessity for distinguishing between the jurisdiction of interstate and intrastate regulators.) *But see Id.* (*Smith* did not delineate the outer limits of congressional regulatory power under the Commerce Clause.)

We seek comment on whether we should establish a mechanism to declare that separations is no longer necessary in a particular market or for a particular carrier. We also seek comment on minimum conditions that should precede any such event.

APPENDIX C

Draft Data Request

A. General Instructions

1. When applicable, please list each account and sub account separately by Uniform System of Accounts (U.S.O.A.)[1] reference number.

2. To the extent your answers vary by state, subsidiary, or study area, please so indicate. You may submit more than one Data Request form if that will assist you to explain differences in responses between state operations, subsidiaries or study areas. If more than one form is filed, use Question B below to indicate those study areas included in the Data Request form.

3. Please respond for all of your cost company study areas.

B. Nature of Company

Please identify your cost company study areas and check the columns that apply to those study areas.

	Nature of Study Area			
Study area	Interstate Price Cap?	Interstate Rate of Return?	Frozen Categories & Factors?	Frozen Categories Only?

C. General Effect of the Freeze

1. When was the last year of operations for which your company(s) calculated, based on current network data, the usage sensitive factors used for state or interstate separations purposes?

2. Would the interstate factors have materially changed if the separations freeze were not in effect?

a) ____ Yes;

b) ____ No;

[1] 47 C.F.R. Part 32.

c) If Yes, please explain:

3. Has your company(s) benefited from or been harmed by the interstate separations freeze? If so, how?

D. Unbundled Network Elements (UNEs)[2]

1. Is your company(s) selling UNEs? _____

If No, please skip ahead to Section E.

2. Does your company(s) separately identify or track the embedded costs associated with your investment used to provide UNEs (answer separately for different UNEs, if answers differ)? ____

If so, please explain below:

a) UNE embedded costs are separately recorded in an account or subaccount created for that purpose _____;

b) UNE embedded costs are included in the following U.S.O.A. account(s) _____.

c) Are UNE embedded costs recorded in accounts (or subaccounts) that also are used for other, non-UNE purposes? _____.

d) How are UNE embedded costs recorded by jurisdiction? Purely interstate costs? Purely intrastate costs? Some interstate, some intrastate?

3. How does your company(s) treat revenues from sale of UNEs (answer separately for different UNEs, if answers differ):

a) UNE revenues are separately recorded in an account or subaccount created for that purpose _____.

b) UNE revenues are included in the following U.S.O.A. account(s) _____.

c) Are UNE revenues recorded in accounts (or subaccounts) that also are used for other, non-UNE purposes? _____.

d) How are UNE revenues recorded by jurisdiction? Purely interstate revenues? Purely intrastate revenues? Some interstate, some intrastate? Please explain below.

[2] *See* 47 U.S.C. §§ 251(c)(3), 252(d)(1); 47 U.S.C. § 271(c)(2)(B)(ii); and 47 U.S.C. §§ 271(c)(2)(B)(iv), (B)(v), and (B)(vi).

E. Wholesale: Resale at a Discount off Retail[3]

1. Does your company(s) provide services to a competitor through a wholesale discount, as provided for under Section 251(c)(4) of the Act? _____.

If No, please skip ahead to Section F.

2. Does your company(s) separately identify and track the embedded costs of provisioning wholesale services provided at a discount? If so, please explain below (answer separately for different wholesale services, if answers differ):

a) Embedded costs for wholesale services are separately recorded in an account or subaccount created for that purpose _____.

b) Embedded costs for wholesale services are included in the following U.S.O.A. account(s) _____.

c) Are embedded costs for wholesale services recorded in accounts (or subaccounts) that also are used for other, non-wholesale purposes? _____.

d) How are embedded costs for wholesale services recorded by jurisdiction? Purely interstate revenues? Purely intrastate revenues? Some interstate, some intrastate?

