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

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

## NOTICE OF PROPOSED RULEMAKING

Adopted: **October 2, 1997** Released: **October 7, 1997**

Comment Date: December 10, 1997
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By the Commission:

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## I. INTRODUCTION

1. The Telecommunications Act of 1996 became law on February 8, 1996, making sweeping changes that affect all consumers and telecommunications service providers.[1] The intent of the 1996 Act is "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition."[2]

2. In this Notice of Proposed Rulemaking ("Notice"), we initiate a proceeding with the goal of reviewing comprehensively our Part 36 jurisdictional separations procedures to ensure that they meet the objectives of the 1996 Act, and to consider changes that may need to be made to the jurisdictional separations process in light of changes in the law, technology, and market structure of the telecommunications industry. Jurisdictional separations is the process of apportioning regulated costs between the intrastate and interstate jurisdictions. Carriers apportion the interstate regulated costs among their interexchange services and rate elements that form the cost basis for their exchange access tariffs.

3. Separations procedures have been performed by incumbent local exchange carriers ("ILECs")[3] since the Supreme Court found the "separation of intrastate and interstate property, revenues and expenses" to be "essential to the appropriate recognition of the competent governmental authority in each field of regulation."[4] Maintaining a jurisdictional separations system that distinguishes between dozens of cost categories is a difficult task that has been a high priority for the Commission throughout the years. One of the primary purposes of this process is to prevent ILECs from recovering the same costs in both the

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[1] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996) (codified at 47 U.S.C. §§ 151 *et. seq.*) ("1996 Act"). The 1996 Act amended the Communications Act of 1934. Hereinafter, the Communications Act of 1934, as amended, will be referred to as "the Act."

[2] Joint Statement of Managers, S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess. 1 (1996) ("*Joint Explanatory Statement*").

[3] For purposes of section 251 of the Act, a local exchange carrier ("LEC") is regarded as an "incumbent local exchange carrier" ("ILEC") for a specific area if, on the date of enactment of the 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. *Id.* § 251(h)(1). Pursuant to section 69.601(b) of our 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).

[4] *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133, 148 (1930).

interstate and intrastate jurisdictions. In *Smith v. Illinois*, the Supreme Court stated that "the proper regulation of rates can be had only by maintaining the limits of state and federal jurisdiction."[5] Therefore, to the extent that rates are subject to distinct jurisdictional limits, we seek comment in this Notice on whether some form of separations must exist under the 1930 *Smith v. Illinois* decision, or whether statutory, regulatory and market changes since that decision have been so pronounced and persuasive as to make its holding inapplicable in our new deregulatory environment. We also seek comment on how the separations rules should be reformed and whether the Commission is required by statute or case law to continue to prescribe such rules.

4. Section II of this Notice briefly describes our current separations procedures. We seek comment in Section III on the changes in law, technology, and market structure of the telecommunications industry affecting the separations process. Section IV of this Notice addresses comprehensive aspects of separations reform. In that Section, we initially seek comment on the criteria that should be used to evaluate the existing separations process and proposals to reform the process in light of the goals of our comprehensive review of the separations process. Next, we seek comment on whether separations rules are still needed during the transition period from a regulated to a competitive marketplace. We then seek comment on industry proposals to replace the existing Part 36 separations rules. Next, we evaluate our existing separations procedures. In addition, we seek comment on how various separations reform options would affect prices and revenue requirements. We also seek comment on whether and how to separate the costs associated with interconnection.[6] Finally, we request comment regarding changes to the separations rules that may be necessary as a result of the *Universal Service Order*[7] and the Communications Assistance for Law Enforcement Act ("CALEA").[8]

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5 *Id.* at 149.

6 Section 251 prescribes steps ILECs must take to open their networks to competition, including: providing interconnection; offering access to unbundled elements of their networks; furnishing transport and termination of competitors' traffic; and making their retail services available to resellers at wholesale rates. 47 U.S.C. § 251(c).

7 Federal-State Joint Board on Universal Service, *First Report and Order*, CC Docket No. 96-45, FCC 97-157 (rel. May 8, 1997) (*"Universal Service Order"*). *See also* Federal-State Joint Board on Universal Service, *Recommended Decision*, CC Docket No. 96-45, 12 FCC Rcd 87 (1996) ("*Universal Service Recommended Decision*").

8 Communications Assistance for Law Enforcement Act, Pub. L. No. 103-414, 108 Stat. 4279 (1994) (codified as amended in sections of 18 U.S.C. and 47 U.S.C.) ("CALEA"). Many of the requirements imposed by CALEA that may require changes to our separations rules take effect on October 25, 1998. 47 U.S.C. § 1001 note. *See also id.* § 229.

5. Pursuant to section 410(c),[9] we refer the issues raised in this Notice to the Federal-State Joint Board established in CC Docket No. 80-286 ("Separations Joint Board") for preparation of a recommended decision on these matters. We specifically defer issues relating to the jurisdictional treatment of long-term number portability costs to a future proceeding in this docket.

## II. BACKGROUND

6. Jurisdictional separations is the third step in a four-step regulatory process that begins with an incumbent local exchange carrier's accounting system and ends with the establishment of tariffed rates for the ILEC's interstate and intrastate regulated services. First, carriers record their costs into various accounts in accordance with the Uniform System of Accounts ("USOA") prescribed by Part 32 of our rules.[10] Second, carriers divide the costs in these accounts between regulated and nonregulated activities in accordance with Part 64 of our rules.[11] We require this division to ensure that the costs of nonregulated activities will not be recovered in regulated interstate service rates. Third, carriers separate the regulated costs between the intrastate and interstate jurisdictions in accordance with our Part 36 separations rules.[12] Finally, carriers apportion the interstate regulated costs among the interexchange services and rate elements that form the cost basis for their exchange access tariffs. For carriers subject to rate-of-return regulation, this apportionment is performed in accordance with Part 69 of our rules.[13]

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9 47 U.S.C. § 410(c).

10 47 C.F.R. Part 32.

11 The Part 64 cost allocation rules are codified at 47 C.F.R. §§ 64.901-904. By nonregulated activities, we mean activities not regulated under Title II of the Communications Act. Some regulated activities are treated as nonregulated activities for purposes of Part 64 cost allocation. *See* Accounting Safeguards Under the Telecommunications Act of 1996, *Report and Order*, CC Docket No. 96-150, 11 FCC Rcd 17539 (1996). Nonregulated activities generally consist of activities that have never been subject to regulation under Title II; activities formerly subject to Title II regulation that we have preemptively deregulated; and activities formerly subject to Title II regulation that have been deregulated at the interstate level, but not preemptively deregulated, that we decide should be classified as nonregulated activities for Title II accounting purposes. *See* 47 C.F.R. § 32.23(a).

12 47 C.F.R. Part 36. *See also MCI Telecommunications Corp. v. FCC*, 750 F.2d 135, 137 (D.C. Cir. 1984) (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.").

13 47 C.F.R. Part 69. We note that Part 61 of our rules prescribes the procedures for filing and updating interstate tariffs. *See id.* Part 61

7. Since 1930, the costs and revenues associated with facilities used to provide both intrastate and interstate telecommunications services generally have been allocated between the interstate and intrastate jurisdictions.[14] Cooperative efforts and studies undertaken by the industry, state regulatory agencies through NARUC, and the Commission beginning in 1941, were incorporated into what was popularly known as the NARUC-FCC Separations Manual in 1947.[15] Section 221(c) authorizes the Commission to prescribe a method for determining what property "shall be considered as used in interstate" service.[16] The Commission exercised that authority in 1969 by adopting a set of formal separations procedures that are now set forth in Part 36 of our rules and are used by approximately 700 carriers.[17]

8. The Commission substantially revised the separations rules in 1987 to make them consistent with revisions made to the Part 32 Uniform System of Accounts,[18] but the traditional costing methodologies underlying most of the separations procedures have changed little since our separations rules were first adopted in 1969.[19] Jurisdictional separations is currently based on the relative use of the telecommunications plant for interstate and for intrastate services.[20] The first step in the current separations process requires carriers subject to the rules to apportion regulated costs among categories of plant and expenses. Costs are sometimes further disaggregated among service categories. In the second step of the current

[14] *See Smith v. Illinois Bell*, 282 U.S. at 150.

[15] *See* American Tel. & Tel. Co., 3 FCC 2d 307, 309-311 (1966).

[16] 47 U.S.C. § 221(c).

[17] 47 C.F.R. Part 36. The carriers subject to our Part 36 rules include approximately 70 price cap ILECs and more than 600 cost of service companies. "Average schedule" companies do not perform separations. *See* discussion of average schedule companies in para. 41 *infra*. *See also* Mid-Plains Telephone Company, Inc., Petition for Declaratory Ruling Regarding the Commission's Part 36 Separations Procedures, *Memorandum Opinion and Order*, AAD 9-1939, 5 FCC Rcd 7050 (1990).

[18] The Commission adopted Part 36 in 1988 to replace Part 67. Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board, *Report and Order*, CC Docket No. 86-297, 2 FCC Rcd 2639 (1987); *Order on Reconsideration*, CC Docket Nos. 78-72, 80-286, and 86-297, 3 FCC Rcd 5518 (1988). The Part 32 rules are codified at 47 C.F.R. §§ 32.1-9000.

[19] *See* Prescription of Procedures for Separating and Allocating Plant Investment, Operating Expenses, Taxes, and Reserves Between the Intrastate and Interstate Operations of Telephone Companies, *Report and Order*, Docket No. 17975, 16 FCC 2d 317 (1969) ("*1969 Separations Procedures*").

[20] Relative use evolved as a basis for separating costs after the United States Supreme Court indicated that jurisdictional separations should not "ignore altogether the actual uses to which the property is put." *Smith v. Illinois*, 282 U.S. at 151.

separations process, the costs in each category are apportioned between the intrastate and interstate jurisdictions.[21] In both steps of the current separations process, most apportionments are based upon either direct assignment or a relative use factor.[22] In some cases, however, carriers may choose between direct assignment and a prescribed allocation factor.[23] For apportioning regulated costs among categories of plant, direct assignment is generally prescribed by the Part 36 separations rules because the costs of most telecommunications facilities are relatively easy to attribute to broad plant categories.[24] For apportioning costs between the intrastate and interstate jurisdictions, however, the separations rules generally prescribe allocation factors based on usage measurements because costs usually are not dedicated to intrastate or interstate services.[25]

## III. CHANGES THAT AFFECT THE SEPARATIONS PROCESS

9. Due to statutory, technological, and market changes in the telecommunications industry, today's network architecture and service offerings differ in many important ways from the network and services used to define the cost categories appearing in our current Part 36 separations rules. In addition, the separations process that was ultimately codified into the Part 36 rules evolved during a time when common carrier regulation presumed that intrastate and interstate telecommunications services must be provided through a regulated monopoly. In this Section, we discuss the legislative, technological, and market changes that require our comprehensive review of the Part 36 separations rules.

### A. Legislative Changes

10. Several provisions in the 1996 Act reflect Congress' intent "to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to

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

[22] *See id.* §§ 36.1(c) and 36.2(a)(1). *See also* Application for Review of the Common Carrier Bureau's Letter of Interpretation Regarding Clarification of the Role of Direct Assignment in the Jurisdictional Separations Process, *Memorandum Opinion and Order*, AAD 91-48, 8 FCC Rcd 1558 (1993) (carriers must use the allocation procedures prescribed by the rules unless the use of direct assignment is explicitly permitted by those rules).

[23] *See, e.g.*, 47 C.F.R. § 36.121(d).

[24] *See, e.g.*, 47 C.F.R. §§ 36.121(c) and 36.151(c).

[25] *See, e.g.*, *id.* §§ 36.123(b), (c), (d) and 36.154(e).

competition."[26] Section 251(d)(1) instructs the Commission to "establish regulations to implement the requirements of [section 251]" which include the obligations of ILECs to provide interconnection and access to unbundled network elements.[27] In addition, the 1996 Act states that any federal universal service support provided to eligible carriers should be explicit,[28] specific and predictable,[29] and recovered on an equitable and nondiscriminatory basis from all telecommunications carriers providing interstate telecommunications service.[30] Moreover, section 254(k) states that "a telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition."[31]

11. We note that this proceeding is one of a number of interrelated proceedings through which we intend to advance competition, reduce regulation in telecommunications markets and, at the same time, preserve and advance universal service to all Americans. In the *Local Competition Order* and related proceedings,[32] the Commission adopted rules to implement the pro-competitive, deregulatory, national policy framework envisioned by the 1996 Act.[33] Similarly, the *Universal Service Order* released by the Commission on May 8, 1997, adopted rules that create a universal service support system that will be sustainable in an increasingly competitive marketplace. In addition, the Commission adopted the *Access Charge Reform Order* as a companion item to the *Universal Service Order* in order to foster and accelerate the introduction of competition into all telecommunications markets.[34] We ask

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[26] *Joint Explanatory Statement* at 1.

[27] 47 U.S.C. § 251(d)(1).

[28] *Id.* § 254(e).

[29] *Id.* § 254(b)(5).

[30] *Id.* § 254(d).

[31] *Id.* § 254(k). *See also* Implementation of Section 254(k) of the Communications Act of 1934, as amended, *Order*, 12 FCC Rcd 6415 (1997) (codifying § 254(k) in Part 64 of the Commission's rules).

[32] Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, *First Report and Order*, CC Docket No. 96-98, 11 FCC Rcd 15499 (1996) ("*Local Competition Order*"), *Order on Reconsideration*, 11 FCC Rcd 13042 (1996), *Iowa Utilities Board v. FCC*, 120 F.3d 753 (8th Cir. 1997) *aff'd in part and rev'd in part*.

[33] *Joint Explanatory Statement* at 1.

[34] *See* Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges, *First Report and Order*, CC Docket Nos. 96-262, 94-1, 91-213, and 95-72, FCC 97-158 (rel. May 16, 1997) ("*Access Charge Reform Order*"). This separations proceeding is also related to our price cap regulations and our regulation of the interstate, interexchange

commenters responding to this Notice to bear in mind the relationship among these parallel proceedings when developing and explaining their proposals for separations reform.

