B. Pacific's Position on How Additional TELRIC Costs Should Be Derived

As noted above, Pacific's position on how costs should be developed for the "missing" elements was articulated by Mr. Scholl. He agrees with AT&T/MCI that costs for LIDB queries and 800 database queries can be derived from the TSLRIC studies, and that the TELRIC costs approved in D.98-02-106 for the STP port and various transport elements that can serve as SS7 links can be used to develop costs for SS7 links and "link mileage." (Ex. 132, pp. 32-33.)

With regard to other elements, however, Mr. Scholl differs sharply with the approach advocated by Ms. Murray. On DS-1 line ports, for example, he contends that the element has never been adequately defined by AT&T/ MCI, and that trying to cost and price it in the absence of an adequate definition is premature. (*Id.* at 32.)

For 4-wire voice grade entrance facilities and DS-3 entrance facilities without equipment, Mr. Scholl contends that Pacific *has* in fact prepared TELRIC studies. As to the 4-wire entrance facilities, he claims the study was approved in D.98-02-106, but Pacific neglected to propose a price based on the study in the pricing testimony of Mr. Hopfinger. As to DS-3 entrance facilities without equipment, Mr. Scholl states that the TELRIC study prepared for this element "was inadvertently omitted in Pacific Bell's initial TELRIC filing [of January 13, 1997]," although the component pieces were apparently included in Pacific's workpapers. In Mr. Scholl's opinion, the Commission has now effectively approved this study, because the results of it were included in the compliance filings that Pacific made in response to D.98-02-106. (*Id.* at 33-34.)

For digital cross-connect systems (DCS), Mr. Scholl states that the only aspect of this element that has been defined is multiplexing, which is included in Pacific's TELRICs:

> "[T]he DCS is a component part of the EISCC used to connect digital [UNEs] to a collocation cage, and its cost is contained in the TERLIC for the DS-1 EISCC. In the arbitrations, what was called by some the 'DCS' element became defined as 'multiplexing.' The TELRIC of that multiplexing element is included in the TELRICs presented here. There has been no further identification of any DCS network element. If any additional DCS network element is ever defined, then Pacific Bell will identify the TERLIC of that element." (*Id.* at 33.)

Finally, as to unbundled loops provided over digital loop carrier and delivered to the entrant as a digital facility, Mr. Scholl again argues that all necessary TELRIC costs have already been adopted. Mr. Scholl describes the necessary cost foundation as follows:

> "[T]he TELRIC for a DS-1 unbundled loop was included in the adopted TELRICs, as were the costs of digital entrance facilities. These loops are delivered via the DS-1 EISCC to the entrant's cage as a digital facility. They are the only digital loops provided, and the only ones requiring digital facilities for the connection to the entrant's collocation cage. There are no additional digital services which require [UNEs]. Other unbundled loops for analog services are delivered directly to the entrant's cage via the appropriate EISCC." (*Id.* at 34.)[91]

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[91] In its Reply Brief, Pacific seems to be taking a different position on digital loops than Mr. Scholl. In the brief, Pacific heatedly argues that Ms. Murray's testimony is the latest salvo in a thus far-unsuccessful battle designed to force Pacific to install expensive Next Generation Digital Loop Carrier (NGDLC) in its network:

> "AT&T/MCI proposed a "Digital Loop" with rate elements . . . presuming the use (and unbundling of) NGDLC digital loop carrier equipment. These proposed prices continue AT&T's ongoing campaign to obtain UNE prices for loops based on NGDLC equipment which has not been installed in our network, is not scheduled to be installed, and is not used in any of our approved incremental cost studies. In the TELRIC cost phase[,] AT&T/MCI attempted unsuccessfully to put these cost elements into this proceeding through the Hatfield Model. They now try again in the

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C. Discussion Concerning Additional Costs

On several of the uncosted elements, we think AT&T/MCI generally have the better of the argument. We will use a modified version of their approach to estimate TELRIC costs for the DS-1 Port, the DS-3 entrance facility without equipment and unbundled loops provided over digital loop carrier. However, we agree with Mr. Scholl that the AT&T/MCI approach is unnecessary, and that our adopted TELRIC studies make it relatively easy to develop costs for, the 4-wire entrance facility, SS7 links and link mileage and digital cross connects. For LIDB and 800 database queries, we have decided that the TSLRIC costs for these elements that were approved in D.96-08-021 should be used for the time being.

For DS-1 line ports, the main difference between the parties is whether the element has been adequately described. The PD concluded that it had been, and that the adopted TELRIC costs for End Office Switching Trunk Port Termination could be used to derive a suitable estimate for the "line side" DS-1 port. In its comments on the PD, Pacific states that the other parties' definition of the line side DS-1 port "is recognizable to us only if it is the same thing as the switch portion of our 'Supertrunk' offering." (Pacific Opening Comments, p. 17.) We agree the switch portion of Pacific's Supertrunk offering is a justifiable proxy for the DS-1 line side port, and we have used it in Appendices A and B.

For the DS-3 entrance facility without equipment, the situation is more complicated. The PD concluded that the costs reported in the TELRIC

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pricing phase . . . [A]s Ms. Murray acknowledged on the stand, these Digital Loop rate elements include 'black box' components such as 'Channelized DS-1 Virtual Feeder to RT.'" (Pacific Reply Brief, pp. 38-39.)

study that Pacific belatedly submitted for this element were excessive, and that the most reasonable approach was to use Ms. Murray's suggestion of backing out remote and central office circuit equipment costs from the adopted TELRICs for the DS-3 entrance facility *with* equipment. However, in its comments on the PD, Pacific argues that this method would result in "dark fiber," because "the standard industry definition of DS-3 entrance facilities without equipment only excludes the *remote* equipment at the customer location. The termination electronics at the central office *is* included. The PD incorrectly proposes to eliminate the equipment at both ends." (*Id.* at 17-18.) Upon further study, we agree with Pacific, and have made appropriate adjustments in the pricing appendices.

As to unbundled loops provided over digital loop carrier (DLC), we think the argument in Pacific's reply brief that the adopted TELRIC costs do not include DLC is without merit. As a review of D.96-08-021 indicates, Pacific's investment plans for DLC were an issue in connection with the proper "cross-over" point assumed in its TSLRIC studies. (*Mimeo.* at 58.)[92] The loop and access line costs we approved in D.96-08-021 assumed about a 52-48 ratio of copper to fiber, and this assumption was carried forward into the TELRIC studies we adopted in D.98-02-106. (*See* D.98-02-106, *mimeo.* at 83-85; D.98-12-079, *mimeo.* at 68-69.)

In view of this history, we find reasonable Ms. Murray's approach of using a combination of fiber and fiber electronics from the DS-1 loop and the DS-1 EISCC as a proxy for estimating the TELRIC of providing unbundled loops over DLC. Mr. Scholl also appears to acknowledge that this approach is

[92] In D.96-08-021, we defined the cross-over point as "the point at which it becomes more economic to use fiber instead of copper" in loops. (*Mimeo.* at 57.)

reasonable. If we were to accept the argument in Pacific's brief that digital loop carrier cannot be unbundled, we would be unfairly hampering entrants in their ability to use DLC technology over longer loops.[93]

As Mr. Scholl notes, we have already approved Pacific's TELRIC study for 4-wire voice grade entrance facilities. In view of the discomfort we expressed in D.98-02-106 with the allegedly "historic" multiplier relied on by Ms. Murray in her 4-wire analysis, *mimeo.* at 83-85, we will use Pacific's approved study for pricing this element.[94]

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[93] In its comments of the PD, Pacific continues to argue that a price for DLC loop should not be adopted, "since no DLC loop was brought forward through the OANAD cost study process, and none exists in interconnection agreements." (Pacific's Opening Comments, p. 18.) As noted in the text, we think that the assumptions about the fiber-copper ratio for loop plant used in both the TSLRIC and TELRIC studies make it feasible to derive a cost for this element.