3. How does your company(s) treat revenues from wholesale services provided at a discount:

a) Revenues from wholesale services provided at a discount are separately recorded in an account or subaccount created for that purpose _____.

b) Revenues from wholesale services provided at a discount are included in the following U.S.O.A. account(s) _____.

c) Are revenues from wholesale services provided at a discount recorded in accounts (or subaccounts) that also are used for other, non-wholesale purposes? _____.

d) How are revenues from wholesale services provided at a discount recorded by jurisdiction? Purely interstate revenues? Purely intrastate revenues? Some interstate, some intrastate? Please explain below.

[3] *See* 47 U.S.C. §§ 251(c)(4), 252(d)(3).

F. Local Interconnection (other than UNE or Wholesale)[4]

1. Does your company(s) provide interconnection under Section 251(c)(2) of the Act (other than UNE or Wholesale)? _____.

If No, please skip ahead to Section G.

2. Does your company(s) separately identify or track the embedded costs associated with the investment used to provide interconnection? _____ If so, please explain below:

a) Interconnection-related embedded costs are separately recorded in an account or subaccount created for that purpose _____.

b) Interconnection-related embedded costs are included in the following U.S.O.A account(s) _____.

c) Are interconnection-related embedded costs recorded in accounts (or subaccounts) that also are used for other, non-interconnection purposes? _____.

d) How are interconnection-related embedded costs recorded by jurisdiction? Purely interstate revenues? Purely intrastate revenues? Some interstate, some intrastate?

3. How does your company(s) treat interconnection revenues:

a) Interconnection revenues are separately recorded in an account or subaccount created for that purpose _____.

b) Interconnection revenues are included in the following U.S.O.A account(s) _____.

c) Are interconnection revenues recorded in accounts (or subaccounts) that also are used for other, non-interconnection purposes? _____.

d) How are interconnection revenues recorded by jurisdiction? Purely interstate revenues? Purely intrastate revenues? Some interstate, some intrastate? Please explain below.

G. Digital Subscriber Lines (DSL)

Definitions:

For purposes of this question, "shared DSL" means that a customer buys traditional local exchange service from the telephone company and also buys high frequency DSL service from that same company or its affiliate or subsidiary.

[4] *See* 47 U.S.C. §§ 251(c)(2), 252(d)(1); 47 U.S.C. § 271(c)(2)(B)(i).

For purposes of this question, "solo" DSL means that a customer buys high frequency DSL service from the telephone company or its affiliate but does not buy traditional local exchange service from the same company.

If not otherwise specified, the term "DSL" refers to both solo and shared DSL.

1. Does your company or an affiliate or subsidiary offer DSL? _____

If No, please skip ahead to Section H.

2. How does your company treat revenue from retail DSL customers?

a) Retail DSL revenues are separately recorded in an account or subaccount created for that purpose _____.

b) Retail DSL revenues are included in the following U.S.O.A. account(s) _____.

c) Are Retail DSL revenues recorded in accounts (or subaccounts) that also are used for other, non-DSL purposes? _____.

d) How are retail DSL revenues recorded by jurisdiction? Purely interstate revenues? Purely intrastate revenues? Some interstate, some intrastate? Please explain below:

If your answers above differ depending upon whether the service is solo or shared DSL, please explain.

3. Unless explained earlier, how does your company treat revenues collected for DSL functions purchased by another carrier or an affiliate for resale?

a) ____ Resale DSL revenues are separately recorded in an account or subaccount created for that purpose.

b) ____ Resale DSL revenues are included in the following U.S.O.A. accounts _____.

c) Are Resale DSL revenues recorded in accounts (or subaccounts) that also are used for other, non-DSL purposes? _____.

d) How are Resale DSL revenues recorded by jurisdiction? Purely interstate revenues? Purely intrastate revenues? Some interstate, some intrastate, as explained below?

If your answers above differ depending upon whether the service is solo or shared DSL, please explain.