**B. Technological Changes**

12. The telephone network has changed substantially since the jurisdictional separations rules were first established in 1947. At that time, virtually all services were voice-grade and the network was entirely analog.[35] Today, almost all telephone switching facilities, as well as interoffice transmission, have been converted from analog to digital.[36] The transition to digital technologies has resulted in the provision of voice and data services over the same network facilities. In addition, carriers have been deploying alternative network architectures, such as synchronous optical network ("SONET") rings, in order to improve the efficiency and reliability of their networks. We request comment on how the differences between today's network architecture and the network used to define the cost and service categories in the Part 36 rules should influence the Joint Board's review of the existing Part 36 separations rules.

13. The introduction of new network control technologies changes the way services are delivered and thus calls into question the validity of service distinctions specified in the separations rules. For example, some private line services, which traditionally have been delivered over unswitched circuits that are dedicated to individual subscribers[37] can be distinguished from switched message services (such as message telecommunications service), which are delivered over switched circuits that are not dedicated to individual subscribers.[38] Increasingly, however, the provision of private line service is accomplished through the creation of virtual private lines that actually involve a switched transmission path, transporting

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marketplace, as we explain *infra*. *See* Price Cap Performance Review for Local Exchange Carriers, *Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262*, CC Docket Nos. 94-1 and 96-262, FCC 97-159 (rel. May 21, 1997) ("*Price Cap Fourth Report and Order*"). *See also*, Policy and Rules Concerning the Interstate, Interexchange Marketplace, *Second Report and Order*, CC Docket No. 96-61, 11 FCC Rcd 20730 (1996) (detariffing nondominant interexchange carriers).

[35] "Voice-grade" defines a communications channel that can transmit and receive voice conversation in the frequency range of approximately 500 Hertz to 4000 Hertz.

[36] More than 93% of switching facilities for reporting ILECs are digital. This data was compiled from a review of filings of ARMIS Report 43-07 (1996) made by subject carriers. Hereinafter, references to data compiled from ARMIS Reports of all subject carriers will be in the form "FCC ARMIS Report 43-xx (19xx)."

[37] Private line service provides subscribers with a transmission path between specified locations for a continuous period or for regularly occurring periods at stated hours.

[38] Switched message services therefore enables many subscribers to use the same transmission path in succession throughout the day.

private line service calls together with switched service calls. Modern switches can provide subscribers with switched virtual private line service that, from the subscribers' perspective, is indistinguishable from traditional unswitched private line service. Accordingly, it may be unnecessary for our separations rules to distinguish between virtual private line services and switched message services that use the same transmission paths and switches. We seek comment on whether these and other technological changes and network improvements have blurred the service distinctions specified in the separations rules and require modifications to Part 36.

14. Not only are traditional services being provided in technically new ways but recent developments in technology have also resulted in many new telecommunications services. For example, consumer demand for high-capacity services, such as integrated services digital network ("ISDN") service,[39] has grown dramatically.[40] In addition, many ILECs have packet-switched networks, separate from, but overlaying, the older circuit-switched networks.[41] The former are used, among other things, to transport signaling messages outside the talk path, *i.e.*, on circuits that are separate from those used by voice calls.[42] In addition, the use of separate signaling circuits, called common channel signaling, enables carriers to provide a host of new services, including ISDN, Toll-Free Data Base, and CLASS™ services.[43] We seek comment on how the introduction of new telecommunications services has affected the utility of the Part 36 separations rules.

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39 The Integrated Services Digital Network ("ISDN") is a digital network that gives customers expanded, flexible access to existing and new voice and data services through a standard set of user-to-network and network-to-network interfaces. The two available ISDN access interfaces are Basic Rate Interface (providing two voice-grade channels plus a data channel) and Primary Rate Interface (providing 23 voice-grade channels and one data channel).

40 Basic and Primary Rate ISDN switched access lines in service increased from 66,513 in 1991 to 762,284 in 1996, representing a 1046% increase. *See* FCC ARMIS Report 43-08 (1991 and 1996).

41 Packet-switched networks use a switching technique in which data is divided into packets for routing through the network. Packet switching enables a single transmission path, *i.e.*, a circuit, to carry packets from many different customers during the same period. In contrast, circuit-switching dedicates a single transmission path to one customer for the duration of a call.

42 Similar to circuit-switched networks, packet-switched networks also transport customers' non-voice data transmissions, *e.g.*, the high-capacity service that Internet service providers acquire in order to transport their customers' combined, non-voice, data transmissions.

43 CLASS™ services offer features beyond that of other Custom Calling Services because the CLASS™ features are based on the transport of the calling party number through the common channel signaling network. CLASS™ services include anonymous call rejection, automatic callback, automatic recall, and caller identification.

15. Many new services have usage characteristics that raise doubts about the continued validity of the usage-based separations procedures established for older services. For example, older services such as voice transmission engage specific facilities for the duration of a call. As a result, our existing separations rules generally allocate equipment used for such services based on relative usage factors, such as relative minute-of-use measurements. Some newer services, such as caller identification, however, engage facilities only during the call set-up period. As a result, an allocation factor based solely on call-duration measurements may not yield reasonable separations results when applied to equipment used to provide such newer services.[44] We seek comment on the continued utility of the usage-based separations procedures in our current Part 36 rules.[45]

16. Further, the growth in the number of services offered, often using the same facilities, makes an increasingly larger share of telecommunications costs joint or common.[46] This suggests that separations procedures may need to place increased emphasis on the allocation of joint or common costs. We seek comment on whether the currently prescribed allocation procedures for joint and common costs should be superseded by procedures that better reflect the increased number, and wider variety, of services using shared facilities, and, if so, what those new procedures should be.

### C. Market Changes

17. Implementation of the 1996 Act, together with technological developments, is likely to accelerate competition in many telecommunications markets. Section 251 mandates that ILECs open their networks to competition by providing interconnection, offering access to unbundled elements of their networks, and making their retail services available at wholesale rates so that they can be resold.[47]

18. As a result of the changes required by the Act, and the rapid development of technology, individual carriers may, increasingly, provide interstate and intrastate long distance service as well as local exchange service. In fact, in some cases, these carriers may choose to market their services on a bundled basis, without respect to their jurisdictional nature. In addition, because some of these carriers may be required to comply with our

[44] A determination of what constitutes a reasonable separations procedure is a matter to be resolved in this proceeding. As explained in Section IV.A, this determination largely depends on the criteria used in evaluating alternative procedures.

[45] *See* discussion of this subject in Section IV. D(4)(b) *infra*.

[46] *See* discussion in Section IV.B for a definition of joint and common costs.

[47] *See* 47 U.S.C. § 251.

separations rules while others will not, this dichotomy may have a competitive effect in the telecommunications marketplace.

19. We therefore seek comment on whether the existing separations process may hinder competition, especially when carriers that are subject to our separations rules compete with carriers that are not subject to our separations rules. For example, our separations rules may hinder an ILEC's ability to compete by limiting its flexibility to recover costs according to market demand. While a competitive LEC is free to recover costs according to market demand, an ILEC subject to our jurisdictional separations rules may only attempt to recover costs classified as interstate through charges for interstate services, and costs classified as intrastate through charges for intrastate services. We also seek comment on whether our current separations rules may create incentives for such ILECs to improperly allocate costs to the jurisdiction in which they may have a greater opportunity to recover those costs through charges for less competitive services. We seek comment on other ways in which the existing separations process may hinder competition. We also seek comment on how proposed revisions to the separations process could address these concerns and promote the pro-competitive objectives of the 1996 Act.

## IV. SEPARATIONS REFORM

20. In this Section, we request comment on issues related to separations reform. As an initial matter we seek comment on the criteria that should be used to evaluate the existing separations process and proposals to reform the process in light of the goals of our comprehensive review of the separations process. Next, we seek comment on whether separations rules are still needed during the transition from a regulated to a competitive marketplace. We then seek comment on industry proposals to replace the existing Part 36 separations rules. Next, we evaluate our existing separations procedures. In addition, we seek comment on how various separations reform options would affect prices and revenue requirements. In addition, we seek comment on whether and how to separate the costs associated with interconnection. Finally, we seek comment on any changes to the separations rules that may be necessary as a result of the *Universal Service Order* and CALEA.

21. Those commenters advocating reform of the separations rules should submit proposed separations rules and identify amendments or deletions to our existing separations rules that would be necessary if their proposals were adopted. In addition, we also request comment on how our Part 36 rules should be amended to eliminate provisions that have become obsolete.[48] We also request that parties address whether a transition plan for separations reform is needed and propose any transitional measures that should be used.

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[48] For example, the terms of several of our separations rules have expired and are no longer applicable. *See e.g.*, *id.* §§ 36.125(c), (d), and (e).

Finally, we contemplate that following our receipt and analysis of the parties' initial and reply comments, we will issue a further NPRM that will more specifically focus on identifying proposed modifications to the separations rules. We invite the state members of the Joint Board to develop a report setting forth their analysis of the parties' comments and identifying issues and subjects to address in the further NPRM.

**A. Criteria for Evaluating the Separations Process**

22. The purpose of the separations process is to divide an ILEC's regulated costs into two jurisdictional categories (intrastate and interstate). Once those costs are identified, regulators in each jurisdiction can begin the process of determining just and reasonable rates. As discussed above, the goals of this proceeding are to review our Part 36 jurisdictional separations procedures to ensure that they meet the objectives of the 1996 Act,[49] especially the goal of promoting competition, 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.[50]

23. In order to evaluate whether our current separations rules and proposals to reform those rules meet the objectives of the 1996 Act and address the statutory, technological and market changes discussed in Section III, we propose that our existing separations rules and any proposals to reform our rules achieve a reasonable balance among the following criteria: (a) competitive neutrality; (b) administrative simplicity; and (c) principles of cost causation. We seek comment on whether these criteria should be applied to our review of the separations process, and, if so, how they should influence separations reform. We also invite commenters to propose additional or alternative criteria that further the goals of our comprehensive review of the separations process.

24. *Competitive neutrality.* We seek comment on whether, to promote competition, we should ensure that the separations process is competitively neutral. Competitive neutrality would require that separations rules not favor one telecommunications provider over another or one class of providers over another class. It would not, however, preclude carriers in dissimilar situations from being treated differently. In addition, the principle of competitive neutrality encompasses the concept of technological neutrality.[51] We seek comment on

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[49] The intent of the 1996 Act is "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition." *Joint Explanatory Statement* at 1.

[50] *See* discussion in Sections I and III.

[51] *See Universal Service Order* at para. 49.

whether competitive neutrality is consistent with the goals of our review of the separations process. Moreover, we seek comment on how we can assess whether the separations process allocates costs in a manner that is competitively neutral.

25. *Administrative simplicity.* We tentatively conclude that the principle of administrative simplicity, which calls for the elimination of unnecessary regulatory costs and burdens, is consistent with the goals of our review of the separations process. Interested parties proposing changes to the separations rules should consider how any changes would lessen the regulatory burden on both carriers and the Commission in furtherance of the 1996 Act's deregulatory national policy framework. We recognize that simplified separations procedures may, as a practical matter, allow subject carriers to maintain less-detailed cost data. This could reduce our ability to evaluate whether separations procedures are, in fact, attributing costs in conformance with the principles of cost causation, described below. Accordingly, we ask how best to achieve administrative simplicity in light of principles of cost causation, as well as any other proposed criteria.

26. *Principles of cost causation.* Generally, economic principles of cost causation dictate that costs should be attributed to their source whenever possible. The ability to attribute costs in a cost-causative manner depends on whether the costs are incremental, joint, or common.[52] When costs are incremental with respect to particular classes of services,[53] a

[52] Nearly all ILEC facilities and operations are used for multiple services. Some portion of costs nonetheless can be attributed to individual services in a manner reflecting cost causation. This is possible when one service, using capacity that would otherwise be used by another service, requires the construction of greater capacity, making capacity cost *incremental* to the service. The service therefore bears causal responsibility for part of the cost. The cost of some components in local switches, for example, is incremental (*i.e.*, sensitive) to the levels of local and toll traffic engaging the switch. Most ILEC costs, however, cannot be attributed to individual services in this manner because in the case of joint and common costs, cost causation alone does not yield a unique allocation of such costs across these services. The primary reason is that shared facilities and operations are usually capable of providing at least one additional service at no additional cost. In such instances, the cost is *common* to the services. For example, the cost of a residential loop used to provide traditional telephony services, usually is common to local, intrastate toll, and interstate toll services. In a typical residence, none of these services individually bears causal responsibility for loop costs because no service places sufficient demands on capacity to warrant installation of a second loop. Another reason why a relationship may not exist between cost and individual services is that some shared facilities or operations provide services in fixed proportion to each other, making the cost *joint* with respect to those services. ILEC billing costs, for example, tend to be joint with respect to local, state toll, and interstate toll services. For the majority of bills rendered, billed charges always include all three services. This fixed combination of services makes it impossible for one service to bear causal responsibility for billing costs.

[53] Our separations rules apportion costs among broadly defined classes of services, not among individual services. Because ILECs offer numerous services in each jurisdiction, and because the separations rules uniformly apply to ILECs having diverse cost structures, these rules are not intended to be sufficiently accurate to identify the costs incurred by individual services. State and federal regulators therefore use separations results

cost-causative relationship exists between costs and the individual service classes. Accordingly, the principle of cost causation would require that separations rules directly attribute such costs to individual service classes based on direct analysis of the origin of the cost whenever possible, or indirectly attribute these costs based on indirect, but cost-causative, links to the service classes. When costs are joint or common among several services, however, cost causation alone does not yield a unique allocation of such costs across these services. In a competitive market, costs that are joint and common between two services are borne more heavily by the service that is less price sensitive (more price inelastic). In practice, our separations rules allocate joint and common costs among service classes on some basis, such as relative-use measurements, or fixed factors that are relative-use surrogates and ignore price elasticity.

27. Because ILEC costs are predominantly joint and common between intrastate and interstate services, an important issue is how to separate joint and common costs. Economists have addressed this issue by comparing incremental cost to "stand-alone cost," defined as the forward-looking cost that an efficient entrant would incur in providing a service or group of services.[54] In the context of jurisdictional separations, stand-alone cost thus represents the total cost of constructing and operating facilities dedicated to a specific class of services.[55] In order to avoid cross-subsidization and the resulting inefficient investment incentives, the cost attributed to a given service class should be less than or equal to the stand-alone cost but greater than or equal to the incremental cost of that class.[56] Hence, these two measures of cost are the upper and lower bounds within which cost apportionment should fall. Costs of a service class may include incremental costs and any portion of joint and common costs that are allocated to that service class. Accordingly, economic efficiency requires that the amount of joint and common costs allocated to a given service class not exceed the difference between incremental and stand-alone cost.