Moreover, Pacific is flatly wrong when it asserts that a DLC loop is not provided for in any of its interconnection agreements. The Pacific-MCI interconnection agreement, for example, provides:

> "Certain of Pacific's geographical areas are currently served solely via integrated digital loop carrier (IDLC). In such areas Pacific will make alternate arrangements equal in quality to those used by Pacific . . . At Pacific's option, these arrangements may include, . . . (ii) universal digital loop carrier facilities." (Pacific-MCI Interconnection Agreement, approved pursuant to D.97-01-039, Attachment 6, Section 3.5, Article 3.5.1.)

[94] In its comments on the PD, Pacific points out that while Appendix A to the PD included a price for 4-wire voice-grade entrance facilities based on the discussion in the text, the appendix did not include a price for 2-wire entrance grade facilities. Pacific argues that a final price for the 2-wire entrance facility is needed, since its interconnection agreement with AT&T provides for such a facility. (Pacific's Opening Comments, p. 21.)

This raises a complication, because the TELRIC costs that we adopted in D.98-02-106 covered only a 4-wire voice-grade entrance facility; no cost was adopted for the 2-wire option. *See* Pacific's January 13, 1997 TLERIC submission, Tab B-7. Pacific suggests that

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Because Mr. Scholl also acknowledges that the adopted TELRIC studies include values for the STP port and transport elements that could serve as SS7 links, we will use these values for pricing SS7 links and link mileage.[95]

For digital cross-connects (DCS), we think there is sufficient cost support in the TELRIC studies to justify using the TELRIC of the DS-1 EISCC as the DCS cross-connect. For multiplexing, the cost of a single DCS channel will be one twenty-fourth the TELRIC of the DS-1 multiplexing function, because there are 24 DS-0 channels in a DS-1.

Two elements for which it is not currently possible to estimate TELRIC costs are LIDB queries and 800 database queries. As indicated above, we have decided that for the time being, the most reasonable course of action is to use the TSLRIC costs that we adopted for these elements. However, we will also adopt AT&T/MCI's suggestion that Pacific be ordered to derive TERLIC costs for these elements. The costs so derived shall be submitted in a General Order 96-A advice letter filing, which will be subject to protest.

The recurring costs of the additional elements discussed above are set forth in Appendix A. The price of each element will be its respective cost plus a 19% markup to cover shared and common costs.

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we deal with this problem simply by dividing the price of the 4-wire entrance facility by two. (Pacific's Opening Comments, p. 21.) Since the costing record that we considered in D.98-02-106 does not allow us to derive a more precise estimate, and since no party has objected to Pacific's suggestion in reply comments, we will adopt it.

[95] In its comments on the PD, Pacific argued that the PD had erred in pricing the SS7 link on a per minute-of-use (MOU) basis rather than per-circuit, which is how they are billed in Pacific's interconnection agreements. (Pacific Opening Comments, p. 19.) Since no party has argued in its reply comments that billing on a per-circuit basis is inappropriate, we have modified the prices shown in Appendix A to reflect per-circuit billing. The SS7 link price is based on the Dedicated Transport UNE, and varies depending on whether the purchasing CLEC chooses a DS-0 or DS-1 line.

It is also appropriate to discuss briefly the non-recurring charges applicable to these elements. Pacific pointed out in its opening comments on the PD that while Appendix B thereto contained non-recurring charges for some of the elements discussed in this section, it did not set forth non-recurring charges for unbundled loops provided over DLC, the DS-1 switch port and DCS service. Pacific recommended specific non-recurring charges for each of these elements. (Pacific Opening Comments, p. 20-21.)

In its discussion of the DLC issue, Pacific recommended that in setting a non-recurring charge, the Commission should "start with the non-recurring cost for the 2-wire basic link, and then adjust the work group occurrence factor for the NOTG[96] group to 100%, to reflect the need to involve that group each time a DLC loop would be provisioned." (*Id.* at 19.)

Pacific's recommendation is unreasonable and should not be adopted. Not only is it inconsistent with the determinations made in our recent NRC/OSS order, D.98-12-079, but its practical effect would be to increase the cost of DLC loops substantially. In D.98-12-079, the NRCs adopted for 2-wire loops assumed a 48% occurrence factor for the NOTG group to account for the provisioning of DLC loops. This occurrence factor was consistent with the 52-48 ratio of copper-to-fiber found reasonable in the decision. *See* D.98-12-079, COLs 21-22. The effect of adopting Pacific's recommendation and assuming a 100% occurrence factor would be to increase both the connect and disconnect charge for each DLC loop sold by $5.50. We have therefore decided to base the non-recurring charges for DLC loops on our adopted NRCs for 2-wire loops. These charges are shown in Appendix B.

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[96] "NOTG" stands for Network Operations Translation Group. The NOTG performs a "grooming" function for loops provided over fiber-fed digital loop carrier systems.

Pacific's position on the appropriate non-recurring charge for the DS-1 switch port is more reasonable. For this element, Pacific recommends using the DS-1 Trunk Port as a surrogate. (Pacific Opening Comments, p. 17.) We agree and have modified Appendix B accordingly.

For DCS service, Pacific makes the following recommendation:

> "[T]he Commission should start with the non-recurring cost for Pacific's Digital Cross-Connect Service DCS. The cost for that service should [be] used as the cost for the 'initial' channel of the DCS UNE. 'Additional' channels of that UNE appearing on the same service order would have these costs reduced by the travel time included in the cost of the initial channel." (*Id.* at 20-21.)

Pacific's approach is unreasonable and should not be adopted. DCS non-recurring charges include multiplexing based on 24 DS-0 channels for every DS-1 channel. Under Pacific's proposal, competitors would be required to pay a second complete non-recurring charge for multiplexing for each "additional" channel they order. Instead of this, we will direct Pacific to provide 24 channels for each DCS ordered. The CLEC leasing the DCS will have 24 DS-0 channels available to it at that specific DCS bank, but will not be permitted to distribute these DS-0 channels to different locations. The same principle will apply for multiplexing DS-1 signals into DS-3, and for de-multiplexing both DS-3 and DS-1 signals. This approach is reflected in the non-recurring charges for DCS set forth in Appendix B.

D. The Loop Costing and Pricing Issues Raised By Covad

We now turn to the special costing and pricing issues raised by Covad, a new entrant that offers telecommunications services based on asymmetric digital subscriber line technology (ADSL). Covad has raised two principal points in its testimony and briefs: (1) Pacific's proposed prices for

dedicated transport are excessive, and (2) Pacific has failed to justify its proposal to charge nearly 40% more for digital loops than for copper loops.

On the first point, Covad argues that Pacific's proposed prices for dedicated transport are unreasonable because they equal or exceed Pacific's own retail rates for dedicated transport.[97] Covad contends that Pacific should be required to price transport at the adopted TELRIC plus a markup of no more than 15% to cover shared and common costs. Moreover, Covad argues, Pacific's TELRIC studies and proposed prices fail to reflect the economies of scale associated with SONET[98] technology for higher capacity dedicated transport, such as DS-3x3 and DS-3x12 services. (*Id.* at 13-14, 19-20.)

On the second point, Covad argues that "the digital-capable loops that Covad requires from Pacific consist of plain old end-to-end copper wires freed of . . . encumbrances such as load coils that are placed on 'plain copper' loops to support analog services, or are free from bridge taps." (*Id.* at 10.) Covad argues that it should therefore have to pay only a copper-based price for the loops it seeks, because "Covad purchases and attaches its own electronic hardware to the copper loop to make it digital-capable." (*Id.* at 12.) Covad also argues that the ADSL tariff Pacific recently filed with the FCC supports the argument that a copper-based price is justified for ADSL loops.

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[97] Like several other parties, Covad seizes upon the fact that Pacific witness Hopfinger proposed a dedicated transport rate that was 9900% of the adopted TELRIC cost for such transport. (Covad Opening Brief, p. 14.)