4. Does your company(s) separately identify or track the cost associated with loops used to provision solo DSL? ____. If so, please describe the assignment of that cost by jurisdiction.

a) ____ 100% is directly assigned to interstate;

b) ____ 25% is directly assigned to interstate;

c) ____ A different method is used, as explained below:

5. Does your company(s) separately identify or track the cost associated with loops used to provision shared DSL? ____. If so, please describe the assignment of that cost by jurisdiction.

a) ____ 100% is directly assigned to interstate;

b) ____ 25% is directly assigned to interstate;

c) ____ A different method is used, as explained below.

6. Does your company separately identify or track costs that are directly attributable to DSL service (e.g., line conditioning, Digital Subscriber Loop Access Module (DSLAM) investment)? _____. If so, please describe the assignment of that cost by jurisdiction.

a) ____ 100% is directly assigned to interstate;

b) ____ 25% is directly assigned to interstate;

c) ____ 100% is directly assigned to intrastate;

d) ____ A different method is used, as explained below.

7. Do you believe that complying with the freeze or other separations requirements have resulted in your company inappropriately assigning DSL costs or revenues between the jurisdictions? _____. If Yes, please explain:

H. Special Access Lines

Definitions:

For purposes of this section, "Special access lines" means both "private lines" and "special access lines", and includes "intrastate private lines," "interstate private lines" and "WATS lines." It includes both lines and "trunks," and it includes both wholesale and retail sales.

1. Has the reporting and cost separations for special access lines been working properly during the freeze?

2. Has complying with the freeze or other separations requirements caused your company(s) to assign special access costs or revenues to an incorrect jurisdiction? _____. If Yes, please explain:

3. Does your company(s) ever assign a special access line's costs to a different jurisdiction than that to which the revenues are assigned? _____. If Yes, please explain:

Given the FCC's 90%-10% rules classifying most mixed use special access traffic as interstate, how (from a jurisdictional standpoint) does your company classify embedded costs and applicable expenses for mixed-use special access circuits that have been classified as 100% interstate? Has the separations freeze affected your practice in this area? If so, please explain.

Given the FCC's 90%-10% rules classifying most mixed use special access traffic as interstate, how (from a jurisdictional standpoint) does your company classify revenues for mixed-use special access traffic? Has the separations freeze affected your practice in this area? If so, please explain.

I. Internet Traffic

Definitions:

For purposes of this section, "Internet Traffic" means traffic that terminates on your company(s) switched network that was originated on the Internet or that has passed through the Internet.

1. If you have reliable information, please estimate the nature of all the terminating traffic reaching your network (by minutes of use):

a) ____% Interstate toll usage subject to switched access charges.

b) ____% Intrastate toll usage subject to switched access charges.

c) ____% Circuit switched local usage.

d) ____% Wireless usage.

e) ____% Other (please specify: _____).

2. If you have reliable information, please estimate the extent to which Voice Over Internet Protocol (VOIP) calls either originate or terminate over the company's network?

3. If your company provides voice services using VOIP technology, are you recording the revenues for this service as:

a) ____ Non-regulated revenue.

b) ____ Interstate revenue.

c) ____ Intrastate revenue.

d) ____ A mix of interstate and intrastate revenue based on the origination and termination points of the call.

e) _____Other (please specify: _____).

4. If your company provides voice services using VOIP technology, are you recording the costs for this service as:

a) ____ Non-regulated costs.

b) ____ Directly assigned interstate costs.

c) ____ Directly assigned intrastate costs.

d) ____ A mix of interstate and intrastate costs based on the origination and termination points of the call.

e) _____Other (please specify: _____).

5. Have your costs increased as a result of Internet usage? Why? How much? In which jurisdiction are those costs being assigned?

6. If there had been no separations freeze, would Internet usage have increased your local exchange costs more than has actually occurred? If Yes, please explain.

J. Bundled Packages

Definition:

For purposes of this question, "Package" means a group of individual services or products offered to customers that includes at least one tariffed service (e.g., local calling or non-local services such as toll services), and sold for a fixed monthly price.