28. This requirement likely would not be very limiting, however, when applied to the separations process. For interstate (or intrastate) services as a whole, the gap between

to evaluate earnings for groups of services, not for evaluating the pricing of individual services.

[54] *See Local Competition Order* at para. 698.

[55] *See* William J. Baumol and Robert D. Willig, Verified Statement before the Interstate Commerce Commission, *Ex Parte* no. 347 (sub-No. 1), *Coal Rate Guidelines: Nationwide* at 7 (July 28, 1983); see also William J. Baumol, John C. Panzar, and Robert D. Willig, Contestable Markets and the Theory of Industry Structure 352-352 (1982).

[56] Both incremental cost and stand-alone cost (which are usually expressed per unit of output) are greatly affected by the way we choose to define the increment and service class. The incremental cost of carrying an additional call from residences to end offices, for example, is virtually zero if the residences are already connected to end offices, but the incremental cost of establishing such connections is the cost of the loops.

incremental and stand-alone costs often equals approximately half of the total cost incurred to provide those services by a typical ILEC because a large portion of an ILEC's cost of providing interstate services is the cost of facilities that are common to the provision of both interstate and intrastate services.[57] Accordingly, when state and federal regulators use separations results only for evaluating an ILEC's overall level of earnings in each jurisdiction, as generally is the case for ILECs under price cap regulation, economic principles of cost causation can play only a minor role.

29. Such principles may be more useful, however, when state and federal regulators use separations results for evaluating an ILEC's earnings for each of several broad categories of services, *e.g.*, common line, transport, and switched services.[58] In such cases, a determination of cost causation may play an important role in separations reform because a service category could include costs that are predominantly traffic-sensitive (TS) and, hence, largely incremental to the group of services provided in each jurisdiction. If so, the large size of incremental costs relative to joint and common costs would mean that a relatively narrow range of acceptable allocation factors could be identified by the efficiency requirement, because the gap between incremental and stand-alone costs would be small. Moreover, the use of an allocation factor reflecting cost causation could have important pricing implications. Because regulators evaluate earnings at the level of broad service categories in this situation, a misallocation of costs to the category having TS costs would affect its earnings. This change in costs and earnings would affect prices only where a link exists between costs, earnings, and prices, as occurs under rate-of-return regulation. Where that form of regulation is used, the cost change could affect the category's general price level, resulting in a loss of economic efficiency if some customers are charged prices below incremental cost or above stand-alone costs. Even under price cap regulation, such a change could affect prices if regulators were to decide that a rebalancing of prices is warranted. Under the Commission's current form of price cap regulation, for example, separations changes could affect prices through low-end adjustments. We seek comment on our discussion of the principles of cost causation and ask whether parties share our views or have alternative or supplemental views to offer on our discussion of economic theory.

30. We also seek comment on whether principles of cost causation are consistent with the goals of this proceeding. If so, we seek comment on how we can assess whether the separations process attributes costs in a cost-causative manner. We further seek comment on

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[57] For example, ARMIS data indicates that loop plant investment in 1996 was 49% of total plant investment. *See* FCC ARMIS Report 43-04 (1996).

[58] *See, e.g.*, Annual 1988 Access Tariff Filings by GTE Operating Companies, *Order*, CC Docket No. 88-1, Phase II, 5 FCC Rcd 2150 (rel. March 28, 1990) (finding that projected interstate revenue requirements were miscalculated not for individual services but for two service classifications: local transport and special access).

how best to incorporate these principles into the separations process in conjunction with the criteria discussed in this Section, as well as any other proposed criteria.

31. *Other Criteria.* We also seek comment on any other criteria that could be reasonably employed in the separations process. In this regard, we seek comment on other regulatory principles or standards (such as relative-use measurements and fixed factors) that may offer a viable means of allocating costs between the interstate and intrastate jurisdictions in situations in which cost causation does not lead to a unique allocation of joint and common costs.

**B. Is There a Need For a Separations Process?**

32. The most fundamental question in this proceeding is whether separations rules are still necessary during the transition from a regulated to a competitive marketplace.[59] Specifically, we must determine whether the *Smith* doctrine is still applicable with the advent of competition or whether regulatory and market changes since that case was decided have so eroded the factual predicate of that decision that it is no longer pertinent. If there is still a need to allocate costs between jurisdictions, we must determine whether the Commission must prescribe the specific methodology for allocating costs, or whether the Commission could adopt a rule that would allow the carriers themselves to develop their own methods of separating costs under more relaxed regulatory supervision. In addition, we must determine whether companies regulated under federal price cap regulation should continue to perform jurisdictional separations. If the Commission and the Joint Board determine that the current form of separations does not comport with today's regulatory structure and technology, alternative methods of defining jurisdictional boundaries for costs and expenses must be developed so long as rates remain regulated.

**1. The Legal Basis for Separations**

33. Commenters advocating the elimination of separations rules entirely should specify how such an approach would be consistent with the Supreme Court's holding in *Smith v. Illinois*.[60] 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.[61] The Court held that when distinct jurisdictional limits exist as to the determination of reasonable rates, some form of jurisdictional separations must occur. The

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59 If we ultimately decide that the separations process is necessary today, we leave open the possibility of eventually considering whether separations will still be necessary once full competition is realized.

60 *Smith v. Illinois*, 282 U.S. 133 (1930).

61 *Id.* at 149.

Court also stated that "extreme nicety is not required" in such allocations.[62] The Court, however, established that "reasonable measures [are] essential" and indicated that such measures should not "ignore altogether the actual uses to which the property is put."[63] In light of this holding of the Court, we seek 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. We also seek comment on whether the holding in *Smith v. Illinois* is still relevant with the advent of competition, or whether market conditions have changed so drastically since that decision as to make its holding inapplicable in our new competitive environment.

34. Commenters addressing the elimination of separations rules should also address whether, and if so, how, the Commission could fulfill its duties under sections 201 through 205 of the Act in the absence of any separations process that would identify the jurisdictional costs for which a carrier may seek recovery. Commenters should also specify whether, and if so, how, in the absence of separations rules, the Commission could ensure that carriers do not seek to recover the same costs in both the interstate and intrastate jurisdictions. Commenters should also address whether the absence of separations might have any implications for anti-competitive pricing.

35. In addition, we seek comment on whether the Commission is required by *Smith v. Illinois* or any other authority to prescribe jurisdictional separations. We note that section 221(c) of the Act states that "the Commission *may* classify the property...used for wire telephone communication, and determine what property of said carrier shall be considered as used in interstate...service."[64] We tentatively conclude that while the state and federal jurisdictions are responsible for ensuring that rates are not confiscatory, the Commission is not required to prescribe a specific methodology for allocating costs between the jurisdictions. We seek comment on whether the Commission has authority to adopt alternatives to prescribing a specific methodology for allocating costs and whether such alternatives would likely yield, in both the interstate and intrastate jurisdictions, just and reasonable rates.

36. We also seek comment on whether *Smith v. Illinois* would permit the Commission to adopt a rule allowing carriers to determine on an individual basis how to allocate all or a portion of their regulated costs between the jurisdictions. For example, we seek comment on whether the Commission could adopt a rule allowing ILECs to determine on an individual basis how to allocate joint and common costs. Under this approach, the Commission would prescribe a specific methodology for separating only those costs that are

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[62] *Id.* at 150.

[63] *Id.* at 151.

[64] 47 U.S.C. § 221(c).

incremental to the intrastate and interstate jurisdictions. The ILEC could propose its own methodology to separate the balance of its regulated costs which are joint and common.

37. Commenters that support a less prescriptive approach to jurisdictional separations should consider how such proposals would affect the recovery of joint and common costs through carriers' rates, and whether some form of regulatory oversight would be necessary to ensure that joint and common costs are allocated in a manner that produces rates that are just and reasonable. In particular, we seek comment on whether a rule allowing ILECs to separate joint and common costs on an individual basis should be contingent on an ILEC's showing that competition exists in the local markets for which they seek relaxed separations regulation. If such a showing is required, we also seek comment on what level of competition would be required and what indicators should be used to measure the levels of competition in local markets, to ensure that joint and common costs are allocated in a manner that produces just and reasonable rates.

**2. Is There a Need for Separations Under Price Caps?**

38. Some companies claim that our prescribed jurisdictional separations process is no longer necessary because of federal price cap regulation[65] that applies to a large share of exchange access services.[66] These companies contend that under price cap regulation the reasonableness of rates for new or established interstate services generally are not based on separations results.[67] Approximately 70 ILECs, including all the Bell and GTE operating

[65] Under price cap regulation, prices cannot exceed certain prescribed limits that typically change annually based on an index reflecting changes in productivity, input costs, and other pertinent factors. The Commission's price cap plan uses a separate Price Cap Index ("PCI") for each service group. Individual prices within a service group may be changed if the price change meets certain constraints and if the proposed change does not cause the aggregate price for all services in the group to exceed the PCI for that group. The initial PCIs were set at 100 and corresponded to the costs and rates in effect as of July 1, 1990. *See* Policy and Rules Concerning Rates for Dominant Carriers, *Report and Order and Second Further Notice of Proposed Rulemaking*, CC Docket No. 87-313, 4 FCC Rcd 2873 (1989). The PCIs are adjusted on an ongoing basis to reflect three factors: (a) annual changes in the nationwide economy, as expressed in the gross domestic product price index ("GDP-PI"); (b) a productivity differential offset that recognizes the telecommunications industry to be more productive than the general economy; and (c) exogenous cost changes that have a unique or disproportionate affect upon ILECs, are beyond the control of carriers, and are not reflected in the inflation factor used to adjust price caps annually. 47 C.F.R. §§ 61.1-61.48.

[66] *See* Comments filed by Bell Atlantic and USTA in response to New England Telephone and Telegraph Company and New York Telephone Company, *Petition for Forbearance to Simplify Jurisdictional Separations*, AAD 96-66 (filed May 2, 1996) ("*NYNEX Petition for Forbearance*").

[67] *See* discussion of the NYNEX proposal to simplify the Part 36 separations process in Section IV.C.1.

companies, are now subject to federal price cap regulation.[68] These "price cap ILECs" serve at least 92 percent of total industry access lines and handle more than 94 percent of total industry access minutes.[69]

39. At present, however, price cap ILECs use the separations rules for several different purposes. First, some price cap ILECs use the separations rules to determine whether their interstate earnings are sufficiently low to qualify for a "low end adjustment." Under our Part 61 rules, a price cap ILEC is entitled under certain conditions to raise its price cap indices when its rate of return falls below a certain level, *i.e.*, the "low end" of a specified range of earnings levels.[70]

40. Second, price cap ILECs are required to adjust their price cap indices to reflect cost changes that generally are beyond their control and for which the price cap formula does not otherwise account. Carriers may also file adjustments to their price cap indices to reflect cost increases that generally are beyond their control and for which the price cap formula does not otherwise account. Our rules define such cost changes as "exogenous" and specify that they include, among other things, changes resulting from revisions to the jurisdictional separations rules.[71] To the extent that such cost changes have an effect on regulated services, price cap ILECs must separate the costs associated with the exogenous event. Furthermore, an interstate cost change that can be attributed to changes in our jurisdictional separations rules could be factored into the price cap formula, thereby affecting interstate service rates. Although the price cap indices of ILECs may be relatively unaffected by normal year-to-year variations in separations results, any significant changes in the way costs are separated

[68] The companies under federal price caps include the operating companies owned by the Bell holding companies, Citizens Utilities Company, GTE Corporation, and the Sprint Corporation. They also include Frontier Communications of Iowa and Minnesota, Alliant Communications Corp., Rochester Telephone Corporation, and Southern New England Telecommunications Corporation. These companies had a combined total of 71 operating companies in 1996. *See* 1996 Annual Interstate Access Tariff Filings submitted by company to the Commission on April 2, 1996.

[69] *See* 1995 data compiled from Universal Service Fund 1996 Submission of 1995 Study Results by the Nat'l Exchange Carrier Assoc., Inc., Oct. 1, 1996; Nat'l Exchange Carrier Assoc., Inc. Supplemental Report of Common Line Pool Results Reported as of November, 1996 (Feb. 28, 1997); USTA Statistics of Local Exchange Carriers, 1996.

[70] 47 C.F.R. § 61.45(d)(1)(vii).

[71] *Id.* § 61.45(d)(1)(iii).

resulting from this proceeding, under current price cap rules, would likely result in an exogenous change to the price cap formula.[72]

41. In addition, our current rules require price cap ILECs to perform separations for the purpose of reporting their annual interstate earnings to the Commission.[73] Moreover, ILECs that are subject to federal price cap regulation and state rate-of-return regulation use separations results to identify those costs subject to state regulation that enable the state commissions to assess the level of the ILECs' earnings on intrastate services.[74] In addition, states that have implemented price cap regulation may have included features in which reported earnings are relevant. We seek comment and discussion on whether there is a continued need to prescribe separations rules for ILECs operating under the existing price cap rules as modified by the *Access Reform Order* and the *Price Cap Fourth Report and Order*.

42. *Rate-of-Return ILECs.* More than 1200 ILECs (operating in approximately 1400 study areas) provide eight percent of the nation's access lines and remain under rate-of-return regulation.[75] These carriers concur in tariffs, administered by NECA, that are subject to federal rate-of-return regulation.[76] Approximately half of these ILECs use our Part 36 rules to separate their costs between intrastate and interstate operations because they settle with NECA on a cost basis; the remaining half do not directly use the rules because they settle with

[72] Changes in the separations process would not have an impact on ILECs operating under federal price cap rules if the Commission changed its definition of exogenous events to exclude changes in the separations process.

[73] 47 C.F.R. §§ 65.600(c) and (d).

[74] In 1996, approximately 24 percent of the billable access lines in the nation were served by carriers operating under price cap regulation in the federal jurisdiction and under rate-of-return regulation in their respective state jurisdictions. Total industry billable access lines for reporting ILECs was obtained from FCC Armis Report 43-01 (1996), Row 2150. We increased that number by 5 percent to account for the remaining nonreporting ILECs, thus obtaining an estimate for the ILEC industry as a whole. The federal price cap companies under state rate-of-return regulation were obtained from Table 148 of the Utility Regulatory Policy in the United States and Canada, National Association of Regulatory Utility Commissioners, Compilation 1995-1996, and from calls to state public utility commissions.