[98] "SONET" stands for Synchronous Optical Network, a fiber optic transmission standard that allows for transmission speeds ranging from 51.84 Mbps to 13.2 Gbps.

E. Pacific's Response To Covad

In its reply brief, Pacific forcefully argues that its pricing proposals for dedicated transport *do* reflect the benefits of SONET technology, and that Covad is wrong in arguing for "deeply discounted transport UNE rates" based on the alleged failure of Pacific's cost studies to reflect SONET technology. On this issue, Pacific states:

> "Mr. Scholl explained [in Exhibit 137] that the TELRIC of each DS-3 service already reflects the SONET technology of Pacific's forward-looking network, which provides each DS-3 transport as a portion of the overall optical transport of the SONET network (OC-12 or OC-48).[99] Thus, the TELRIC of each of the DS-3 transport arrangements reflects the economies of that OC scale. Consequently, the network used to provide each DS-3 transport is identical regardless of whether it is provided singly or as part of a DS-3x3 or DS-3x12 service." (Pacific Reply Brief, p. 19.)

On the question of loop pricing, Pacific is more conciliatory. It concedes that ADSL services can be provided over copper loops and suggests a "compromise" pricing scheme depending on whether Pacific or the ADSL provider performs any necessary "loop conditioning" work. Pacific's proposal is as follows:

> "ADSL cost work conducted subsequent to the TELRIC cost studies indicate that, where the ADSL provider furnishes its own electronics, the *recurring* costs for an ADSL loop are the same as for the two-wire loop UNE. And, it now appears that the electronics for the ADSL UNE will be furnished by the ADSL provider [itself], as COVAD is currently proposing. Consequently, as the industry is now developing, the

[99] "OC" stands for optical carrier, and is a standard carrier reference for SONET used to express bandwidth. For example, OC-1 indicates 51.84 Mbps, OC-12 indicates 622.08 Mbps, and OC-48 indicates 2.488 Gbps.

> recurring costs for many ADSL loop UNEs will be bare copper.
>
> "Given these industry developments, a potential compromise may be to develop separate 'with equipment' and 'without equipment' prices for ADSL providers. Providers furnishing their own electronics (DSLAM, etc.) would pay the 2-wire loop UNE rate. ADSL providers relying upon Pacific to provide DSLAM would pay the ISDN loop rate. This rate structure would remain in effect for the remaining terms of current interconnection agreements . . .
>
> "For this compromise to be viable, it is critical that Pacific be permitted to collect applicable loop conditioning charges on a time and materials basis, as Mr. Deere proposes. The costs for loop conditioning can be substantial where it is required: Pacific's FCC ADSL tariff . . . includes a $900 conditioning charge for loops requiring such work. It would be inappropriate to reduce the monthly recurring UNE charge for ADSL providers unless the conditioning charge is also required." (*Id.* at 20-21.)

F. Discussion of Loop Issues Raised by Covad

We agree with Pacific that its cost studies for dedicated transport are forward-looking and adequately reflect the benefits of SONET technology. However, we also agree with Covad's larger point in raising the SONET issue; *viz.*, Pacific's proposed prices for dedicated transport (and several other UNEs) are too high. Accordingly, as noted in Sections III.E. and VI.B.5. of this decision, the price for each UNE being offered by Pacific will be set at the adopted TELRIC for that element, plus a markup of 19% to cover shared and common costs.

On the issue of the appropriate charge for ADSL loops, we believe that the "compromise" proposal suggested by Pacific should not be adopted. The loop conditioning charges in Pacific's proposal are very high, and -- as the quotation immediately above indicates -- are taken from the ADSL tariff that

Pacific has filed with the FCC. Our own staff's examination of this FCC tariff indicates that the loop conditioning charges in it are based on embedded rather than forward-looking costs. Thus, Pacific's proposed compromise does not take account of our decision in D.98-02-106 to use TELRIC for pricing network elements.

While we agree that it would be unfair to require Pacific to furnish loops that require conditioning without receiving some compensation for this work, we believe that these conditioning charges should be based on forward-looking cost principles.[100] Until we can adopt final TELRIC-based costs and prices for loop conditioning,[101] we have decided that Pacific should receive the non-recurring charge applicable to ISDN loops to cover conditioning costs for all 2-wire loops used to provide digital subscriber line service.[102] The monthly recurring charge that Pacific should receive will depend on whether the digital subscriber line service provider purchasing the loop will use it to offer ADSL

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[100] We note that in the Revised UNE List Order issued on November 5, 1999, the FCC has explicitly provided that loop conditioning charges must be based on forward-looking cost principles, and must comply with the rules for non-recurring costs set forth in 47 C.F.R. § 51.507(e). *See* ¶¶ 172, 194; Appendix C, § 51.319(a)(3)(B) & (C).

[101] We hereby direct Pacific to begin preparations immediately for submitting line conditioning cost studies based on the TELRIC methodology. At an appropriate point in the future, we will instruct Pacific (and other parties interested in submitting their own line-conditioning studies) where and in what docket these studies should be submitted.

[102] For ADSL-ready loops that require no additional conditioning, the non-recurring charge should be the one applicable to analog loops. The ADSL loops that fit this description are those very close to the central office. Load coils and signal boosters are not present in such loops, and thus there is no need to remove, or "condition," them.

service (which requires a 2-wire copper loop), or IDSL service (which requires an ISDN loop).[103]

In the PD that was issued on May 10, 1999, we restricted our discussion of digital subscriber line service to ADSL. The parties' comments on the PD make clear, however, that there are currently two types of digital subscriber line service, ADSL and IDSL. As noted above, ADSL service uses a 2-wire copper loop; it requires that the customer be located within 3 miles of the central office where the loop originates. IDSL service, on the other hand, uses an ISDN loop; it allows the customer to be located as much as 5 miles from the originating central office. Except for copper loops located very close to a central office, both the basic copper loop and the ISDN loop require conditioning before digital subscriber line service can be offered over them. *See* Pacific's Reply Comments, p. 11.

Although Covad's testimony and briefs concerned ADSL service, its comments on the PD address mainly IDSL service. Covad does not challenge our decision (and the PD's) to use the ISDN non-recurring charge as interim compensation for loop conditioning. However, Covad argues strenuously that

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[103] As the discussion in the text suggests, we disagree with Pacific's assertion that until final conditioning costs are adopted, we should set "nominal prices" for loop conditioning that would be subject to a "retroactive true-up" once the TELRIC costs for conditioning are determined. (Pacific's Opening Comments, p. 16.) As Northpoint emphasizes in its reply comments on the PD, Pacific has offered no specifics about what these "nominal prices" should be. (Northpoint Reply Comments, pp. 1-2.) Moreover, in order to promote commercial stability, we have generally disfavored the use of true-ups with interconnection agreements. Page 2 of Resolution ALJ-174 states, for example, that the "rates adopted in the Commission's OANAD pricing decision or decisions" shall be substituted for the interim UNE rates in arbitrated interconnection agreements "on a forward basis."

the monthly price of the IDSN loop is too high. Covad argues that this price – which is comprised of the basic loop price of $11.70 plus the ISDN increment of $4.44 – should be reduced by $2.22. Covad states:

> "Such a long time (2 years plus) has passed since Pacific Bell's *1994 based* costs were examined in this proceeding that the Commission should use its discretion and general expertise to make current its decision by discounting the costs of ISDN plug-in hardware by 50% based on the passage of time alone . . . , or go further and eliminate entirely the ISDN mark up for ISDN loops . . ." (Covad Opening Comments, p. 4.)