1. Services.

a) Do you offer bundled packages to your customers? _____. If Not, you are done with this questionnaire.

b) How many bundled packages do you offer that include both intrastate and interstate services?

c) What services or products have you packaged with local services?

2. Revenue

a) For your most popular bundled package, please list the revenue allocation for that service:
(1) ____% Unregulated revenue.
(2) ____% Intrastate revenue.

(3) ____% Interstate revenue.
(4) ____% Other (Please specify: _____).

b) How did you determine the percentages given in (a) above?

c) When your company sells services as part of a bundle for which the total price is discounted, please explain how your company allocates the discounts as between local exchange, intrastate toll and interstate toll revenues. Do you use a separate account or subaccount to record discounts associated with the bundle?

d) When your company sells services as part of a discounted bundle, how do you record the revenues? For example, do you record the amount paid by the customer directly, or do you record the sale at the undiscounted rates, then record the discount separately?

APPENDIX D

Final Regulatory Flexibility Certification

1. The Regulatory Flexibility Act of 1980, as amended (RFA),[1] requires that a regulatory flexibility analysis be prepared for rulemaking proceedings, unless the agency certifies that "the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities."[2] The RFA generally defines "small entity" as having the same meaning as the terms "small business," "small organization," and "small governmental jurisdiction."[3] In addition, the term "small business" has the same meaning as the term "small business concern" under Section 3 of the Small Business Act.[4] Under the Small Business Act, a small business concern is one that: (1) is independently owned and operated; (2) is not dominant in its field of operation; and (3) satisfies any additional criteria established by the Small Business Administration (SBA).[5]

2. In the instant Order, we extend the current freeze of the Part 36 category relationships and jurisdictional cost allocation factors for price cap carriers, and of the allocation factors only for rate-of-return carriers.[6] Among the underlying objectives of the freeze are to ease the administrative burden of regulatory compliance and to provide greater regulatory certainty for all local exchange carriers subject to the Commission's Part 36 rules, including some entities employing 1500 or fewer employees.[7] The extension of the freeze will continue the status quo that has existed since July 1, 2001, when the freeze originally became effective.[8] Moreover, the freeze has eliminated the need for all incumbent LECs, including incumbent LECs with 1500 employees or fewer (small incumbent LECs), to complete certain annual studies formerly required by the Commission's rules.[9]

3. This Order poses no additional regulatory burden on incumbent LECs, including small incumbent LECs. If this extended action can be said to have any effect under the RFA, it is to reduce a regulatory compliance burden for small incumbent LECs, by eliminating the aforementioned separations studies and providing these carriers with greater regulatory certainty. Furthermore, we note that the Commission specifically considered the impact of the freeze on small incumbent LECs (in general, rate-of-return carriers) in the *2001 Separations Freeze Order*, and provided them with the option to freeze

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[1] The RFA, *see* 5 U.S.C. §§ 601-12, has been amended by the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

[2] 5 U.S.C. § 605(b).

[3] 5 U.S.C. § 601(6).

[4] 5 U.S.C. § 601(3) (incorporating by reference the definition of "small business concern" in Small Business Act, 15 U.S.C. § 632). Pursuant to 5 U.S.C. § 601(3), the statutory definition of a small business applies "unless an agency, after consultation with the Office of Advocacy of the Small Business Administration and after opportunity for public comment, establishes one or more definitions of such term which are appropriate to the activities of the agency and publishes such definition(s) in the Federal Register."

[5] 15 U.S.C. § 632.

[6] *See* Order and Further Notice, *supra*, para. 15.

[7] *See* Order and Further Notice, *supra*, paras. 22-23.

[8] *See Separations Freeze Order*, 16 FCC Rcd at 11387, para. 9. *See also 1997 Separations Notice*, 12 FCC Rcd at 22170, para. 113.