[75] Price cap regulation governs more than 92% of total ILEC access lines. This data is based on ILECs' 1995 and 1996 Annual Access Tariffs filed with the Commission.

[76] Each company participating in the tariffs administered by NECA charges the rates appearing in those tariffs, pools its revenues with other participants and receives an amount from the pools equal to its costs (or surrogate cost through average schedules) and its *pro rata* share of the pools' earnings.

NECA based on average schedules.[77] The Part 36 rules are taken into consideration, however, when NECA develops the average schedules.[78] Hence, our separations rules are used directly or indirectly by the more than 1200 ILECs under rate-of-return regulation.[79] Accordingly, we seek comment on whether there is a continued need to prescribe separations rules for ILECs operating under rate-of-return regulation.

### C. Industry Separations Proposals

43. A number of parties have criticized the Part 36 rules as being unnecessarily complex and burdensome, and several parties have proposed procedures to replace our current Part 36 rules. In this Section, we seek comment on the relative merits of several industry separations proposals.

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[77] Of the more than 1200 ILECs participating in the tariff administered by NECA, approximately half receive money from NECA based on their actual costs. *See* Universal Service Fund 1995 Submission of 1994 Study Results by the National Exchange Carrier Association, Inc. (Sept. 29, 1995). These ILECs are termed "cost settlement LECs" or "cost companies" because the Part 36 rules require them to perform numerous cost studies to separate certain types of costs. To avoid the expense of performing such studies, the remaining half of the ILECs participating in the NECA tariff use an informal separations process not codified in the rules. These small ILECs are commonly called "average schedule companies" because, for purposes of determining their interstate rates, they estimate some or all of their interstate costs using an average schedule. NECA develops that schedule based on generalized industry data that reflect the costs of a typical small ILEC. These average schedule companies may convert themselves to "cost companies" and receive compensation from NECA based on their company-specific costs. Once they make this election, however, they cannot later resume average schedule status. *See* 47 C.F.R. § 69.605(c).

[78] NECA is responsible for developing average schedule formulas that "simulate the disbursements that would be received . . . by a [cost study] company that is representative of average schedule companies." 47 C.F.R. § 69.06(a). Such a simulation is complicated by the fact that average schedule companies do not report cost and revenue data to NECA at the same level of detail as the cost companies. The formulas thus must be partially based on the separations results reported to NECA by cost companies in order for NECA to disaggregate the data of average schedule companies to the level of detail that cost companies use to comply with the Part 36 rules. Accordingly, the formulas reflect the application of the Part 36 rules to these cost companies. Typically in late December, NECA files modified average schedule formulas that they propose become effective the following July. In the time interval between December and July, the Commission reviews the filing to assure itself of the statistical integrity and accuracy of the proposed formulas.

[79] In addition to this group of more than 1200 ILECs that participate in the tariffs administered by NECA, a group of approximately 40 small companies file their own tariffs on a rate-of-return basis.

### 1. NYNEX Proposal

44. On May 2, 1996, NYNEX filed a petition for forbearance[80] under section 10 of the Act in which NYNEX advocated that all costs for each ILEC study area be jurisdictionally separated based on a single, frozen, interstate allocation factor.[81] Under this proposal, the frozen interstate factor would be the average percentage of total investment for that study area that had been allocated to the interstate jurisdiction during the period 1993-95.[82] NYNEX argues that this simple methodology is especially appropriate for price cap ILECs because the Commission's use of price cap regulation has broken the direct linkage between costs and prices, making the traditional separations process unnecessarily complex.[83] NYNEX also argues that the growth of competition has diminished the significance of separated costs in pricing.[84] Moreover, NYNEX contends that its proposal comports well with legal precedent, including *Smith v. Illinois*.[85] NYNEX asserts that a fixed factor based on interstate investment is consistent with *Smith v. Illinois* because the Court did not require an exact apportionment reflecting use, and that its proposal "reasonably and practically apportions amounts between the jurisdictions."[86]

45. NYNEX states that the current separations rules have produced fairly consistent results in recent years.[87] In particular, NYNEX observes that nationwide interstate usage between 1991 and 1993 changed only five basis points, decreasing from 14.37 percent to 14.32 percent.[88] Nonetheless, NYNEX contends that future separations results may not be so stable and predictable because selective competitive losses in one jurisdiction could cause costs to shift to the other jurisdiction as a declining demand for services in the first

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80 *NYNEX Petition for Forbearance*; New England Telephone and Telegraph Company and New York Telephone Company, *Public Notice*, DA 96-959 (rel. June 17, 1996) (soliciting comments on the NYNEX petition); *Order*, 12 FCC Rcd 2308 (1997) (denying the NYNEX petition and incorporating the issues raised by NYNEX into this proceeding).

81 *See NYNEX Petition for Forbearance* at 3-5.

82 *Id.* at 3.

83 *Id.* at 5.

84 *Id.*

85 *Id.* at 12.

86 *Id.*

87 *Id.* at 5-6.

88 *Id.*

jurisdiction alters the relative-use factors that are used as a basis of allocation under the current rules.[89] According to NYNEX, these jurisdictional shifts would be undesirable because their magnitude and direction would be unpredictable.[90] NYNEX further contends that many of the costs that are separated based on relative-use factors (and, hence, are likely to shift jurisdictionally as demand changes) are joint and common costs that are not directly related to the service lost to competitors.[91]

46. Moreover, NYNEX asserts that an examination of several expense and investment-related separations factors revealed that, in the aggregate, the combined result of using multiple factors did not differ significantly from the result of using the single fixed factor it proposes.[92] NYNEX estimates that, if its proposal were applied to all the ILECs filing ARMIS reports with the Commission, less than $80 million (only 0.3 percent of a base of $24.2 billion) would be shifted to the interstate jurisdiction.[93] Accordingly, NYNEX concludes that the use of a single factor simplifies the separations process without yielding significant differences in the separations results.[94]

### 2. BellSouth Proposal

47. Similar to NYNEX, BellSouth Corporation and BellSouth Telecommunications, Inc., ("BellSouth") propose separations rules that rely entirely on frozen interstate allocation factors.[95] While supporting NYNEX's objective of simplifying the separations process, BellSouth states that the single-factor approach proposed by NYNEX would not be the best solution for all price cap ILECs.[96] BellSouth suggests that a two-factor approach, using separate factors for investment and expenses in each state, may be more appropriate for some carriers because its implementation would result in a smaller shift in costs between the intrastate and interstate jurisdictions.[97]

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89 *See id.* at 9.

90 *Id.*

91 *Id.*

92 *Id.* at 7.

93 *Id.* at 6-7.

94 *Id.*

95 BellSouth Comments on *NYNEX Petition for Forbearance* (filed Aug. 5, 1996) at 2.

96 *Id.* at 1-2.

97 *Id.* at 2.

### 3. Southwestern Bell Proposal

48. Southwestern Bell Telephone Company ("Southwestern Bell") proposes a separations procedure that consolidates the several dozen plant and service categories in our existing separations rules into four cost categories: loop; trunk; switching; and operator systems.[98] Under this proposal, expenses and taxes would be apportioned among the four categories, making additional categories unnecessary for those costs.[99] According to Southwestern Bell, this approach provides more meaningful cost detail than the single-factor approach proposed by NYNEX and represents more clearly the relative use of primary facilities by the intrastate and interstate jurisdictions.[100] Southwestern Bell does not suggest a specific allocation procedure for jurisdictionally separating the costs in any of the four categories. Southwestern Bell does suggest, however, that the allocation factor for each category be frozen after its approach has been used long enough for jurisdictional allocations to stabilize.[101]

### 4. Request for Comments

49. We seek comment on the industry separations proposals described above. Specifically, we ask whether any of these proposals achieve the goals of this proceeding and meet the criteria discussed in Section IV.A. or other proposed criteria. We request comment on whether any of these proposals should be used as a general separations proposal applied to all ILECs or, perhaps, only to the price cap ILECs. In particular, we ask commenters to consider how costly and burdensome any of these industry separations proposals would be for small carriers.[102] We specifically invite comment on NYNEX's claim that fixed allocation factors could play a far more significant role in the separations process without resulting in unreasonable rates because many costs that are now separated based on relative-use factors

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[98] Southwestern Bell Comments on *NYNEX Petition for Forbearance* (filed Aug. 5, 1996) at 4. Southwestern Bell, however, does not believe separations reform should be undertaken at this time. Instead, it recommends waiting until three related proceedings, interconnection, universal service, and access charge reform, are substantially complete. *Id.* at 2.

[99] *Id.*

[100] *Id.*

[101] *Id.* at 4-5.

[102] In several instances, our rules have been modified to avoid imposing unreasonable costs or burdens on small companies. For example, the accounting requirements for small carriers in Part 32 are more streamlined. *See* 47 C.F.R. §§ 32.11 and 32.13.

are joint and common costs that are not related to service usage.[103] Moreover, we invite comment on whether freezing existing interstate allocation factors based on current separations allocators, as proposed by NYNEX and BellSouth, would adequately reflect the goals of this proceeding and would meet the criteria discussed in Section IV.A. or other proposed criteria. In addition, we ask whether freezing existing allocation factors would adequately reflect changing use of the telecommunications network, such as increased Internet use.

50. We invite commenters to suggest other approaches to separations. One alternative is a separations procedure that freezes carriers' overall jurisdictional allocation factors at the existing levels, as in the NYNEX proposal, and applies multiple frozen factors in each study area, thus allowing a study area's overall interstate assignment to vary in response to changes in the relative share of total cost that is attributed to various facilities or operations. Another alternative is a separations procedure that initially freezes carriers' overall jurisdictional allocation factors at the existing levels, as in the NYNEX proposal, but then adjusts those allocation factors in subsequent periods to reflect changes in relative intrastate and interstate usage or changes in intrastate and interstate revenues. We seek comment on the relative merits of other separations proposals in light of the goals of this proceeding and the criteria discussed in Section IV.A. or other proposed criteria.

**D. Review of Existing Separations Procedures**

51. In this Section, we review our existing separations procedures. First, we seek comment on whether the current definition of "study areas" should be revised. Second, we seek comment on how our Part 36 cost categories should be defined. Third, we seek comment on how costs should be apportioned among Part 36 cost categories. Fourth, we seek comment on how the categorized costs should be separated between the jurisdictions. We ask that commenters discuss whether and how our existing separations procedures and any proposed changes to those procedures achieve the goals of this proceeding and meet the criteria discussed in Section IV.A. or other proposed criteria. We also request that commenters consider how costly and burdensome any proposed changes to our separations rules would be for small carriers.

**1. Defining Study Area**

52. We seek comment on whether to change the current definition of "study area." A study area is a geographical region generally composed of a telephone company's exchanges within a single state. There are instances, however, where telephone companies

[103] *NYNEX Petition for Forbearance* at 1, 9.

own and operate more than one study area within a single state.[104] The definition of a study area is significant for Part 36 separations purposes because ILECs calculate their costs and perform jurisdictional separations at the study area level.

53. The Separations Joint Board recommended, and the Commission adopted, a freeze of telephone companies' study area boundaries as they existed on November 15, 1984.[105] The Commission took that action primarily to prevent companies from subdividing study areas in a way that would create isolated high cost areas and increase the high cost support provided under Part 36.[106] Another effect of the freeze, however, has been to prevent changes in study areas for other reasons, such as the sale of local exchanges, unless a waiver of the study area definition is obtained. This has led to numerous waiver requests which, in turn, raise the question of whether the Commission's 1984 decision continues to serve the public interest.

54. We seek comment on whether a revised definition of study area would eliminate the need for study area waivers. We tentatively conclude that changing the definition of study area from the current frozen study area as of November 15, 1984, to "the common carrier operations of affiliated companies within a single state" would eliminate the need for such waivers.[107] Under this proposal, a carrier's study area boundaries would change automatically as exchanges are bought and sold.[108] We seek comment on the above tentative conclusion and on any other proposal to change the current definition of study area. We also seek comment on whether an ILEC that expands its territory to compete with another carrier in the same state should calculate its costs based on two separate study areas, one for the area where the carrier is the incumbent and one for the area in which the carrier is a new

[104] *E.g.*, US West operates two study areas in Oregon and two study areas in Colorado; GTE operates two study areas in Texas and two study areas in Missouri.

[105] MTS and WATS Market Structure, Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, *Recommendation to the Commission*, CC Docket Nos. 78-72 and 80-286, 49 Fed. Reg. 48325 (Dec. 12, 1984), adopted by the Commission, *Final Rule*, 50 Fed. Reg. 939 (Jan. 8, 1985) ("*Rule Freezing Study Area Boundaries*").

[106] *See Rule Freezing Study Area Boundaries*, 50 Fed Reg. at 940.

[107] "Affiliated companies" means companies that directly or indirectly, through one or more intermediaries, control or are controlled by, or are under common control with, the accounting company. 47 C.F.R. § 32.9000, Subpart G.

[108] Under the new universal service rules, a carrier making a binding commitment on or after May 7, 1997 to purchase a high cost exchange, will receive the same level of support per line as the seller received prior to the sale. *See Universal Service Order* at para. 308. This rule was adopted to discourage carriers from placing unreasonable reliance upon potential universal service support in deciding whether to purchase exchanges from other carriers. *Id.*

competitive entrant. If a carrier were to calculate its costs based on two separate study areas, we seek comment on how costs that are common to both areas should be separated. We also seek comment on whether any revisions to the study area definition would significantly shift costs between the jurisdictions and what impact such revisions would have on revenues.

**2. Defining Cost Categories**

55. If we continue to require separations but modify the current rules, a fundamental issue is whether the existing set of plant, expense, and service categories should be revised to reflect more accurately the manner in which plant costs and expenses are incurred in providing the wide variety of services carriers provide today. The purpose of the separations rules is to distribute costs between the federal and state jurisdictions, not to individual services. This implies that there may be no need to disaggregate the costs in a plant category further into several service categories if the rule applied to separate these costs is the same for each service category.