We decline this suggestion for several reasons. First, although we expect to undertake a general reexamination of Pacific's network element costs eventually, now is clearly not the time to do so. If we were to adjust ISDN prices here based on events that have allegedly occurred since Pacific's cost studies were submitted, we would logically be required to reevaluate all of Pacific's other costs as well.[104] Such reevaluation would, as a practical matter, prevent us from adopting final UNE prices. Second, Pacific is correct that the evidence Covad is relying on to justify a $2.22 ISDN increment (including the Chicago loop price offered by Ameritech and the loop price offered by GTEC) lies outside the record of this proceeding. (Pacific Opening Comments, p. 10.)[105]

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[104] However, as noted in Section VII.B. of this decision, we are establishing an annual cost reexamination proceeding for the purpose of reconsidering the costs of no more than two UNEs per year, if either a CLEC or ILEC can demonstrate that there has been a cost change for the element of at least 20% from the costs adopted in D.98-02-106 (and related compliance filings).

[105] We also reject the implicit claim of discrimination that Covad has made with respect to ISDN pricing. In its comments on the PD, Covad argues that the ISDN loop price is too high because, *inter alia*, when this loop is combined with an ISDN port, the price for the combination specified in the PD, $30.24, exceeds Pacific's *retail* price for both

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VI. SHOULD PACIFIC BE REQUIRED TO CONTINUE COMBINING UNEs FOR ALL PARTIES WHOSE INTERCONNECTION AGREEMENTS PROVIDE FOR SUCH COMBINATIONS, AND IF SO, HOW SHOULD THE APPROPRIATE COMPENSATION FOR SUCH COMBINATIONS BE DETERMINED?

As noted in the introduction, one of the principal issues in the UNE pricing hearings was whether Pacific should be required to combine unbundled network elements at the request of CLECs that purchase them. This issue figured prominently in the Eighth Circuit's decision in *Iowa Utilities Board v. FCC*, 120 F.3d 753 (8th Cir. 1997), as well as in the U.S. Supreme Court's reversal of the Eighth Circuit in *AT&T-Iowa*.

In order to understand how the "recombination" issue was framed at the hearings -- and what remains of it for us to decide after the Supreme Court's decision -- it is useful to review some of the background that occurred before the hearings. This background includes the discussion at the March 16, 1998 prehearing conference (PHC), as well as the March 27, 1998 ruling in which the assigned ALJ asked the parties for testimony on various issues related to recombinations.

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residential ($26.00) and business ($28.82) ISDN service. (Covad Opening Comments, p. 5.)

We agree with Pacific that Covad's comparison is misleading. As Pacific points out, FCC end user charges totaling $7.04 must be added onto these retail ISDN prices. (Pacific Reply Comments, p. 11.) Furthermore, we agree with Pacific that for residential service, the relevant comparison is with Pacific's price for flat-rate rather than measured ISDN service. Pacific's price for flat-rate ISDN residential service is $31.25, whereas the rate for measured ISDN residential service is $26.00. Letter of Timothy S. Dawson to ALJ McKenzie, dated June 29, 1999.

A. Background of the Recombination Controversy

1. Rulings on Recombination in the Eighth Circuit's Iowa Decision

The controversy at the pricing hearings over whether Pacific could be required to offer combinations of UNEs arose out of two passages in the Eighth Circuit's decision in *Iowa Utilities Board*. In the first passage, the Eighth Circuit held that under the Telecommunications Act, the FCC could not require incumbent local exchange carriers (ILECs) to combine network elements for CLECs:

> "The last sentence of subsection 251(c)(3) reads, 'An [ILEC] shall provide such unbundled network elements in a manner that allows *requesting carriers to combine* such elements in order to provide such telecommunications service.' . . . This sentence unambiguously indicates that requesting carriers will combine the unbundled elements themselves. While the Act requires incumbent LECs to provide elements in a manner that enables the competing carriers to combine them, we do not believe that this language can be read to levy a duty on the incumbent LECs to do the actual combining of elements." (120 F.3d at 813.)

In the second passage (which resulted from the Eighth Circuit's October 14, 1997 Order on Reconsideration), the Court of Appeals held that the FCC had erred in prohibiting the ILECs from tearing apart network elements that were already combined on a "platform." The Eighth Circuit said:

> ". . . § 251(c)(3) does not permit a new entrant to purchase the incumbent LEC's assembled platform(s) of combined network elements (or any lesser existing combination of two or more elements) in order to offer competitive telecommunications services. To permit such an acquisition of already combined elements at cost based rates for unbundled access would obliterate the careful distinctions Congress has drawn in

> subsections 251(c)(3) and (4) between access to unbundled network elements on the one hand and the purchase at wholesale rates of an incumbent's telecommunications retail services for resale on the other. Accordingly, the Commission's rule, 47 C.F.R. § 51.315(b), which prohibits an incumbent LEC from separating network elements that it may currently combine, is contrary to § 251(c)(3) because the rule would permit the new entrant access to the incumbent LEC's network elements on a bundled rather than an unbundled basis." (*Id.*)

In D.98-02-106, we took note of these holdings and ruled that the recombination issue was a proper one for the UNE pricing hearings. (*Mimeo.* at 16-17.) Moreover, we stated that "we will . . . leave it to the discretion of the ALJ, working in consultation with Commissioner Duque, to determine how the Eighth Circuit's rebundling directive should be implemented in the supplementary pricing hearings." (*Id.*)

2. Discussion of Recombination Issue at the March 16, 1998 Prehearing Conference and in the ALJ Ruling of March 27, 1998

After the issuance of D.98-02-106, the assigned ALJ convened a prehearing conference (PHC) to discuss issues and procedures for the supplementary pricing hearings.[106] In his ruling convening the PHC, the ALJ instructed the parties that they should be prepared to discuss various aspects of the recombination issue, including whether they read the above-quoted language as "merely . . . prohibit[ing] the FCC from ordering the States to implement rebundling, or whether this language also acts as a bar on the States' power to

[106] Administrative Law Judge's Ruling Convening Prehearing Conference To Discuss Issues For Supplementary Pricing Hearings, issued March 4, 1998, *mimeo.* at 3-4.

limit and control the extent to which [ILECs] may 'tear apart' their preassembled platforms (and charge a fee for reassembling the pieces)." (*Mimeo.* at 3.)

Considerable time was spent on the recombination issue at the PHC held on March 16, 1998. The parties' positions were summarized as follows in the ALJ's post-PHC ruling of March 27, 1998[107]:

> "Pacific and [GTEC] took the position at the PHC that the language in *Iowa Utilities Board* at 120 F.3d 813 means that this Commission lacks authority, under principles of preemption, to order combinations of network elements . . . All the non-LEC parties took the position that this Commission has independent authority under California law to order the LECs to offer combinations of [UNEs], but differed on how that authority should be exercised in particular cases.
>
> "Several parties that have signed interconnection agreements requiring Pacific to provide varying combinations of elements, such as [AT&T and MCI], took the position that the Commission should not disturb those agreements, some of which provide for renegotiation in the event of a 'final and non-appealable' court ruling that the FCC lacks authority to order recombinations . . . Although Pacific disagrees with AT&T and MCI over whether the renegotiation provisions in its agreements have been triggered, it agrees with AT&T and MCI that the Commission should not disturb those interconnection agreements insofar as they set forth Pacific's obligations to offer recombinations of UNEs . . .

[107] Administrative Law Judge's Ruling Concerning Issues Raised at March 16, 1998 Prehearing Conference, issued March 27, 1998. Hereafter, this ruling will be referred to as the "March 27, 1998 Ruling."

> "For those parties who have not entered into interconnection agreements, or whose interconnection agreements are silent on the issue, there was agreement among the non-LEC parties that the Commission should exercise its authority under California law to order Pacific to offer any combination of UNEs that a CLC might want . . . Most of these parties are opposed to the idea that Pacific should receive any compensation (which they describe as a 'regluing charge') for combinations of UNEs that Pacific already employs itself or offers to other CLCs . . ." (*Mimeo.* at 3-4; citations omitted.)