[9] *See* Order and Further Notice, *supra*, paras. 22-23.

their category relationships at the onset of the freeze.[10] Our action, therefore, does nothing more than temporarily extend the status quo, which itself was certified not to have a significant economic impact on a substantial number of small entities.[11]

4. Therefore, we certify that the requirements of this Order will not have a significant economic impact on a substantial number of entities. The Commission will send a copy of the Order, including a copy of this final certification, in a report to Congress and the Government Accountability Office pursuant to the Congressional Review Act.[12] In addition, the Order and this certification will be sent to the Chief Counsel for Advocacy of the Small Business Administration, and will be published in the Federal Register.[13]

[10] *See id.*, 16 FCC Rcd at 11394, para. 21.

[11] *See 2001 Separations Freeze Order*, 16 FCC Rcd at 11408-10, paras. 56-59.

[12] *See* 5 U.S.C. § 801(a)(1)(A).

[13] *See* 5 U.S.C. § 605(b).

APPENDIX E

Initial Regulatory Flexibility Analysis

1. As required by the Regulatory Flexibility Act of 1980, as amended (RFA),[1] the Commission has prepared this present Initial Regulatory Flexibility Analysis (IRFA) of the possible significant economic impact on small entities by the policies and rules proposed in this Further Notice of Proposed Rulemaking (Further Notice). Written public comments are requested on this IRFA. Comments must be identified as responses to the IRFA and must be filed by the deadlines for comments on the Further Notice provided above in section V(F). The Commission will send a copy of the Further Notice, including this IRFA, to the Chief Counsel for Advocacy of the Small Business Administration (SBA). See 5 U.S.C. § 603(a). In addition, the Further Notice and the IRFA (or summaries thereof) will be published in the Federal Register.

A. Need for, and Objectives of, the Proposed Rules

2. In the *1997 Separations Notice*, the Commission noted that the network infrastructure by that time had become vastly different from the network and services used to define the cost categories appearing in the Commission's Part 36 jurisdictional separations rules, and that the separations process codified in Part 36 was developed during a time when common carrier regulation presumed that interstate and intrastate telecommunications service must be provided through a regulated monopoly.[2] Thus, the Commission initiated a proceeding with the goal of reviewing comprehensively the Commission's Part 36 procedures to ensure that they meet the objectives of the 1996 Act.[3] The Commission sought comment on the extent to which legislative changes, technological changes, and market changes might warrant comprehensive reform of the separations process.[4] Because over eight years have elapsed since the closing of the comment cycle on the *1997 Separations Notice*, and the industry has experienced myriad changes during that time, we ask that commenters, in their comments on the present Further Notice, refresh the record on the issues set forth in the *1997 Separations Notice*, and we seek comment on several new issues related to separations reform.

3. We seek comment on four issues relating to comprehensive separations reform. First, the Commission seeks comment on specific proposals for comprehensive separations reform advanced by the State Members of the Joint Board.[5] Second, the Commission seeks comment on a draft data request prepared by the State Members that is intended to elicit data that may be helpful in formulating a reformed separations process.[6] Third, the Commission seeks comment on the separations ramifications of four specific issues associated with the emergence of new technologies and local exchange service competition, including the appropriate separations treatment of: 1) UNEs; 2) DSL services; 3) private lines; and 4) Internet traffic.[7] Fourth, the Commission seeks comment on how the market adoption and

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[1] 5 U.S.C. § 603. The RFA, *see* 5 U.S.C. §§ 601-12, has been amended by the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

[2] *1997 Separations Notice*, 12 FCC Rcd at 22126, para. 9.

[3] *See id.*, 12 FCC Rcd at 22122, para. 2.

[4] *See id.*, 12 FCC Rcd at 22126-22131, paras. 9-19.

[5] *See* Order and Further Notice, *supra*, paras. 27-30.

[6] *See* Order and Further Notice, *supra*, paras. 31-32.