56. The current rules for categorizing cable and wire facilities ("C&WF") costs, for example, require *exchange line* costs to be disaggregated between voice-grade and wideband services but do not require *exchange trunk* costs to be disaggregated in this manner. The exchange line costs must be divided between these two service classes because their separations treatments differ. Whereas the exchange line costs attributed to voice-grade services are jurisdictionally separated based on a fixed factor, the costs attributed to wideband services are either directly assigned or allocated based on relative minutes-of-use measurements.[109] Exchange trunk costs, however, are not divided between these two services, because the current separations treatment is the same regardless of whether such costs can be attributed to voice-grade or wideband services.[110]

57. Presently, a "wideband channel" is defined as "a communication channel of a bandwidth equivalent to twelve or more voice-grade channels."[111] The distinction between wideband services and voice-grade services in our separations procedures was jointly established by the Commission and NARUC in the 1947 Separations Manual long before the

[109] *See* 47 C.F.R. §§ 36.152(a) and 36.154.

[110] Indeed, the exchange trunk wideband service costs and exchange trunk voice-grade service costs are not only consolidated with each other but also with exchange line wideband service costs. A single service category (Wideband and Exchange Trunk C&WF) presently includes all three of these services because the separations treatment is the same for each. *See id.* §§ 36.152(a) and 36.155(a).

[111] *Id.* Part 36, Glossary.

advent of digital services.[112] Since that time, the telephone network has evolved significantly. Today, almost all telephone switching equipment and interoffice transmission is digital and, as already noted, consumer demand for high-capacity services has grown, with DS1, DS3,[113] and ISDN service being prime examples.

58. In view of these changes, we seek comment on whether the distinction for analog wideband services in our current separations procedures promotes the goals of this proceeding and meets the criteria discussed in Section IV.A. or other proposed criteria. Commenters should discuss whether the current distinction, described above, is sufficiently precise to distinguish analog wideband services providing a capacity of twelve voice-grade channels from digital services providing a capacity several hundred times as great. Commenters asserting that the current distinction is inadequate should suggest definitions of "high-capacity services" to replace the references to "wideband" in our rules. These commenters should also discuss, for example, whether there is a digital signal rate, *e.g.*, 64 kbps, that unambiguously distinguishes voice-grade from high-capacity channels. Commenters recommending definitions should explain how their definitions would apply to current services and facilities and how they might accommodate future offerings.

59. In addition, we seek comment on whether the distinction between exchange and interexchange services, used in separating circuit equipment and C&WF costs,[114] promotes the goals of this proceeding and meets the criteria discussed in Section IV.A. or other proposed criteria. We recognize that carriers find it difficult to divide costs between these two service classes in the separations process and therefore ask whether this distinction should be eliminated. Commenters advocating the elimination of this distinction should propose new categories to replace the current categories for these costs. We also ask the same questions regarding the distinction between loops and trunks that is used in separating C&WF and circuit equipment costs.[115]

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[112] Cooperative efforts and studies undertaken by the industry, state regulatory agencies through NARUC, and the Commission beginning in 1941, were incorporated into what was popularly known as the NARUC-FCC Separations Manual in 1947. *See* American Telephone & Telegraph Co. and the Associated Bell System Companies Charges for Interstate and Foreign Communication Service, *Memorandum Opinion and Order*, Docket No. 16258, 3 FCC 2d 307, 309-311 (1966). The Separations Manual was codified into the Commission's rules in 1969. *1969 Separations Procedures*, 16 FCC 2d 317.

[113] Digital Signal 1 ("DS1") and Digital Signal 3 ("DS3") services provide transmission capacity equivalent to 24 and 672 voice-grade channels, respectively.

[114] *See* 47 C.F.R. §§ 36.126(b) and 36.152(a).

[115] *See id.* §§ 36.126(b) and 36.152-156.

60. Further, we ask parties to discuss whether the distinction between private line and message services should be modified or eliminated.[116] Under the current separations rules, the costs in several plant categories are apportioned between these two service classes because, historically, these services have not engaged all facilities in the same way.[117] As we explained earlier, however, network improvements resulting from new technologies have enabled ILECs to create virtual private line networks that blur the distinction between private line and message telecommunications service required by the separations rules.[118] We therefore ask commenters to discuss whether these two service categories should be consolidated. In addition, we seek comment on whether the consolidation of any other Part 36 categories would further the goals of this proceeding and meet the criteria discussed in Section IV.A. or other proposed criteria.

61. A proper review of the separations rules must consider the need not only for consolidation but also for disaggregation. We therefore ask whether the costs in any existing category should be further disaggregated into subcategories in order to permit different separations treatment for different costs in that category. Parties favoring such a change should discuss what criterion or criteria should be used to apportion costs among these new subcategories. Parties should also discuss how their suggestions promote the goals of this proceeding and meet the criteria discussed in Section IV.A. or other proposed criteria.

### 3. Apportioning Costs to Categories

62. The separations rules require carriers to apportion costs among categories before apportioning costs between jurisdictions. As explained earlier, carriers generally are required to assign costs directly to categories because most costs are easily attributed to the prescribed plant, expense, and service categories.[119] Yet, when direct assignment is not feasible, the rules require carriers to allocate costs among categories based on relative-use factors. Those allocation factors are based on measurements of relative usage if such measurements are practicable. We encourage interested parties to discuss whether these procedures for apportioning costs among existing cost categories should be revised. Commenters advocating the creation of new cost categories or consolidation of existing cost categories should explain how costs would be apportioned to those categories.

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[116] *See* discussion in Section III.B. for an explanation of the distinction between private line and message telecommunications service.

[117] *See, e.g.*, 47 C.F.R. §§ 36.126(e)(3) and 36.156(b).

[118] *See* discussion in Section III.B.

[119] *See* discussion in Section II.

a. **Direct Assignment to Categories**

63. There are two types of situations for which direct assignment for categorizing costs is relatively easy to perform and verify: first, when plant costs can be attributed to plant categories based on accounting and engineering records; and second, when plant costs can be attributed to service categories based on operating records demonstrating that the facilities are fully dedicated to services in those categories.

64. There are situations, however, where direct assignment is not easily performed or where it would not produce results that are easily verifiable. Newer technologies increasingly permit a single cable to be used for a mix of services. For example, a local loop providing voice-grade service may also provide video service. The technological changes that enable carriers to use the same facilities to deliver multiple services (*e.g.*, voice, video, and data) may make direct assignment of a facility to a particular service category increasingly difficult for carriers to perform and for regulators to verify. In addition, ILECs likely will use outside plant for an increasing number of new services as the local competition provisions of the Act open telecommunications markets to competition.[120] We therefore ask interested parties to comment on whether these changes in the use of outside plant will make direct assignment increasingly impractical as a categorization tool.

65. Where our separations rules require carriers to apportion a group of costs among multiple categories, our rules may require carriers to directly assign as much of the costs as possible to several categories based upon accounting or engineering records while allowing carriers to assign the unassigned costs to the remaining category. Under this practice the remaining category becomes a "residual" category. For example, carriers are required to apportion outside plant costs among four separations cost categories.[121] On average, carriers directly assign 15 percent of outside plant costs based on accounting and engineering records while the remaining 85 percent of outside plant costs are assigned to the residual category, non-wideband loops.[122] As direct assignment becomes increasingly difficult

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[120] *See* Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services, *Notice of Proposed Rulemaking*, CC Docket No. 96-112, 11 FCC Rcd 17211 (1996) ("*Video Cost Allocation NPRM*").

[121] The separations rules refer to outside plant as cable and wire facilities ("C&WF"). The four categories of C&WF costs include Exchange Line C&WF Excluding Wideband, Wideband and Exchange Trunk C&WF, Interexchange C&WF, and Host/Remote Message C&WF. *See* 47 C.F.R. § 36.152. We note that a host/remote trunk typically is used to connect a small remote switch to a sophisticated switching system located in a wire center.

[122] The 1994 ARMIS Reports show that the largest ILECs, including the BOCs and GTE Companies, directly assign approximately 85 percent of outside plant costs to the non-wideband loop category. Part 36 permits ILECs to use the "residual" method of direct assignment to define these non-wideband loop costs. *See*

due to the technological advances allowing provision of multiple services over the same facilities and statutory changes permitting the use outside plant for an increasing number of new services, however, the residual method of direct assignment of costs may become increasingly arbitrary. We therefore invite comment on whether our separations rules should continue to allow the residual method of direct assignment. We also invite comment on whether the direct assignment of costs to residual categories overassigns or underassigns costs to any other categories. Finally, we ask whether alternative approaches may better achieve the goals of this proceeding and meet the criteria discussed in Section IV.A. or other proposed criteria.

### b. Categorization Based on Usage Measurements

66. The procedures that Part 36 prescribes for allocating costs to service categories are generally based on relative-use measurements that today are performed and recorded by sophisticated computer software programs.[123] One important issue is whether these programs are now so complex that the usage measurements no longer can be verified easily by regulators. Another important issue is whether these measurements still reflect accurately the way that facilities are, in fact, used. Usage-based measurements are most reasonable for allocating costs when all of the traffic across a facility share the same characteristics.[124] If that is the case, facility costs might be allocated reasonably among service categories based on only one type of usage measurement, such as minutes of use or number of call attempts.

67. The usage characteristics of video services, for example, may differ significantly from those of voice-grade services. These two services do not always engage or use facilities in the same way. Today, video services generally constitute one-way

*id.* § 36.153(a)(1)(ii)(B).

[123] In July 1987, the Commission adopted an Order that established the ARMIS reporting system for collecting financial and operating data from ILECs with revenues over $100 million. *See* Automated Reporting Requirements for Certain Class A and Tier 1 Telephone Companies, *Report and Order*, CC Docket No. 86-182, 2 FCC Rcd 5770 (1987) ("*ARMIS Order*"). Pursuant to sections 402(b) and (c) of the 1996 Act, the Commission released an Order and Notice of Proposed Rulemaking modifying our rules to require only annual ARMIS reports and annual cost allocation manual revisions. *See* Implementation of the Telecommunications Act of 1996: Reform of Filing Requirements and Carrier Classifications, Anchorage Telephone Utility, Petition for Withdrawal of Cost Allocation Manual, *Order and Notice of Proposed Rulemaking*, CC Docket No. 96-193, 11 FCC Rcd 11716 (1996). Because the 1996 Act did not specify how to measure inflation in adjusting annual revenue thresholds used to define the ILECs that must file annual reports, the Commission adopted interim rules that adjust the thresholds for inflation using a generally-available inflation index. *Id.* at 11722 para. 10. The Commission made the interim rules for measuring inflation permanent in a Report and Order released May 20, 1997. *See Report and Order,* CC Docket No. 96-193 (rel. May 20, 1997).

[124] For example, a usage-based measurement to allocate switch costs works most efficiently when all of the services using the switch engage the switch in the same manner.

communications for periods of several hours; voice-grade services predominantly constitute two-way communications for much shorter periods of time.[125] Because of these different usage characteristics, circuit equipment and many other facilities must be "full duplex" (*i.e.*, capable of transmitting and receiving simultaneously) for voice-grade services but not for video services. In addition, the transmission speeds of video services dramatically exceed those of voice services. These differences in the utilization of facilities may not be reflected in existing allocation factors that are based on duration measurements or circuit counts.

68. We therefore seek comment on the extent to which usage measurements should play a role in the cost-categorization process, given our goals and criteria identified above. For unswitched services, we ask whether there are reasonable surrogates for usage measurements. For switched services, we ask what type of usage measurement would best quantify the traffic share or occupancy of a certain facility attributable to the various services. Further, we ask how we and the state commissions would be able to verify usage measurements that are recorded by sophisticated software programs.

69. We also ask whether our rules now apply any of the prescribed relative-use factors to costs that are largely unaffected by the type of usage measured by the allocation factor. With respect to circuit equipment costs, for example, commenters should discuss whether costs are closely related to the relative use of the total circuit capacity created by that equipment. If so, a circuit having ten times the capacity of another circuit may incur ten times the cost. This will not be true, however, if circuit equipment cost is more closely tied to the number of times that a signal is split by the circuit equipment. An allocation factor based on the relative use of total circuit capacity would not lead to apportionments reflecting cost causation if costs depend upon the number of circuits used, regardless of the capacity of those circuits.

70. Another issue on which we invite comment is whether we should consider changing the apportionment procedure used for distributing the costs of spare network facilities among categories.[126] Our separations rules generally require carriers to apportion the cost of such facilities among categories on the basis of working network facilities.[127] Thus, if an ILEC assigns 60 percent of the costs of the working facilities in a trunk to the narrowband loop category, 60 percent of the spare facilities in that trunk also is assigned to narrowband loop. This procedure did not raise significant cost allocation issues in the past

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[125] We do recognize, however, that the facilities providing video services might also provide two-way voice-grade communications or one-way signaling.

[126] We are also reviewing the Part 64 treatment of spare facility costs in a separate proceeding. *See Video Cost Allocation NPRM*, 11 FCC Rcd at 17231-32, paras. 51-54.

[127] *See, e.g.*, 47 C.F.R. § 36.153(a)(1)(i)(B).

because networks were designed primarily to carry voice-grade services over copper cables, and the engineering designs for those services called for relatively small amounts of spare facilities. As telecommunications networks evolve to provide more high-capacity services over fiber cables, however, the deployment of spare facilities appears to be increasing. Indeed, ILECs have deployed approximately twice as much spare fiber as they have working fiber.[128] Further, the growth of competition in the local services market, particularly for high-capacity services, is creating incentives for ILECs to assign a greater share of the costs of spare facilities to separations categories encompassing less competitive services.[129] This is an important issue because a significant portion of both fiber and copper loops and interoffice trunks represent spare facilities, and the costs associated with those facilities are substantial. According to the most recent ARMIS data, large ILECs have a total of $125 billion invested in C&WF, with a significant percentage of that investment associated with spare facilities: 68 percent for fiber and 30 percent for copper loops.[130] Because the C&WF investment is not reported separately for metallic and nonmetallic cable, it is difficult to determine the total amount of spare in C&WF investment.[131] Nonetheless, by applying the more conservative spare percentage---30 percent---to the $125 billion total, the ILECs' investment in spare C&WF likely exceeds $37.5 billion.

71. We tentatively conclude that ratepayers of voice-grade services, over which ILECs still exert market power, should not be paying for the spare facilities that eventually will be used for more competitive services. This could occur, for example, if *spare facilities* intended for competitive high-capacity services are assigned to residual categories of plant reserved for voice-grade telephone services. This could also occur if *spare capacity* of

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[128] During 1996, the ILECs' total spare fiber, as a percent of total fiber deployment, was approximately 68 percent. FCC ARMIS Report 43-08 (1996). During the same period, the ILECs' total spare copper loop, as a percent of total equipped copper loop, was approximately 30 percent. FCC ARMIS Report 43-07 (1996). Although comparable data are unavailable for copper interoffice trunks, the spare portion of those facilities likely exceeds 30 percent (the spare portion of copper loops) because ILECs have substituted fiber trunks for many copper trunks which are still deployed as spare facilities even though they are no longer used.