After presenting this summary, the March 27 ruling set forth the ALJ's preliminary conclusions[108] about the issues raised. First, rejecting the arguments of Pacific and GTEC, the ALJ tentatively concluded that this Commission has independent authority under California law to order recombinations.[109] The ALJ further opined that – provided appropriate steps were taken to minimize the potential for arbitrage between resale service and the purchase of UNEs - exercise of the Commission's recombination authority would not be inconsistent with the Eighth Circuit's discussion in *Iowa Utilities Board.* (*Id.* at 5-8.)

The ALJ then offered the parties some guidance about two issues he wanted them to address in their testimony. First, he instructed Pacific to specify which combinations of UNEs it was willing to make available on a

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[108] The ALJ noted that his conclusions were tentative because "we have not yet had the benefit of briefing from the parties on the precise scope of our authority under California law." (March 27, 1998 Ruling at 7.)

[109] In reaching this conclusion, the ALJ relied upon the powers conferred on the Commission by sections 451, 453, 454, 701, 761, 851, 871 and 2871-2897 of the Pub. Util. Code.

voluntary basis to all parties, as well as which combinations had been requested by at least two CLECs. (*Id.* at 9.) Second, the ALJ set forth a proposed formula for a "regluing" charge (on the assumption that such a charge might be legally necessary to overcome the arbitrage problem), and asked the parties to propose alternative formulae for compensating Pacific for "the intellectual and physical work necessary to create services from elements." (*Mimeo.* at 9-11.)[110]

As we shall see, Pacific ultimately ended up taking the position at the hearings that this Commission lacked authority to order ILECs to provide UNE combinations. Instead, Pacific proposed to let CLECs create their own combinations through "points of access." To complicate matters further, it became apparent during the hearings that notwithstanding its legal position, Pacific had entered into separate agreements with AT&T, MCI and Sprint to continue providing previously agreed-upon UNE combinations to those carriers during the remaining term of their interconnection agreements.

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[110] The ALJ stated that all proposals for a "recombination fee" or "regluing charge" would be subject to a ceiling suggested in a January 7, 1998 summary judgment ruling by the U.S. District Court in Seattle in *U.S. West Communications, Inc. v. MFS Intelenet, Inc.* (Western District of Washington, No. C97-222WD). The ALJ described the ceiling as follows:

> "[T]he recombination fee is equal to the difference between the wholesale rate established under § 252(d)(3) of the Telecommunications Act and the *sum* of the UNE costs that make up wholesale service. Further, it is our understanding that this fee is then spread *pro rata* among the elements according to the TELRIC costs determined for them. In view of the absence of data from Pacific regarding the actual costs of offering UNE combinations, and as an interim expedient, we think this type of recombination fee offers an equitable starting point for determining what compensation Pacific should receive for the actual work of combining UNEs." (March 27, 1998 Ruling, *mimeo.* at 10.)

3. Pacific's Agreements with AT&T, MCI and Sprint To Continue Providing UNE Combinations During The Remaining Term Of Those Carriers' Interconnection Agreements

During the hearings, it became apparent that despite Pacific's argument that it could not be required to furnish UNE combinations, Pacific had in fact agreed to continue providing such combinations to certain parties in exchange for a change in billing systems. Under Memoranda of Understanding with Sprint, MCImetro[111] and AT&T (which agreements were admitted into evidence as Exhibits 141, 142 and 143, respectively), Pacific agreed with these three carriers that in exchange for an agreement to replace the CABS system for resale ordering and billing with the new CRIS system, Pacific would continue providing the UNE combinations called for under these three carriers' interconnection agreements. Pacific agreed to continue providing such combinations for the remaining life of the interconnection agreements (all of which expire by early 2000.)

The language in the Pacific-AT&T Memorandum of Understanding (Exhibit 143) is typical:

> "1. In return for, and conditioned upon, AT&T's agreeing to meet, and meeting, the May 11, 1998 CABS to CRIS conversion for Pacific and Nevada [Bell] and the payment by Pacific of expenses of such conversion as set forth below, Pacific and AT&T agree to the following:
>
> "a. Pacific will waive what it believes to be its legal right to require AT&T to combine UNEs and its

[111] MCImetro is the subsidiary of MCI through which local exchange service is provided in California and certain other states. For convenience, we hereafter refer to MCImetro simply as MCI.

> contractual right to renegotiate the UNE Combination provisions of its Interconnection Agreement for the remainder of the term of the Interconnection Agreement. Instead, Pacific will comply with the current provisions regarding UNE Combinations in the Interconnection Agreement (including the terms and conditions related to the recurring and nonrecurring price(s) for UNE Combinations as set forth in Attachment 8 of the Interconnection Agreement)... Other than the recurring and non-recurring charges currently specified in the Interconnection Agreement ... Pacific will not impose any bundling charges for the term of the Interconnection Agreement to perform such agreed upon Combinations. These provisions will apply for the remainder of the term of the Interconnection Agreement regardless of any regulatory, legislative, or judicial change or ruling unless such continued compliance is expressly prohibited by a change in the law subsequent to the date of this Memorandum of Understanding."

Although the language conditioning Pacific's continued provision of UNE combinations upon acceptance of the CABS-to-CRIS conversion was largely the same in all three Memoranda of Understanding, the payment terms were different. While Pacific agreed to reimburse AT&T and Sprint up to $500,000 in conversion costs (conditioned upon a right to audit these costs), it agreed to pay MCI only $200,000 "in complete settlement" for the claimed costs of converting from CABS to CRIS, with no right of audit.

Each Memorandum of Understanding contained a confidentiality clause. For example, paragraph 1.g. of Pacific's agreement with AT&T required, in effect, that both parties keep secret the existence of Appendix D to their Memorandum, which specified some of the UNE combinations to be made available. The Pacific-AT&T confidentiality clause provided as follows:

> "This Memorandum of Understanding and each term hereof and the negotiation hereof are confidential and

> proprietary to AT&T and Pacific and, except as provided in the following two sentences, are subject to the terms of Section 19 of the Interconnection Agreement. Either party may disclose the provisions set forth in section 1.a. hereof and that AT&T has agreed to convert from CABS to CRIS, and either party may file Exhibits A, B and C hereto with the California Public Utilities Commission as mutually approved amendments to the Interconnection Agreement. Other than as stated in the prior sentence, the second sentence of Section 19.5 of the Interconnection Agreement shall not apply to permit disclosure of this Memorandum of Understanding or any term hereof or the negotiation hereof without the advance written consent of the other Party."

During the hearings and in its briefs, Pacific argued that it would provide UNE combinations to AT&T, Sprint and MCI in accordance with the terms of the Memoranda of Understanding. However, Pacific continued, it could not be required to file what it termed a "recombination tariff," because -- in Pacific's view -- the Commission lacked authority to require either UNE tariffs or the provision of UNE platforms. (Pacific Opening Brief, p. 69.)

B. Pacific's Proposal For Allowing CLECs to Combine Unbundled Network Elements For Themselves

As explained in Section VI.C., *infra*, Pacific argued at length that this Commission lacked authority under California law (and was preempted by the Eight Circuit decision) from ordering ILECs to recombine network elements for carriers who wish to purchase them. However, in order to comply with the Eight Circuit ruling that ILECs must make UNEs available so that CLECs can combine

them for themselves, Pacific put forward what it described as its "points of access" proposal.[112]

The points-of-access proposal was presented in Exhibit 107, the direct testimony of Pacific's network engineering witness, William Deere. Mr. Deere described a point of access as "a location where the CLEC has physical access to UNEs for the purpose of combining those elements to provide telecommunications services." (Ex. 107, p. 15.)

According to Mr. Deere, Pacific expects to offer five points of access eventually, although only the first – which is premised on physical collocation – was available at the time of the hearings. (Tr. 42: 6235-36.) Under this first point-of-access, where a CLEC is physically collocated in one of Pacific's central or tandem offices, Pacific "extends UNEs that require cross connection to a Point of Termination (POT) frame located inside the CLEC's physical collocation space. Using this method, the CLEC has secure access to its circuits and they are protected from access by others. This option also allows cross connection to equipment provided by the CLEC in the collocation space." (Ex. 107, p. 16.)