[7] *See* Order and Further Notice, *supra*, para. 33. *See also Separations Freeze Order*, 16 FCC Rcd at 11398, paras. 31, 33 (citing *Separations Freeze Recommended Decision*, 15 FCC Rcd at 13175, para. 27).

regulatory treatment of IP-enabled services, and other issues and proceedings before the Commission, may affect, or be affected by, comprehensive separations reform.[8]

4. Furthermore, we seek comment on clarifications sought by NARUC and by USTelecom as to direct assignment of investment categories and portions of investment categories during the freeze.[9]

5. The purpose of proposed separations reform is to ensure that the Commission's separations rules meet the objectives of the 1996 Act, and to consider changes that may need to be made to the separations process in light of changes in the law, technology, and market structure of the telecommunications industry.[10] Though the Commission originally proposed that competitive neutrality, administrative simplicity, and principles of cost causation should be the primary criteria for evaluating proposals for separations reform,[11] in the Further Notice we seek guidance on whether these criteria should be retained as the primary criteria, or whether other criteria should be balanced in addition to or in place of these criteria.

B. Legal Basis

6. The legal basis for the Further Notice is contained in Sections 1, 2, 4, 201 through 205, 215, 218, 220, 221(c), 254 and 410 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151, 152, 154, 201-205, 215, 218, 220, 221(c), 254 and 410; Section 706(a) of the Telecommunications Act of 1996, 47 U.S.C. § 157 nt; and sections 1.421, 36.1 and 36.2 of the Commission's rules, 47 C.F.R. §§ 1.421, 36.1, and 36.2.

C. Description and Estimate of the Number of Small Entities to Which Rules May Apply

7. The RFA directs agencies to provide a description of, and, where feasible, an estimate of the number of small entities that may be affected by the proposed rules, if adopted.[12] The RFA generally defines the term "small entity" as having the same meaning as the terms "small business," "small organization," and "small governmental jurisdiction."[13] In addition, the term "small business" has the same meaning as the term "small business concern" under Section 3 of the Small Business Act.[14] Under the Small Business Act, a "small business concern" is one that: (1) is independently owned and operated; (2) is not dominant in its field of operation; and (3) satisfies any additional criteria established by the Small Business Administration (SBA).[15]

8. We have included small incumbent LECs in this RFA analysis. As noted above, a "small

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[8] *See* Order and Further Notice, *supra*, paras. 34-37.

[9] *See* Order and Further Notice, *supra*, para. 38.

[10] *See 1997 Separations Notice*, 12 FCC Rcd at 22122, para. 2.

[11] *See id.* at 22132-36, paras. 22-31.

[12] *See* 5 U.S.C. § 603(b)(3).

[13] 5 U.S.C. § 601(6).

[14] 5 U.S.C. § 601(3) (incorporating by reference the definition of "small business concern" in the Small Business Act, 15 U.S.C. § 632). Pursuant to 5 U.S.C. § 601(3), the statutory definition of a small business applies "unless an agency after consultation with the Office of Advocacy of the Small Business Administration and after opportunity for public comment, establishes one or more definitions of such term which are appropriate to the activities of the agency and publishes such definition(s) in the Federal Register."

[15] 15 U.S.C. § 632.

business" under the RFA is one that, *inter alia*, meets the pertinent small business size standard established by the SBA, and is not dominant in its field of operation. Section 121.201 of the SBA regulations defines a small wireline telecommunications business as one with 1,500 or fewer employees.[16] In addition, the SBA's Office of Advocacy contends that, for RFA purposes, small incumbent LECs are not dominant in their field of operation because any such dominance is not "national" in scope.[17] Because our proposals concerning the Part 36 separations process will affect all incumbent LECs providing interstate services, some entities employing 1500 or fewer employees may be affected by the proposals made in this Further Notice. We therefore have included small incumbent LECs in this RFA analysis, although we emphasize that this RFA action has no effect on the Commission's analyses and determinations in other, non-RFA contexts.