[129] Incentives to reallocate cost from high capacity services to the narrowband loop category exist only to the extent that the narrowband loops are under some type of cost-of-service regulation, *i.e.*, the reallocation allows the carrier to raise rates to recover these reallocated costs.

[130] The $125 billion figure is derived from end-of-year 1996 cost data submitted by large ILECs which together account for approximately 95 percent of the industry's access lines. *See* FCC ARMIS Report 43-04 (1996).

[131] Although carriers keep subsidiary records on nonmetallic and metallic cable, such information is not reported in ARMIS. *See* 47 C.F.R. §§ 32.2421-26.

working facilities,[132] deployed for eventual use by competitive high-capacity services, is allocated based on current usage of those facilities and thus is distributed entirely to existing voice-grade services. We therefore ask whether the current practice of apportioning spare facility costs on the basis of working facility costs should be replaced by another apportionment procedure. For example, spare facility costs could be allocated based on the expected use of the spare facilities, a procedure currently prescribed by our Part 64 cost allocation rules for determining the allocation of central office equipment and outside plant investment costs between regulated and nonregulated activities.[133]

### c. Categorization Based on Fixed Factors

72. As services become more diverse, the use of fixed factors for allocating costs to categories may help ensure that separations is administratively simple. We therefore seek comment on whether fixed factors should play a larger role in categorizing costs and, if so, what those factors should be and which costs should be allocated based on such factors. We ask commenters to discuss this issue in light of the goals of this proceeding and the criteria discussed in Section IV.A. or other proposed criteria. Commenters supporting the use of fixed factors as a method for allocating costs to categories should also comment on whether fixed factors should be applied to all costs--joint, common, and incremental--or only to particular types of cost. We also seek comment regarding whether a fixed allocation approach should be prescribed for all ILECs or only for ILECs operating under price cap regulation.

73. Proponents of fixed allocation factors should also address the basis for setting these fixed factors. For example, if a proposed factor is based on how the category was assigned during a historical period, commenters should identify the specific years to be used in deriving the fixed factors and explain why use of data for those years is appropriate. Commenters also should discuss whether these factors should be revised periodically and, if so, how frequently revision should occur or what event should trigger the revision.

### 4. Apportioning Categorized Costs to Jurisdictions

74. Like the rules for distributing costs to categories, the rules for distributing the categorized costs between jurisdictions rely on two fundamental procedures, direct assignment and allocation. As explained above, carriers generally are required to allocate costs between jurisdictions because most costs within a category are joint or common with respect to

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[132] An underutilized facility may have spare capacity even though it is classified as working. Carriers may classify a DS3-level optical line terminating multiplexer, for example, as working even though 27 of its 28 DS1-level channels are unused.

[133] *See, e.g.*, 47 C.F.R. § 64.901(b)(4).

intrastate and interstate services, thus making direct assignment difficult.[134] We encourage interested parties to discuss whether revising these jurisdictional allocation procedures would help to achieve the goals of this proceeding and the criteria discussed in Section IV.A. or other proposed criteria. Additionally, commenters advocating the creation of new cost categories or consolidation of existing categories should explain how the costs in those categories would be apportioned between the jurisdictions.

#### a. Direct Assignment to Jurisdictions

75. Under our existing separations rules, some costs are directly assigned to the interstate and intrastate jurisdictions.[135] We invite comment on whether there are any additional costs that should be directly assigned to the jurisdictions but which are currently allocated to the jurisdictions based on relative-use measurements or fixed factors. Parties are encouraged to comment, for example, on whether a significant number of the unswitched high-capacity services are jurisdictionally pure. If so, we ask for comment on how ILECs would identify the jurisdictional nature of such services. Commenters should address how opening of markets to competition, as required by the local competition provisions of the Act, will affect the number of jurisdictionally pure services. We also ask how state and federal regulators could verify that a carrier had accurately assigned the facilities to the intrastate or interstate jurisdiction.

#### b. Allocation Based on Usage Measurements

76. When our rules prohibit the direct assignment of specific costs to a jurisdiction, they generally require that those costs be allocated between jurisdictions based on measurements of the relative use by intrastate and interstate services. Usage-based measurements are most reasonable to allocate costs when all of the traffic across a facility exhibits identical characteristics.[136]

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[134] *See* discussion in Section II.

[135] *See, e.g.*, 47 C.F.R. § 36.154(b).

[136] For example, a usage-based measurement to allocate switch costs works most efficiently when all of the services using the switch engage the switch in the same manner. As we noted in Section III. B., however, older services such as voice transmission engage specific switch facilities for the duration of a call while newer services such as caller identification engage facilities only during the call set-up period.

77. Local switching costs, for example, are allocated between the jurisdictions based on a usage measurement called dial equipment minutes ("DEM").[137] Traditional analog and digital switches set up a circuit for each call. The circuit is maintained for the duration of the call, making part of the switch unavailable for other transmissions during that period. The newer technologies, however, operate much differently. Packet switches,[138] including frame relay and asynchronous transfer mode ("ATM") used to provide services offering different capacities on demand,[139] do not dedicate a circuit to each communication throughout its duration. An important issue thus may be whether call duration, which serves as the basis for separating costs between the jurisdictions in traditional switches, is a reasonable basis for allocating the costs of packet switches between jurisdictions. Perhaps the cost of these switches is more closely related to other forms of traffic measurement, *e.g.*, number of packets, than to call duration. We ask parties to discuss whether other allocation factors should be used to separate the costs of packet or traditional switching equipment, and if so, what factors would be most appropriate for various types of traffic.

78. In the *Access Charge Reform Order*, the Commission concluded that the costs of the line side port (including the line card, protector, and main distribution frame), and trunk-side cards and ports dedicated to a particular access customer, are non-traffic sensitive ("NTS").[140] The current separations process does not distinguish NTS port costs from the TS costs of the local switch. Accordingly, another important issue is whether a usage-based allocator is appropriate for the portion of local switching costs that is NTS and does not vary

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[137] The DEM allocation factor equals the interstate minutes of holding time of originating and terminating local switching equipment divided by the total intrastate and interstate minutes of such holding time for local switching equipment. 47 C.F.R. § 36.125.

[138] Packet switching divides data to be sent into individual packets, each with a unique identification and destination address. Each packet may arrive at the destination by a different route and may arrive in a different order from the order in which the packets were initially sent. The identification allows the data to be reassembled in its proper sequence. "Frame relay" is a form of packet switching.

[139] ATM is a flexible digital transmission protocol that allows different kinds of services to be offered in one network. It accomplishes this by putting the digitized voice, data or video signal into standard, fixed-length packets of bytes, called cells. Cells are assembled from the bit stream of the source call or service. In the network, these cells may be intermixed with cells from other services. Cells receive their routing instructions at ATM switching points. At their destination, the cells for each service are sorted, collected and disassembled into a bit stream appropriate to each service. Each cell moves through the network independent of other cells, even those of the same call. Cells for a given call, however, are routed over the same path, but with no assigned time slots, as there are in synchronous switching systems; hence the name *asynchronous* transfer mode. BOC Notes on the LEC Networks -- SR-TSV-002275, Section 7.10 (April, 1994) (Prepared and published by Bellcore).

[140] *Access Reform Order* at paras. 125-127. NTS costs, by definition, are costs that do not vary with usage. *Id.* at para. 6.

with use.[141] We request that commenters discuss these issues in light of the goals of this proceeding and the criteria discussed in Section IV.A. or other proposed criteria.

79. Another important issue, assuming that costs of switched and unswitched services should continue to be categorized separately, is whether the usage measurements of switched services should be used as surrogate relative-use factors to jurisdictionally separate the costs imposed by unswitched services, such as DS1 and DS3 services, for which usage measurements are unavailable. For incremental costs that are TS, such an approach may be more consistent with principles of cost causation than the use of a fixed allocation factor that cannot respond to changes in jurisdictional usage. We therefore seek comment on the relative merits of this approach.

80. More generally, we seek comment on whether the ratio of intrastate to interstate usage for voice-grade services differs significantly from the ratio of intrastate to interstate usage for high-capacity services. If these differences are significant, we seek comment on how, if at all, these differences will be affected by the opening of local exchange markets to competition. For example, would a reduction in prices in certain services, as a result of increased competition, increase or decrease the difference between the existing ratios? Commenters should address whether such differences, now or in the future, would produce a jurisdictional allocation of costs inconsistent with the goals of this proceeding and the criteria discussed in Section IV.A. or other proposed criteria if the current usage-based allocation methods were retained. Commenters endorsing relative-use methodologies should explain the mechanics of usage measurements they recommend and how regulators can verify the accuracy of carrier measurements.

81. In addition, we seek comment on whether the goals of this proceeding and the criteria discussed in Section IV.A. or other proposed criteria would be better met if our separations rules no longer required the allocation factor for interexchange trunk costs to be weighted to reflect the length of trunks. Under our current rules, when direct assignment is not feasible, interexchange trunk costs are allocated between the state and federal jurisdictions based on the conversation-minute-kilometers attributable to intrastate and interstate services.[142] This means that allocation is based partly on trunk usage and partly on trunk length. Because overall trunk costs are significantly reduced with the ILECs' increased use of fiber and radio technologies, there may no longer be a measurable link between trunk length and cost causation. We therefore invite parties to discuss whether technological advances have obviated the need for this allocation procedure to be based, in part, on trunk length.

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[141] Independent industry estimates indicate that as much as, or even more than, half of local switching costs may be NTS. *Id.* at para. 131.

[142] *See* 47 C.F.R. §§ 36.153(a)(1)(i) and 36.156.

82. We also seek comment on whether the allocation factor for marketing expenses should be revised to satisfy the goals of this proceeding and the criteria set forth in Section IV.A. Under the current Part 36 rules, marketing expenses are allocated between the jurisdictions on the basis of current billing for local and toll services (excluding certain billings for non-affiliated companies and those performed in connection with intercompany settlements).[143] We seek comment on whether the costs associated with marketing expenses could be allocated in a more cost-causative manner. Because marketing expenses generally are incurred in connection with promoting the sale of retail services, those expenses for the most part should be recovered from ILEC retail services, which are found predominantly in the intrastate jurisdiction. We therefore tentatively conclude that ILECs' marketing costs that are not related to the sale or advertising of interstate switched access services are not appropriately allocated to the interstate jurisdiction.[144] We seek comment on this tentative conclusion. In addition, we seek comment on allocation factors that are not revenue-based, or that may incorporate weighted factors. In addition, we seek comment on whether there may be a need for a transition period or a phase-in approach if we adopt a new allocation factor for marketing expenses.

### c. Allocation Based on Fixed Factors

83. Our rules prescribe fixed factors for allocating certain ILEC costs between the jurisdictions. A fixed factor of 25 percent, for example, is prescribed for identifying the interstate portion of costs associated with subscriber lines that are joint or common with respect to local exchange, intrastate toll, and interstate toll services.[145] Our current separations rules generally require the use of a fixed factor, rather than a factor based on usage measurements of line traffic, when costs are considered to be NTS.[146] With the introduction

[143] 47 C.F.R. § 36.372

[144] In 1987, the Commission reconsidered a decision to exclude access revenues in the allocation factor for marketing expenses because neither the Joint Board nor the Commission had sufficient information to fully analyze the potential revenue requirement impact of excluding access revenues from the allocation factor. *See* MTS and WATS Market Structure, Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Joint Board, *Memorandum Opinion and Order on Reconsideration and Supplemental Notice of Proposed Rulemaking*, CC Docket Nos. 78-72, 80-286, and 86-297, 2 FCC Rcd. 5349, 5352 para. 24 (1987).

[145] 47 C.F.R. § 36.154(c). Further, the rules require interexchange carriers to allocate residual circuit equipment costs based on factors frozen at 1985 levels. *Id.* § 36.126(d)(3).

[146] For example, equipment cost is NTS when an increase in the volume of telephone activity over that equipment does not require carriers to enlarge equipment capacity or purchase additional equipment units. Although these NTS costs are fixed with respect to traffic changes, they may vary with respect to other factors. Residential loop costs, for example, generally are fixed with respect to traffic on individual loops but will vary in response to changes in the demand for loops. This distinction is important because NTS costs are easily mistaken for fixed costs. Fixed costs not only remain the same with respect to changes in traffic but also with

of new technology, however, portions of the network that were once considered NTS may become sensitive to traffic.[147] Accordingly, we seek comment on whether the usefulness of fixed factors in the separations process may need to be re-examined in light of the goals of this proceeding and the criteria discussed in Section IV.A. or other proposed criteria. We also seek comment on whether fixed factors are a reasonable basis for allocating joint and common costs that cannot be allocated on a cost-causative basis or for allocating incremental costs that are difficult to attribute to intrastate and interstate operations.

**E. Impact on Prices and Revenue Requirements**

84. If we determine that modifications to our separations rules are necessary, it will be important to know how those modifications would affect (a) the overall level of prices paid by consumers, (b) the way costs are recovered in the intrastate and interstate jurisdictions, and (c) jurisdictional revenue requirements.

85. *Price Level.* If an ILEC is regulated under price caps in the interstate jurisdiction and rate-of-return regulation in the intrastate jurisdiction, the allocation of costs between jurisdictions could potentially affect the overall level of revenue collected by the ILEC. To the extent that price cap regulation breaks the link between costs and prices while rate-of-return regulation maintains such dependence,[148] the assignment of a cost that is expected to fall over time to the interstate jurisdiction could lead to a greater revenue recovery for the ILEC than the assignment of that cost to the intrastate jurisdiction.[149] We seek comment on the extent to which an ILEC's overall revenues (and by implication the overall rates paid by consumers) are affected by any proposed changes to our separations rules.

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respect to all other factors. This occurs in the short run, a period in which the carrier has insufficient time to sell the equipment or acquire additional units of it. Fixed costs do not exist in the long run because the carrier has sufficient time to change all equipment. Yet, even in the long run, a substantial portion of telecommunications costs is NTS because it is unaffected by traffic volume.

[147] For example, the subscriber loop has historically been considered NTS. New technology in the loop, however, now permits multiple subscribers to share a limited number of transmission channels. *See* Integrated Digital Loop Carrier System Generic Requirements, Objectives, and Interface (GR-303-CORE). This network architecture may cause portions of the subscriber loop to become more sensitive to traffic.