In the second method of access, Pacific proposes to "extend[] UNEs that require cross connection to a CLEC UNE access point (common frame) located in a collocation *common area*. This method provides a CLEC an option of connecting UNEs that do not require connection to CLEC equipment in the collocation space. All physically collocated CLECs choosing Method 2 in an office have access to the same access point." (*Id.*; emphasis supplied.)

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[112] The points-of-access proposal apparently applied to parties who did not have an interconnection agreement with Pacific, or whose interconnection agreement was silent on the subject of UNE combinations.

In the third method, Pacific proposes to extend UNEs requiring cross connection to the CLEC's "UNE Frame located in a common area room space, *other than collocation common areas,* within the central office or tandem office building. The CLEC point of access is located in a secure area of the building other than the collocation space. This allows CLECs to share a common frame for the connection of [Pacific] UNEs. The CLEC does not have access to its own equipment from this point." (*Id.*; emphasis supplied.)

In the fourth method, Pacific would "extend[] UNEs to an external Point of Presence, such as a cabinet located outside the central office or tandem office building, provided by [Pacific] on [Pacific's] property. This arrangement will operate like Method 3, except the point of access will be *outside of* [Pacific's] building." (*Id.* at 17; emphasis supplied.) In the fifth method, Pacific would extend UNEs "to a building not controlled by [Pacific] via cabling provided by the CLEC. The CLEC provides the cable necessary to reach from a manhole outside the central office building to [Pacific's] Distribution Frame" in the Pacific central office where connection is requested. (*Id.*)

Although UNE prices for GTEC are not being set in this phase, GTEC also presented testimony on how it enables CLECs to combine UNEs for themselves. (Ex. 307; Hartshorn.) All three of GTEC's proposed methods relied on some form of collocation. The first method, based on physical collocation, is similar to the first point of access described by Mr. Deere. (*Id.* at 7-11.) GTEC's second method, which was based on "virtual"[113] collocation, is similar to the fifth

[113] Virtual collocation has been defined as a situation in which "the LEC owns and maintains the circuit terminating equipment, but the CAP designates the type of equipment that the LEC must use and strings its own cable to a point of interconnection close to the LEC central office." *Bell Atlantic Telephone Companies v. F.C.C.*, 24 F.3d 1441, 1444 (D.C. Cir. 1994).

point of access described by Mr. Deere. (*Id.* at 11-13.) GTEC's third proposed method relied on "common collocation," in which a common area in a central office is made available to all CLECs who wish to collocate in that office. (Ex. 308, pp. 2-5.) This method, on which the Commission is now considering cost studies submitted by Pacific and GTEC,[114] is similar to Pacific's second proposed point of access. Indeed, Sprint states that "GTE's proposal for providing access to UNEs is nearly identical to Pacific's proposal, with the exception of interconnection outside the central office." (Sprint Opening Brief, p. 42; footnote omitted.)

C. The Parties' Positions on the Extent of the Commission's Authority To Order ILECs To Recombine Unbundled Network Elements For CLECs

1. The Pacific and GTEC Argument That the Commission Lacks Authority To Order UNE Combinations

In their post-hearing briefs, Pacific and GTEC both argued that the Commission should not consider the recombination issue, because any Commission ruling was likely to be superseded quickly by the Supreme Court's decision in the *Iowa Utilities Board* case. (Pacific Opening Brief, pp. xiv-xv; GTEC Reply Brief, pp. 24-25.) However, they continued, if the Commission felt obliged to address the recombination issue before the Supreme Court ruled, then it was

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[114] *See* Joint Assigned Commissioner and Administrative Law Judge's Ruling Concerning Costing and Pricing of Collocation for Pacific Bell and GTE California Incorporated, issued August 31, 1998, *mimeo.* at 8. This ruling defines "common collocation" as

> ". . . very similar to physical [collocation] in that the arrangement utilizes a caged area with direct or escorted access available to all collocating CLCs; it differs in that the area within the cage is jointly occupied by one or more CLCs, with each carrier leasing 'space' within the cage in terms of how much space it occupies." (*Id.* at 5.)

clear that the Commission lacked authority under either state or federal law to order UNE combinations. Pacific stated:

> "[T]here is only one legally defensible interpretation of the Eighth Circuit opinion: Neither the FCC nor any state commission can require an ILEC to combine UNEs or prevent an ILEC from separating UNEs it may currently combine." (Pacific Opening Brief, p. 59; footnote omitted.)

The reason the Commission lacks such authority, Pacific continued, was that the pre-assembled UNE platforms sought by CLECs were "the exact equivalent of resale under another name," and "any attempt to allow CLECs to offer a full line of resold services under the guise of purchasing ILEC-combined [UNEs] is contrary not only to the language of the specific provisions governing unbundling, but also to the basic statutory distinction between resale and access to [UNEs]." (*Id.* at 62.)

Pacific also rejected the idea that the UNE-resale distinction could be preserved if a "regluing" charge were to be imposed. Noting that all appeals of the First Report and Order had been consolidated in the Eighth Circuit, whose "decision is the law of the land until the Supreme Court rules," Pacific argued:

> "[The gluing charge approach] simply disregards the Eighth Circuit order. The Eighth Circuit's holding is that the plain language of the Act requires 'requesting carriers' to do the combining of network elements. The holding stops there. The Eighth Circuit did not modify, but instead *nullified* the FCC's rules requiring ILECs to combine because such requirements were 'inconsistent' with the Act. The Eighth Circuit did not say it was 'OK' to require combining 'if' ILECs were compensated in a

way which left the resale provisions of the Act intact." (*Id.* at 63-64; footnotes omitted.)[115]

Pacific also disagreed with the conclusion in the March 27, 1998 ALJ Ruling that the Commission has independent authority under the California law to order UNE combinations. Pacific argued that the provisions in the Pub. Util. Code relied upon by the ALJ are inconsistent with Pub. Util. Code § 709.2, which is the Legislature's most specific discussion of unbundling in the telecommunications context. Pacific asserted that prior to the passage of § 709.2(c)(1) – which expressly refers to "fair unbundling of exchange facilities" in *this* docket -- unbundling was understood to mean whether "one part of the network could be physically 'unplugged' from the rest of the incumbent's facilities and separately priced so that other companies could compete to provide just that single piece of the network." (Pacific Opening Brief, pp. 67-68.) According to Pacific, the argument that CLECs should have access to platforms of assembled UNEs "turns that understanding of 'unbundling' on its head." (*Id.* at 68.)

GTEC joined Pacific in arguing that a requirement that ILECs make combinations of UNEs available to requesting carriers on a platform amounted to resale by another name. However, GTEC's position in this regard was based entirely on the alleged preemptive effect of the Eighth Circuit's decision. Without discussing Pub. Util. Code § 709.2, GTEC acknowledged that "[a]ssuming there were no federal laws regarding local competition, California

[115] Interestingly, Pacific argued in the alternative that if the Commission concluded it had authority to order UNE combinations, it should impose a gluing charge consistent with the "cap" described in the March 27, 1998 ALJ Ruling. (*Id.* at 69-70.)

state law probably would authorize this Commission to order ILEC rebundling." (GTEC Reply Brief, p. 21.)

2. The Contention of the Facilities-Based Coalition That the Commission Has Statutory Authority To Order UNE Combinations

The strongest position favoring the Commission's authority to order the provision of UNE combinations was staked out by the Facilities-Based Coalition. The FBC argued that Pacific had badly misread the Eighth Circuit's decision when it argued that, under principles of preemption, that decision precluded the States as well as the FCC from ordering ILECs to provide UNE combinations. Noting that the issues before the Eighth Circuit related solely to the extent of the FCC's powers, the FBC maintained that "[t]he Eighth Circuit's decision was a ruling on the extent of the FCC's power under the Telecommunications Act; *Iowa Utilities Board* is not a ruling that preempts the states from acting under their state law powers." (FBC Opening Brief, pp. 76-77.)