9. Neither the Commission nor the SBA has developed a small business size standard specifically for providers of incumbent local exchange services. The closest applicable size standard under the SBA rules is for Wired Telecommunications Carriers.[18] Under the SBA definition, a carrier is small if it has 1,500 or fewer employees.[19] According to the FCC's Telephone Trends Report data, 1,303 incumbent LECs reported that they were engaged in the provision of local exchange services.[20] Of these 1,303 carriers, an estimated 1,020 have 1,500 or fewer employees and 283 have more than 1,500 employees.[21] Consequently, the Commission estimates that most incumbent LECs are small entities that may be affected by the rules and policies adopted herein.

D. Description of Projected Reporting, Recordkeeping, and Other Compliance Requirements

10. The Further Notice seeks comment on a draft one-time data collection designed to assist the Commission in evaluating whether to modify its separations rules, specifically, the Part 36 category relationships and jurisdictional cost allocation factors.[22] To assist the Separations Joint Board and the Commission in this regard, carriers would be requested to identify and explain the way in which specific categories of costs and revenues are recorded for accounting and jurisdictional purposes. The Commission seeks comment on alternatives to the data collection, including the draft data request's impact on small incumbent LECs.[23] Furthermore, we believe that incumbent LECs, including small incumbent LECs, would be able to readily obtain the required data at minimal additional costs. We believe that the information derived from a data request will be useful in assisting the Commission as it contemplates comprehensive separations reform, including evaluation of the possible impact of various reform efforts specifically on small incumbent LECs.[24] We emphasize that any data request that the

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[16] 13 C.F.R. § 121.201, NAICS code 517110.

[17] *See* Letter from Jere W. Glover, Chief Counsel for Advocacy, SBA, to Chairman William E. Kennard, FCC (May 27, 1999). SBA regulations interpret "small business concern" to include the concept of dominance on a national basis. 13 C.F.R. § 121.102(b).

[18] NAICS code 513310.

[19] 13 C.F.R. § 121.201, NAICS code 517110.

[20] FCC, Wireline Competition Bureau, Industry Analysis and Technology Division, "Trends in Telephone Service" at Table 5.3, page 5-5 (June 2005). This source uses data that are current as of October 1, 2004.

[21] *Id*.

[22] *See* Order and Further Notice, *supra*, para. 31.

[23] *See* Order and Further Notice, *supra*, paras. 31-32.

[24] *See* Order and Further Notice, *supra*, paras. 31-32.

Commission adopts looking towards comprehensive separations reform would be a one-time request.

E. Steps Taken to Minimize Significant Economic Impact on Small Entities, and Significant Alternatives Considered

11. The RFA requires an agency to describe any significant alternatives that it has considered in reaching its proposed approach, which may include the following four alternatives (among others): (1) the establishment of differing compliance and reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance or reporting requirements under the rule for small entities; (3) the use of performance, rather than design, standards; and (4) an exemption from coverage of the rule, or part thereof, for small entities.[25]

12. As described above, because over eight years have elapsed since the closing of the comment cycle on the *1997 Separations Notice*, and the industry has experienced myriad changes during that time, we ask that commenters, in their comments on the Further Notice, refresh the record on the issues set forth in the *1997 Separations Notice*. We also seek comment on specific proposals for comprehensive separations reform advanced by the State Members of the Joint Board, as well as a draft data request prepared by the State Members that is intended to elicit data that may be helpful in formulating a reformed separations process. For each of these issues and proposals, we seek comment on the effects our proposals would have on small entities, and whether any rules that we adopt should apply differently to small entities.