[148] If price cap regulation is "impure," a link still exists between costs and prices under limited circumstances. Under current federal price cap rules, for example, ILECs are permitted to make "low-end" adjustments to price caps if cost increases cause the rate-of-return on investment to fall below a specified level.

[149] This result only holds if the assignment of the cost to the interstate jurisdiction that is expected to fall over time is accompanied by an intrastate assignment of a formerly interstate allocated cost that is expected to increase over time (or at least to decrease at a slower rate).

86. *Pricing Structure*. In our recent *Access Charge Reform Order*, the Commission restructured interstate access charges so that ILECs will recover significantly more and eventually all, NTS costs using flat rates and TS costs using usage sensitive rates.[150] We seek comment on whether proposed changes to our separations rules should reflect any differences in the way costs are recovered in the intrastate jurisdiction.

87. *Revenue Requirement*. Information about how modifications to our separations rules would affect jurisdictional revenue requirements will enable us to avoid adopting rules that would cause a sudden and severe mismatch between cost allocation and revenues that could deny carriers a reasonable opportunity to recover their costs. Such information also will enable us to determine whether the expected jurisdictional shift in revenue requirements would be large enough to warrant a transition mechanism. The Commission has found such information useful in the past when developing transition mechanisms. For example, when the Commission established the 25 percent fixed factor for allocating NTS costs between the state and federal jurisdictions, it used such information to determine that many companies were allocating an unusually high percentage of their NTS costs to the interstate jurisdiction.[151] To prevent dramatic cost shifts between jurisdictions that a "flash cut" to the fixed allocator would otherwise have caused, the Commission ordered a gradual transition period from the existing rules to the new 25 percent fixed factor for allocating NTS costs.[152] We therefore ask commenters to estimate, for any proposed modification to our separations rules, the expected shift of costs between the intrastate and interstate jurisdictions. Additionally, commenters should discuss whether such modifications to our separations rules would disproportionately affect specific types of carriers or ratepayers.

## F. Separation of the Costs Associated with Interconnection

88. Section 251 of the Act establishes the general duty of all telecommunications carriers "to interconnect directly or indirectly with the facilities and equipment of other telecommunications carriers,"[153] to "provide...nondiscriminatory access to network elements on

[150] *See generally Access Reform Order*.

[151] Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, *Decision and Order*, 96 FCC 2d 781, 803 (1984) ("*NTS Order*") (adopting most recommendations of the Federal-State Joint Board in 48 Fed. Reg. 46556 (Oct. 13, 1983)); MTS & WATS Market Structure, *Decision and Order*, CC Docket Nos. 78-72 and 80-286, 50 Fed. Reg. 939 (January 8, 1985), (adopting most recommendations of the Federal-State Joint Board in 49 Fed. Reg. 48325 (Dec. 12, 1984)).

[152] See *NTS Order* at 802.

[153] 47 U.S.C. § 251(a)(1).

an unbundled basis,"[154] and to "offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers."[155] In a companion NPRM that we issue today, we propose rules for the accounting treatment of transactions related to interconnection.[156] Specifically, we propose new revenue accounts for amounts ILECs receive for providing interconnection, expense accounts for amounts paid to obtain interconnection and subsidiary recordkeeping categories for the costs of providing interconnection. In addition, we tentatively conclude that the amounts to be assigned to those subsidiary recordkeeping categories should be based on the revenues from interconnection and unbundled network elements and that the apportionment of the costs should be consistent with cost studies underlying the charges for these services and elements. The rules proposed in our companion NPRM are designed to provide the Commission with data it needs to monitor the development of local exchange and exchange access competition and the deployment of advanced telecommunications services by eligible telecommunications carriers during the transition to a competitive market.

89. In the *Local Competition Order*, we sought to implement a separate framework for pricing interconnection that would rely on the combined oversight of federal and state regulation. Our pricing rules were vacated by the 8th Circuit Court of Appeals. The Court concluded that the local competition provisions were "fundamentally intrastate in character."[157]

90. In this NPRM, we propose two alternatives for allocating the costs of providing interconnection between the state and federal jurisdiction. Our first alternative is for the costs, once identified in Part 32 as proposed in the companion item, to be removed entirely from the separations process and allocated through a process designed to apply exclusively to these costs. Commenters supporting this proposal should explain how such a procedure would work and whether removing these costs from the separations process would promote the goals and criteria of this proceeding.

91. We propose as a second alternative that the costs of interconnection, once identified in Part 32, be separated through the current separations process. We seek comment on whether new categories should be created or whether existing categories could be used in

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[154] 47 U.S.C. § 251(c)(3).

[155] 47 U.S.C. § 251(c)(4).

[156] *See* Amendments to Uniform System of Accounts for Interconnection and Infrastructure Sharing, CC Docket No. 97-355 (rel. October 7, 1997). In this NPRM, we use the term "interconnection" to include interconnection, unbundled access, transport and termination, and resale.

[157] *Iowa Utilities Board v. FCC*, WL 403401,8 (8th Cir. July 18, 1997).

the first step of the separations process. We tentatively conclude that in order to promote efficiency and reduce the administrative burden placed on ILECs subject to the separations rules, new categories should be created to segregate the costs associated with unbundled network elements from the costs associated with the provision of all other local exchange services. We seek comment on this tentative conclusion. In addition, with respect to this alternative, we tentatively conclude that all costs associated with interconnection would be directly assigned to the intrastate jurisdiction. We seek comment on this tentative conclusion.

92. We also seek comment on the pertinence of the holding in *Iowa Utilities Board v. FCC* to the assignment of costs associated with the provision of local exchange service to the intrastate jurisdiction. We seek comment on whether the holding in the *Iowa Utilities Board* decision requires the assignment of all costs associated with the provision of local exchange service to the intrastate jurisdiction.[158] Commenters are encouraged to address whether the Court's decision requires review and modification of the current separations allocator of 25% of the loop costs to the interstate jurisdiction. Commenters should also explain how their position would affect the regulation of access charges as well as the recently initiated federal universal service program.

**G. Separations of Universal Service Contributions and Support**

93. As directed by the Act, the Commission adopted a plan that satisfies the statutory requirements of section 254 and establishes a universal service support system that

94.will be sustainable in an increasingly competitive marketplace.[159] In particular, the *Universal Service Order* creates a support system for assisting carriers that provide certain telecommunications services to consumers in rural, insular, and high cost areas based on forward-looking economic costs.[160] The *Universal Service Order* also modifies the existing Lifeline and Link Up programs for low income consumers.[161] The federal Lifeline support amount was increased, the state matching requirement was modified, and the program was expanded to be available in every state, territory, and commonwealth.[162] In addition, the

[158] These costs would include 100% of the cost of the local loop, and all central office/switching costs and transport costs.

[159] 47 U.S.C. § 254.

[160] *See Universal Service Order* at paras. 199 and 200.

[161] *Id.* at para. 326. The Commission's Lifeline Assistance program reduces qualifying consumers' monthly charges by waiving all or part of the federal SLC, and provides additional federal assistance for states that provide a matching reduction in state rates. 47 C.F.R. §§ 36.701 and 36.721. Link Up provides federal support that reduces qualified low-income consumers' initial connection charges by up to one half. *Id.* § 69.117.

[162] *See Universal Service Order* at para 326.

contributions and distributions of low-income support overall will be provided on a competitively neutral basis.[163] The *Universal Service Order* also allows all eligible schools and libraries to receive discounts of between 20 percent and 90 percent on all telecommunications services, Internet access, and internal connections provided by telecommunications carriers.[164] Finally, the *Universal Service Order* adopts a program to provide universal service support for all public and not-for-profit health care providers located in rural areas.[165]

95. We ask that commenters propose changes to our separations rules to account for changes in the universal service support mechanisms discussed in this Section, as well as any other changes in the universal service system that may require modifications to our separations rules. We also ask commenters to discuss how costly and burdensome any proposed changes to our separations rules would be for small carriers.[166]

**1. Universal Service Contributions**

96. In the *Universal Service Order*, the Commission modified the funding methods for the existing federal universal service support mechanisms so that such support is not generated entirely through charges imposed on long distance carriers.[167] Consistent with the 1996 Act, the Commission will require equitable and nondiscriminatory contributions from all providers of interstate telecommunications service.[168] A carrier's contributions for the high cost and low-income programs will be assessed based on the contributor's interstate end-user telecommunications revenues.[169] Contributions to support eligible schools, libraries, and health care providers will be assessed based on contributors' interstate and intrastate end-user revenues.[170] While the bases for assessing contributions to these universal service programs

[163] *Id.* at para. 327.

[164] *Id.* at para. 425.

[165] *Id.* at para. 608.

[166] In several instances, our rules have been modified to avoid imposing unreasonable costs or burdens on small companies. For example, the accounting requirements for small carriers in Part 32 are more streamlined. *See* 47 C.F.R. §§ 32.11 and 32.13.

[167] *See Universal Service Order* at para. 6.

[168] 47 U.S.C. § 254(d); *See Universal Service Order* at para. 6.

[169] *See Universal Service Order* at para. 772.

[170] *Id.*

differ, the Commission determined that carriers may recover their contributions to all of the programs through interstate rates.[171]

97. We tentatively conclude that, in order for contributing ILECs to recover universal service contributions through interstate rates, the expense of the contributions should be directly assigned to the interstate jurisdiction. We request comment on this tentative conclusion. In the event that ILECs subject to our separations rules are required to contribute to a state universal service fund,[172] we request comment on whether the expense of such contributions should, similarly, be directly assigned to the intrastate jurisdiction.

**2. High Cost Support**

98. The Commission determined that the federal universal service mechanism for rural, insular, and high cost areas will provide assistance for the interstate portion of the difference between the forward-looking economic costs of providing service and a nationwide revenue benchmark.[173] As discussed in the *Universal Service Order*, the interstate portion of providing high cost support will be 25 percent because that percentage currently defines the interstate portion of loop costs, which is the predominant cost that varies between high cost and non-high cost areas.[174] In the *Access Charge Reform Order*, the Commission directed that the federal support received by ILECs should be used to satisfy the interstate revenue requirements that are otherwise collected through interstate access charges.[175]

99. While non-rural carriers will begin to receive support based on forward-looking economic cost on January 1, 1999,[176] rural carriers will gradually shift to a forward-looking

[171] *Id.* at para. 773. ILECs subject to price caps may add universal service contributions to their common line basket and may recover them in the same manner as common line charges. *See Access Charge Reform Order* at paras. 379-80.

[172] *See* 47 U.S.C. § 254(f).

[173] *See Universal Service Order* at paras. 199-201. The revenue benchmark will take into account the retail price currently charged for local service and other revenues carriers receive as a result of providing service. *See id.* at paras. 257-267.

[174] *Id.* at paras. 269-72.

[175] *See Access Charge Reform Order* at paras. 378-87. *See also Universal Service Order* at paras. 15, 825-30.

[176] *See Universal Service Order* at paras. 26, 203, 232-51. In the *Universal Service Order*, the Commission found that the cost models presented to the Commission were not sufficiently reliable to determine universal service support based on forward-looking economic costs. The Commission issued a Further Notice of Proposed Rulemaking seeking further comment on the mechanism we should adopt to estimate the forward-

economic cost methodology after further review by the Commission, but in no event sooner than January 1, 2001.[177] Beginning on January 1, 1998, rural carriers will receive high cost loop support, DEM weighting, and LTS benefits for each line based on modifications to the existing mechanism.[178] The final rules released in the *Universal Service Order* include changes to our separations rules that implement these modifications to support for rural areas.

100. Consistent with the *Universal Service Order*,[179] federal support received by ILECs for service to rural, insular, and high cost areas would be directly assigned to the interstate jurisdiction because it is only intended to support the federal share of the costs of providing high cost service, and because such support is intended to offset ILECs' interstate revenue requirement. We request comment on this proposal.[180]

### 3. Low-Income Support

101. *Lifeline*. In the *Universal Service Order*, the Commission made the Lifeline program that assists qualified low-income consumers part of the federal universal service mechanisms by requiring all eligible telecommunications carriers to offer Lifeline service.[181] Under the new universal service mechanism, low-income consumers will benefit from federal support in the amount of $3.50 as well as additional support, if the state approves, of $1.75 (for total federal support of $5.25 per month).[182] A qualified consumer's bill can be reduced further if the state provides matching funds.[183]

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looking economic cost that non-rural LECs would incur to provide universal service in rural, insular and high cost areas. *See* Federal-State Joint Board on Universal Service, Forward-Looking Mechanism for High Cost Support for Non-Rural LECs, CC Docket Nos. 96-45, 96-160, *Further Notice of Proposed Rulemaking*, FCC 97-256 (rel. July 18, 1997).

177 *Id.* at paras. 216-217, 263, and 298-299.

178 *Id.* at para. 299. Our separations rules have been modified to implement these changes. *Id.* at App. I.

179 *See also Access Charge Reform Order* at para. 381.

180 This issue is pending in the Universal Service proceeding on reconsideration.

181 *Id.* at para. 347.

182 *Id.* at para. 351.

183 "[F]ederal support equal to one half of any support generated from the intrastate jurisdiction, up to a maximum of $7.00 in federal support," is available to decrease the monthly telephone bill of low-income consumers under the new mechanism. *Id.* at para. 352 (quoting the *Universal Service Recommended Decision*, 12 FCC Rcd at 301).

102. We tentatively conclude that the $3.50 of baseline federal support received by any ILEC through the Lifeline program should be directly assigned to the interstate jurisdiction because the amount is intended to offset the subscriber line charge ("SLC").[184] In addition, we tentatively conclude that additional federal support above this amount should be directly assigned to the intrastate jurisdiction because it is intended to lower the intrastate rates paid by low-income consumers. We seek comment on these tentative conclusions.

103. *Link Up.* The Link Up program is intended to help low-income subscribers initiate telephone service.[185] To ensure that Link Up support is available on a competitively-neutral basis, the *Universal Service Order* eliminated the requirement that the installation charges eligible for support be filed in a state tariff.[186] Any eligible telecommunications carrier may draw from the new Link Up support mechanism "if that carrier offers to qualifying low-income consumers a reduction of its service connection charges equal to one half of the carrier's customary connection charge or $30.00, whichever is less."[187]

104. Under the current Link Up program, the provision of federal assistance is achieved through an expense adjustment in the separations process that allocates costs from the intrastate jurisdiction to the interstate jurisdiction, thereby reducing the intrastate revenue requirement.[188] We tentatively conclude that support received by ILECs under the new Link Up support mechanism should be directly assigned to the intrastate jurisdiction in order to reduce the intrastate revenue requirement. We seek comment on this tentative conclusion.