Based on the same statutory provisions cited in the March 27, 1998 ALJ Ruling, the FBC concluded that the Commission has authority under California law to order UNE combinations. The FBC placed special reliance on Pub. Util. Code § 761, which in its view "provides the Commission with ample state law authority to require Pacific and GTEC to combine UNEs for the CLCs if the Commission concludes, after hearing, . . . that this is the best and most appropriate means for 'the furnishing of [this] commodity' by ILECs." (FBC Opening Brief, p. 75.)

The FBC disagreed that, when seeking UNE combinations, CLECs like themselves were merely trying to obtain resale service at a deeper

discount.[116] The FBC noted that members had spent millions of dollars on their own facilities, and had no desire to devalue those investments by making finished services (in the form of a UNE platform) available to CLECs who had not invested in facilities.

The reason for requiring Pacific to offer UNE combinations at no charge, the FBC continued, was that Pacific had agreed to do this for AT&T, Sprint and MCI in the Memoranda of Understanding. Failure to do the same thing for other CLECs, the FBC argued, would violate the anti-discrimination requirements of Pub. Util. Code § 453(a):

> "Given [Pacific's failure to file the testimony on UNE combinations requested by the ALJ], and given as well the fact that Pacific secretly agreed to continue to combine UNEs for AT&T, MCI and Sprint *at no charge*, the Commission should not allow Pacific to collect any charge for combining UNEs for all other carriers as well. If Pacific can afford to combine UNEs at no charge for AT&T, MCI and Sprint, the cost of combining UNEs

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[116] Specifically, the FBCs contended that in some cases, purchasing all of the UNEs included in a resale service was *not* equivalent to purchasing the service, because other ingredients might be necessary:

> "The UNE-[platform] is not actually equivalent to the wholesale service. For example, wholesale service customers are not charged for incoming calls or non-completed . . . outgoing calls, whereas CLCs using the UNE-[platform] would be charged for switching on all inbound calls and on all non-completed outgoing calls. To say that such services are 'the same' or 'equivalent' represents a failure to apply close scrutiny." (FBC Opening Brief, p. 83. n. 62.)

Further, the FBCs argued that their members were likely to want to combine UNEs in non-traditional ways. For example, "connecting unbundled loops to multiplexers and dedicated transport UNEs may be a necessary UNE combination to serve customers near ILEC central offices where a CLC does not have a collocation cage." (*Id.* at 72, n. 45.)

> . . . cannot possibly be large; what it is willing to do for free for the three largest ILECs it should also do for free for other carriers as well." (FBC Opening Brief, pp. 82-83.)

An additional reason for imposing such a requirement, the FBC argued, was that Pacific's points-of-access proposal was vague and ambiguous.

3. The AT&T/MCI Position That CLECs Cannot Be Required To Invest in Network Facilities As A Precondition To Combining UNEs For Themselves

Although the primary concern of AT&T and MCI was that the Commission not disturb the arrangements they had negotiated with Pacific in the Memoranda of Understanding, both carriers also argued – for the same reasons as the FBC -- that the Commission has authority under California law to order UNE combinations, and that Pacific's points-of-access proposal was inadequate. (AT&T/MCI Opening Brief, pp. 50-55.)

The AT&T /MCI witness on recombinations, Steven Turner, also criticized the points-of-access approach for relegating CLECs to costly manual recombination arrangements, while Pacific would enjoy fully automated ones:

> "The only 'network access' offered by Pacific to competitors for the purpose of combining UNEs is the opportunity to perform manual combining at competitor facilities in collocation or collocation-like arrangements remote from the [main distribution frame.] The result is this: Pacific will provision telecommunications service to its retail customers over a fully automated set of network components and operations support systems. Competitors, regardless of the state of progress in obtaining access to Pacific OSS, will remain bound to manual, labor-intensive cross-connection activities in order to try to provision

> competing services over those same network components. Pacific offers network access that is 'separate and unequal.'" (Ex. 601, p. 6.)

4. The Concerns of Sprint and the FBC About Security Issues Raised By Pacific's Points-Of-Access Proposal

In addition to their legal objections, Sprint and the FBC raised security concerns about Pacific's points-of-access proposal.

Sprint was one of several parties emphasizing the increased degradation of service quality that might result from the "common collocation" arrangement Pacific was proposing through its advocacy of a Point of Termination (POT) frame. In his reply testimony, Sprint witness Michael West stated:

> "The POT frame will lengthen the time to install or move customer circuits and will add unnecessary coordination costs between the two carriers for re-engineering of circuits and isolating, testing and repairing customer services. In addition, use of the POT frame most likely will impair the ability and efficiency of a CLC to serve customers at the same level of parity as PacBell. Insertion of the POT frame will have a negative impact on the CLC when turning up telecommunications services by adding more complexity to the provisioning process.
>
> "The frame proposal is not based on sound economic and engineering principles to reduce cost and provide a quality service. It appears to be just another barrier to entry for the CLCs. Adding unnecessary loop length in circuits creates design concerns, additional points of failure, unnecessary record keeping, and the increased probability of wrong assignments and disconnects. The addition of a common frame also raises serious issues regarding security, network integrity, facilities management, and protection of proprietary and

> confidential business information among CLCs and the ILEC." (Ex. 409, p. 7.)

As support for these arguments, Sprint pointed to the cross-examination of GTEC's collocation witness, Larry Hartshorn, whose proposals for letting CLECs combine UNEs via collocation were considered by Sprint to be very similar to Pacific's. When Mr. Hartshorn was asked what risks GTEC was trying to guard against when it fenced off its collocation areas, he stated that the risk was "[t]hat inadvertently or unknowingly, personnel in the central office may in fact cause degradation or outage to large segments of our customers." (Tr. 52:7748.) When asked how that might happen, Mr. Hartshorn replied:

> "That could occur by simply leaning on a piece of equipment, brushing a cable, accidentally bumping into a piece of equipment[,] can cause electrical surges, power outages. There are innumerable ways in which outages and impacts to customers can be caused within a central office." (*Id.*)

Sprint argued that these same risks apply to a common collocation cage, and could be avoided if the Commission ordered Pacific not to take apart its preexisting UNE combinations. (Sprint Opening Brief, pp. 43-44.)

The FBC made a similar argument about potential degradation of service and noted that Pacific's proposal raised a discrimination issue:

> "By refusing to connect UNEs directly to each other, Pacific forces CLCs to purchase an additional cross-connect, and further creates additional points of connection at which circuits may fail. Pacific's proposal is discriminatory because Pacific does not combine the elements that it uses to provide finished retail services (*e.g.*, loops and ports used to provide finished local exchange services) in this manner; instead, when using

such elements itself, Pacific combines the elements directly." (FBC Opening Brief, p. 57; footnotes omitted.)

D. Discussion

1. The Supreme Court's Decision in *AT&T-Iowa* Moots Many of the Issues Raised By the Parties in Their Recombination Testimony

The Supreme Court's January 25, 1999 decision in *AT&T Corp. v. Iowa Utilities Bd.* moots much of the testimony that the parties submitted on the recombination issue. In particular, since the Supreme Court has brushed aside the concerns about arbitrage that lay behind the debate over whether we have independent state authority to order UNE combinations, and whether a "recombination" fee or gluing charge must be imposed if we exercise such authority, the scope of the issues that must be decided here has been considerably reduced. However, as explained below, we think that the discrimination issue raised by Pacific's Memoranda of Understanding with AT&T, MCI and Sprint remains a live controversy and must be resolved.