13. For instance, we ask that commenters specifically address how proposals for comprehensive separations reform advanced by the State Members, the *Glide Path Paper* and *Glide Path II Paper*, would affect small carriers, including rural incumbent LECs.[26] Furthermore, we particularly seek comment on the burdens of the draft data request on small carriers.[27] Moreover, we seek comment on whether there are alternatives to a data request to help the Commission educe the desired information, and on whether there is any way to streamline the draft data request without sacrificing its utility.[28] Finally, as a general matter, we direct commenters to "consider how costly and burdensome any proposed changes to the Commission's separations rules would be for small carriers, and whether such changes would disproportionately affect specific types of carriers or ratepayers."[29]

14. We also emphasize that several of our proposals in the Further Notice, if adopted, could have the effect of eliminating the separations rules in whole or in part. For example, we seek comment on whether there is a continued need to prescribe separations rules for either price cap or rate-of-return incumbent LECs.[30] In addition, several of the proposals in the *Glide Path Paper* and *Glide Path II Paper* call for simplifying separations procedures or eliminating separations altogether.[31] Implementation of these proposals would have the same ultimate effect as freezing the separations rules, namely, easing the administrative burden of regulatory compliance for LECs, including small incumbent LECs. As we

[25] *See* 5 U.S.C. § 603(c)(1)-(4).

[26] *See* Order and Further Notice, *supra*, para. 30.

[27] *See* Order and Further Notice, *supra*, para. 32.

[28] *See* Order and Further Notice, *supra*, paras. 31-32.

[29] Order and Further Notice, *supra*, para. 28.

[30] *See* Order and Further Notice, *supra*, para. 28.

[31] *See* Order and Further Notice, *supra*, paras. 11, 13, 29.

recognize in the final RFA certification in Appendix D, the freeze has eliminated the need for all incumbent LECs, including incumbent LECs with 1500 employees or fewer, to complete certain annual studies formerly required by the Commission's rules. If this extended action can be said to have any affect under the RFA, it is to reduce a regulatory compliance burden for small incumbent LECs, by eliminating the aforementioned separations studies and providing these carriers with greater regulatory certainty.[32] Thus, the Commission is considering several proposals that ultimately could lead directly to reducing the regulatory compliance burden for small incumbent LECs.

F. Federal Rules that may Duplicate, Overlap, or Conflict with the Proposed Rules

15. None.

[32] *See* Appendix D, *supra*, para. 3.

STATEMENT OF
COMMISSIONER MICHAEL J. COPPS

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

I agree with today's decision to extend the interim freeze of the Commission's Part 36 separation rules in order to provide stability to carriers as the Joint Board considers comprehensive reform of the jurisdictional separations process. I also support the Commission's decision to seek further comments on the jurisdictional separation process as much has changed with regard to network operations and telecommunications services since the Commission first initiated the separations freeze in 2001.

Congress directed the Commission and the Joint Board to work cooperatively to determine the methods under which incumbent telephone carriers apportion their regulated costs between interstate and intrastate jurisdictions. It is disappointing that the Commission was unable to overhaul the system in the last five years, and equally disappointing that we had to short circuit the ordinary process in order to issue this decision before the interim freeze expired on June 30. It is generally the practice of the Commission to refer matters under the Joint Board's jurisdiction to the Board to enable the Board to seek comment and issue a thorough recommendation to the Commission. Given the important role of the states and the value they bring to this process, I would have preferred to have had the benefit of even more extensive state input prior to reaching today's decision.

It is imperative that the Joint Board be given ample opportunity to participate and make recommendations to the Commission in the course of a comprehensive review of the process so that when the Commission moves ahead we will have the benefit of a full top-to-bottom recommendation from our state partners on the Joint Board.

STATEMENT OF
COMMISSIONER DEBORAH TAYLOR TATE

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

This is my first opportunity to work with both my former state colleagues and my Commission colleagues in my role as Joint Board Chairman. I thank the members of the Joint Board for seizing this opportunity for joint collaboration on this important issue. As is often the case, compromise made this possible, and I appreciate the willingness of all to meet in the middle in order to move forward.

Input from the state members of the Joint Board is important because they provide unique, on-the-ground experiences that can further enhance our decision making. Equally important is providing stability and predictability for carriers. I look forward to working with all members of the Joint Board as we refresh the record in this proceeding. In actuality, as technology has changed so dramatically, we can now make even better decisions with updated information in this digital age.