**4. Schools, Libraries, and Health Care Providers Support**

105. Section 254(h)(1)(B) requires that telecommunications services and any additional services designated by the Commission be provided to schools and libraries at a discount.[189] The discount shall result in "rates less than the amounts charged for similar services to other parties," and shall be sufficient to ensure affordable access to and use of

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[184] The SLC is the existing flat-rate charge on every consumer's line for access to interstate telephone service. If the SLC in a state or territory is less than the $3.50 provided by federal support through the Lifeline program, only that amount equal to the SLC in the state or territory should be allocated to the interstate jurisdiction.

[185] *See Universal Service Order* at para. 344.

[186] *Id.* at para. 380.

[187] *Id.*

[188] *Id.* at para. 344; 47 C.F.R. §§ 36.701-36.741.

[189] 47 U.S.C. § 254(c)(3) and (h)(1)(B). *See generally Universal Service Order* at paras. 424-607.

such services.[190] The Commission and the states will determine the levels of the discounts schools and libraries receive for interstate and intrastate services, respectively.[191] Telecommunications service providers will receive this support as either an offset to their universal service contribution obligations or as a payment from the universal service administrator.[192]

106. Section 254(h)(1)(A) requires that those telecommunications services and any additional services designated by the Commission that are necessary for the provision of health care be provided to health care providers in rural areas at rates that are reasonably comparable to urban rates for similar services.[193] Telecommunications carriers will receive universal service support for the amount of the reduction in rates.[194] A carrier will treat the support amount as an offset against the carrier's universal service contribution obligation for the year in which the costs were incurred.[195] To the extent that a carrier's support exceeds that carrier's obligation, calculated on an annual basis, the carrier may receive a payment from the universal service administrator.[196]

107. Through reimbursement by either a direct payment by the universal service administrator, or by an offset of their universal service obligation, carriers will receive the same amount of revenue for the provision of supported services to eligible schools, libraries, and health care providers as they would receive for the provision of those same services to other customers. For a payment received from the administrator, an ILEC will record such revenue in its Part 32 accounts in the same manner as revenue received from the provision of those same services to other customers. For an offset of a universal service obligation, an ILEC may record the offset in its Part 32 accounts as both an expense (as a contribution) and a revenue (as payment for the provided services). We tentatively conclude that this universal service support may be properly recorded in the existing Part 32 accounts, whether ILECs are reimbursed through a direct payment from the administrator or through an offset of their universal service obligation. We therefore tentatively conclude that universal service support

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[190] 47 U.S.C. § 254(h)(1)(B). *See generally Universal Service Order* at paras. 464-551.

[191] 47 U.S.C. § 254(h)(1)(B). *See generally Universal Service Order* at paras. 464-551.

[192] 47 U.S.C. § 254(h)(1)(B). *See also Universal Service Order* at 585-86.

[193] 47 U.S.C. § 254(h)(1)(A) and (c)(3). *See generally Universal Service Order* at paras. 608-49.

[194] *See Universal Service Order* at paras. 608, 657-701.

[195] *See id.* at paras. 732-37.

[196] *See id.*

for eligible schools, libraries, and health care providers does not require independent separations treatment. We request comment on this tentative conclusion.

**H. Separations of the Costs of Assisting Law Enforcement**

108. CALEA was enacted on October 24, 1994, and requires telecommunications carriers to modify and design their equipment, facilities, and services to support the electronic surveillance needed by federal, state, and local law enforcement agencies.[197] As directed by the Act, we are convening the Federal-State Joint Board established in CC Docket No. 80-286 to "recommend appropriate changes to part 36 of the Commission's rules with respect to recovery of costs pursuant to charges, practices, classifications, and regulations under the jurisdiction of the Commission."[198]

109. Section 103 of CALEA requires telecommunications carriers to ensure that their facilities enable law enforcement officials, pursuant to authorization, to intercept calls and access call-identifying information that is reasonably available to the carrier ("assistance capability requirements").[199] Section 104 of CALEA requires that carriers comply with capacity requirements established by the Attorney General ("capacity requirements").[200] These capacity requirements will aid telecommunications carriers in developing and deploying solutions to meet the assistance capability requirements of section 103. The effective date for complying with the assistance capability requirements is October 25, 1998.[201]

110. Sections 109 and 104(e) grant the Attorney General authority, subject to the availability of appropriations, to reimburse a telecommunications carrier for the reasonable

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[197] Communications Assistance for Law Enforcement Act, Pub. L. No. 103-414, 108 Stat. 4279 (1994) (codified as amended in sections of 18 U.S.C. and 47 U.S.C.).

[198] 47 U.S.C. § 229(e)(3).

[199] 47 U.S.C. § 1002.

[200] *Id.* § 1003. The Attorney General delegated her authority to meet CALEA's responsibilities to the Director, Federal Bureau of Investigation ("FBI"). *See* Advanced Notice of Proposed Rulemaking, 61 Fed. Reg. 68,790 (1996); *See also* 28 C.F.R. 0.85(o), which permits the Attorney General to delegate responsibilities to the FBI Director or his or her designee. The FBI's Telecommunications Industry Liaison Unit and Telecommunications Contracts and Audits Unit are the agents charged with implementing CALEA for the FBI Director and the Attorney General.

[201] *Id.* § 1001 note. The effective date of capacity compliance is three years after the Attorney General releases its final notice on capacity requirements. *Id.* § 1003(b)(1). The FBI has issued two notices on capacity requirements. Implementation of the Communications Assistance for Law Enforcement Act, *Initial Notice and Request for Comments*, 60 Fed. Reg. 53643 (Oct. 16, 1995) ("*Initial Notice*"); *Second Notice and Request for Comments*, 62 Fed. Reg. 1902 (Jan. 14, 1997) ("*Second Notice*"). A final notice has not yet been issued.

costs associated with compliance of the assistance capability and capacity requirements.[202] We seek comment on how to separate the costs a carrier may incur and the reimbursements (revenues) a carrier may receive in establishing the capabilities and capacity necessary to comply with sections 103 and 104. Specifically, we seek comment on whether the costs incurred should be allocated to a single category identified as CALEA-related expenses, or whether the costs associated with compliance should be allocated to the existing separations categories or subcategories within them. Commenters that support allocating the costs to the existing separations categories should consider whether, and if so, how, the associated revenues received from the Attorney General could be allocated to ensure that revenues follow their associated costs to a particular jurisdiction. We further seek comment on whether, in order to be consistent with administrative simplicity, revenues could be allocated to the jurisdictions based on relative-use factors derived from the relative electronic surveillance requirements of federal, state, and local law enforcement agencies.

## V. PROCEDURAL MATTERS

### A. *Ex Parte*

111. This is a permit-but-disclose notice and comment rulemaking proceeding. *Ex parte* presentations are permitted, except during the Sunshine Agenda period, provided they are disclosed as provided in the Commission's rules.[203]

### B. Initial Regulatory Flexibility Analysis

112. This NPRM seeks comment on the extent to which separations rules are required, what standards should be used to evaluate separations proposals, and what changes should be made to our existing separations rules. The NPRM states that we want to adopt rules that are easily interpreted and that will minimize any regulatory burdens on affected parties. Section 603 of the Regulatory Flexibility Act (RFA), as amended,[204] requires an initial Regulatory Flexibility Act Analysis in notice-and-comment rulemaking proceedings unless we certify that "the rule will not, if promulgated, have a significant economic impact on a significant number of small entities."[205]

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[202] *Id.* §§ 1008 and 1003(e).

[203] *See generally* 47 C.F.R. §§ 1.1202, 1.1203, and 1.1206(a).

[204] 5 U.S.C. § 603.

[205] *Id.* at § 605(b).

113. Section 603 of the Regulatory Flexibility Act ("RFA")[206] requires an initial regulatory flexibility analysis that describes the impact of the proposed rule on small entities for rulemakings that are required to have public notice and comment. We have determined that the RFA is inapplicable to this proceeding insofar as it pertains to the Bell Operating Companies and other incumbent local exchange carriers. The RFA defines a "small business" to be the same as a "small business concern" under the Small Business Act.[207] 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) meets any additional criteria established by the Small Business Administration ("SBA").[208] Section 121.201 of the Small Business Administration regulations defines a small telecommunications entity in SIC code 4813 (Telephone Companies Except Radio Telephone) as any entity with 1,500 or fewer employees at the holding company level.[209] Because our proposals concerning the Part 36 separations process will affect all incumbent local exchange carriers providing interstate services, some entities employing fewer than 1500 employees at the holding company level may be affected by the proposals made in this NPRM. However, we do not consider such entities to be "small entiites" under the RFA because they are either affiliates of large corporations or dominant in their field of operations. Therefore, we do not believe that the proposed rules will affect a substantial number of small entities. Even if small ILECs were "small entities" under the SBA, however, we would still certify that no regulatory flexibility analysis is necessary here because none of the proposals in this NPRM, if adopted, would have a significant economic impact (as such term is used in the RFA) on the carriers which must comply with our accounting rules. One of the primary objectives of this proceeding is to seek comment on proposals to simplify the current separations process in an effort to lessen the regulatory burden on carriers in furtherance of a deregulatory national policy framework.

114. We therefore certify, pursuant to section 605(b) of the RFA, that the rules proposed in this NPRM will not have a significant economic impact on a substantial number of small entities. The Commission will publish this certification in the Federal Register and will provide a copy of the certification to the Chief Counsel for Advocacy of the SBA. The Commission will also include this certification in the report to Congress pursuant to the Small Business Regulatory Enforcement Fairness Act.[210]

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[206] *See id.* § 603.

[207] *Id.* § 601(6) (adopting 15 U.S.C. § 632(a)(1)).

[208] *Id.* § 632. *See, e.g., Brown Transport Truckload, Inc. v. Southern Wipers, Inc.*, 176 B.R. 82 (N.D. Ga. 1994).

[209] 13 C.F.R. § 121.201.

[210] 5 U.S.C. § 801(a)(1)(A).

### C. Paperwork Reduction Act

115. This Notice contains either a proposed or modified information collection. The Commission, as part of its continuing effort to reduce paperwork burdens, invites the general public and the Office of Management and Budget ("OMB") to comment on the information collections contained in this Notice, as required by the Paperwork Reduction Act of 1995, Pub. L. No. 104-13. Public and agency comments are due at the same time as other comments on this Notice; OMB comments are due 60 days from date of publication of this Notice in the Federal Register. Comments should address: (a) whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information shall have practical utility; (b) the accuracy of the Commission's burden estimates; (c) ways to enhance the quality, utility, and clarity of the information collected; and (d) ways to minimize the burden of the collection of information on the respondents, including the use of automated collection techniques or other forms of information technology.

116. Written comments by the public on the proposed or modified information collection are due on or before December 10, 1997 and reply comments on or before January 26, 1998. Written comments must be submitted by the Office of Management and Budget (OMB) on the proposed or modified information collections on or before 60 days after date of publication in the Federal Register. In addition to filing comments with the Secretary, a copy of any comments on the information collection contained herein should be submitted to Judy Boley, Federal Communications Commission, Room 234, 1919 M Street, N.W., Washington, DC 20554, or via the Internet to dconway@fcc.gov and to Timothy Fain, OMB Desk Officer, 10236 NEOB, 725 17th Street, N.W., Washington, DC 20503 or via the Internet to fain_t@al.eop.gov.

### D. Comment Filing Procedures

117. We invite comment on the issues set forth above. Pursuant to applicable procedures set forth in Sections 1.415 and 1.419 of the Commission's rules,[211] interested commenters may file comments on or before December 10, 1997, and reply comments on or before January 26, 1998. Comments will be limited to 25 pages, not including appendices. Reply comments will be limited to 20 pages, not including appendices.

118. To file formally in this proceeding, interested parties must file an original and six copies of all comments, reply comments, and supporting comments. If interested parties want each Commissioner to receive a personal copy of comments, an original plus eleven

[211] 47 C.F.R. §§ 1.415 and 1.419.

copies must be filed. Interested parties should send comments and reply comments to Office of the Secretary, Federal Communications Commission, Washington, D.C. 20554 with a copy to Connie Chapman of the Common Carrier Bureau's Accounting and Audits Division, 2000 L Street, N.W., suite 200M, Washington, D.C. 20554. Parties must also serve comments on the Federal-State Joint Board in accordance with the service list. Commenters should also provide one copy of any documents filed in this proceeding to the Commission's copy contractor, International Transcription Service ("ITS"), 2100 M Street, N.W., Suite 140, Washington, D.C., 20037. Comments and reply comments will be available for inspection during regular business hours in the FCC Reference Center, Room 239, 1919 M Street, N.W., Washington, D.C. 20554. For further information contact Connie Chapman at (202) 418-0885.

119. Parties are also asked to submit comments and reply comments on diskettes. Such diskette submissions would be in addition to and not a substitute for the formal filing requirements addressed above. Parties submitting diskettes should submit them to Connie Chapman, Common Carrier Bureau, Accounting and Audits Division, 2000 L Street, N.W., Suite 200M, Washington, D.C. 20554. Such a submission should be on a 3.5 inch diskette formatted in an IBM compatible form using, if possible, WordPerfect 5.1 for Windows software. The diskette should be submitted in "read only" mode. The diskette should be clearly labelled with the party's name, proceeding, type of pleading (comment or reply comment) and date of submission. The diskette should be accompanied by a cover letter.

## VI. ORDERING CLAUSES

120. 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 that NOTICE IS HEREBY GIVEN of proposed amendments to Part 36 of the Commission's rules, 47 C.F.R. Part 36, as described in this NOTICE OF PROPOSED RULEMAKING.

121. IT IS FURTHER ORDERED that, pursuant to section 410(c) of the Communications Act of 1934, 47 U.S.C. § 410(c), the proposals set forth in the Notice of Proposed Rulemaking are hereby referred to the Federal-State Joint Board established in CC Docket No. 80-286 for preparation of a recommended decision.

122. IT IS FURTHER ORDERED, that a copy of all filings in this proceeding shall be served on each of the appointees and staff personnel on the attached service list.

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton
Acting Secretary