In its decision, the Supreme Court quickly dismissed the Eighth Circuit's justification for setting aside the FCC Rule that prohibited ILECs from "tearing apart" their UNE platforms, *viz.*, the potential for "regulatory arbitrage" between resale and the purchase of UNEs. The ILECs had argued to the Supreme Court that resale rates, unlike UNEs, include subsidies to support universal service, and that if CLECs could avoid paying resale rates by purchasing all the UNEs needed to provide a finished service, the incumbents would be left "holding the bag for universal service." (119 S.Ct. at 737.) The Court brushed this concern aside with the observation that "§254 requires that universal-service subsidies be phased out, so whatever possibility of arbitrage

remains will be only temporary." (*Id.*)[117] Moreover, the majority opinion continued, the rule at issue, FCC Rule 315(b) (47 C.F.R. § 51.315(b)) was a reasonable interpretation of § 251(c)(3) of the Telecommunications Act, and was therefore entitled to deference:

> "Because [§ 251(c)(3)] requires elements to be provided in a manner that 'allows requesting carriers to combine' them, incumbents say that it contemplates the leasing of network elements in discrete pieces. It was entirely reasonable for the Commission to find that the text does not command this conclusion. It forbids incumbents to sabotage network elements that *are* provided in discrete pieces, and thus assuredly contemplates that elements *may* be requested and provided in this form (which the Commission's rules do not prohibit). But it does not say, or even remotely imply, that elements *must* be provided only in this fashion and never in combined form." (*Id.*)[118]

After pointing out that "§ 251(c)(3) is ambiguous on whether leased network elements may or must be separated," the Court concluded:

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[117] The Supreme Court also noted that as with the "all elements" rule, its remand of 47 C.F.R. § 51.319 – the rule setting forth the FCC's description of the network elements to be offered on an unbundled basis – "may render the incumbents' concern [about Rule 315(b)] academic." (*Id.*)

[118] Another portion of the Supreme Court's discussion directly rejects the argument made in Pacific's Opening Brief (at pages 67-68) that authority to order combinations of UNEs would be inconsistent with the generally understood meaning of "unbundling." On this question, the Supreme Court said:

> "Nor are we persuaded by the incumbents' insistence that the phrase 'on an unbundled basis' in § 251(c)(3) means 'physically separated.' The dictionary definition of 'unbundled' (and the only definition given, we might add) matches the FCC's interpretation of the word: 'to give separate prices for equipment and supporting services.' Webster's Ninth New Collegiate Dictionary 1283 (1985)." (*Id.*)

> "[T]he rule the Commission has prescribed is entirely rational, finding its basis in § 251(c)(3)'s nondiscrimination requirement. As the Commission explains, it is aimed at preventing incumbent LECs from 'disconnect[ing] previously connected elements, over the objection of the requesting carrier, not for any productive reason, but just to impose wasteful reconnection costs on new entrants.' . . . It is true that Rule 315(b) could allow entrants access to an entire preassembled network. In the absence of Rule 315(b), however, incumbents could impose wasteful costs on even those carriers who requested less than the whole network." (*Id.* at 737-38; citation omitted.)

In keeping with its conclusions, the Court reinstated Rule 315(b).

By brushing aside the arbitrage argument connected with UNE combinations, the Supreme Court has mooted the controversy over whether a gluing charge is appropriate when a CLEC seeks to purchase a UNE platform that an ILEC uses itself. As the ALJ observed in his March 27, 1998 Ruling, the justification for such a charge is to eliminate the possibilities for arbitrage between resale and the purchase of UNE platforms, *mimeo.* at 9-11, and the Supreme Court has now declared the concerns about arbitrage to be *de minimis* as a matter of law.

Similarly, because the Supreme Court has now reinstated the key portion of the FCC's rule on combining elements, it is no longer necessary to resolve the controversy over the extent of our authority under California law to order ILECs to provide pre-assembled UNE "platforms" to CLECs. Under Rule 315(b), Pacific is clearly obliged to provide CLECs with any such platform that it uses itself, and is not entitled to any additional compensation (beyond a "service order" charge) for doing so. As explained below, we think our rulings

in the OSS/NRC decision, D.98-12-079, furnish an adequate record on which to determine proper non-recurring charges for UNE combinations.

However, the Supreme Court's ruling that the FCC must reconsider whether the list of UNEs in the original version of Rule 319[119] meets the "necessary and impair" standard raises a potential complication, because ordering ILECs to provide combinations of unbundled network elements logically presupposes that the underlying elements have been lawfully defined. However, as noted in Section I.D., Pacific's corporate parent has agreed that Pacific will continue to honor its existing interconnection agreements (including the combination provisions thereof) during the period in which Rule 319 is being reconsidered. Further, as explained below, we think that Pacific has effectively waived any legal objections it might have had[120] under the Supreme Court's decision to furnishing UNE combinations specified in existing interconnection agreements by entering into the Memoranda of Understanding with AT&T, MCI and Sprint.[121] We also think that the non-discrimination principle that is deeply

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[119] The original version of Rule 319 is codified in the Code of Federal Regulations at 47 C.F.R. § 51.319.

[120] As explained in Section I.D. of this decision, it appears that under the interconnection agreements modeled on the Pacific-AT&T interconnection agreement, Pacific was obliged to state the basis for its objections to providing UNE combinations, and to seek renegotiation of the agreement on that issue, within 30 days after the Supreme Court's ruling became final. *See* Pacific-AT&T Interconnection Agreement filed pursuant to D.96-12-034, ¶¶ 2.4, 9.3. To our knowledge, Pacific made no such request for renegotiation.

[121] Although we are not setting UNE prices for GTEC in this decision, GTEC emphasizes in its comments on the PD that its situation on UNE combinations is different from Pacific's. First, GTEC points out that it has not entered into any agreements with CLECs like the Memoranda of Understanding that Pacific has signed with AT&T, MCI and Sprint. Second, unlike Pacific, GTEC has apparently refused to agree that it will

Footnote continued on next page

embedded in the Telecommunications Act – and that the Supreme Court relied on in upholding the reasonableness of Rule 315(b) – requires Pacific to make UNE combinations available to CLECs that have not entered into a Memorandum of Understanding.

2. The Costs Adopted in D.98-12-079 Furnish An Adequate Basis For Determining the Compensation That An ILEC Should Currently Receive When A CLEC Purchases A Platform of UNEs That the ILEC Uses Itself, And Also For Determining the Compensation That the ILEC Should Receive When It is Asked to Furnish Additional UNEs That Can Be Combined With the Existing Platform.

FCC Rule 315(b) provides that "except upon request, an incumbent LEC shall not separate requested network elements that the incumbent LEC currently provides." Because the Supreme Court upheld Rule 315(b) on the ground that it was a reasonable exercise of the FCC's power under § 251(c)(3) to prevent discrimination among carriers by prohibiting the "anticompetitive practice" of imposing "wasteful reconnection charges," 119 S.Ct. at 737-38, it is clear that an ILEC is not entitled to any additional compensation for providing to a requesting CLEC, network elements that are already pre-assembled or combined in a "platform" that the ILEC uses itself.

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honor all the terms of its existing interconnection agreements during the time Rule 319 is being reconsidered. GTEC states that its position on UNE combinations is as follows:

> "GTE will continue to provide each of the individual network elements defined in the now-vacated FCC rules and our existing interconnection agreements. GTE has noted that if a CLEC asks for UNE combinations or 'platforms,' relying on the Supreme Court's validation of Rule 315(b) in *Iowa Utilities Bd.*, GTE will decline to do so because *Iowa Utilities Bd.* also vacated Rule 319[,] which means that at the present time there are no specified UNEs which must be supplied – in combination or at all." (GTEC Opening Comments, p. 5.)

This does not mean, however, that there is no cost involved in transferring the ILEC's pre-assembled platform of network elements to the CLEC. In D.98-12-079, as modified by D.99-06-060, we recognized that in this so-called "migration" situation, one approach would be for the ILEC to receive the sum of the adopted service order charges applicable to each UNE in the platform. We declined to adopt this approach in D.98-12-079, however, concluding that the issue should be considered in the pricing phase of OANAD, and would be more appropriately addressed after the Supreme Court issued its ruling in *AT&T-Iowa.* (D.98-12-079, *mimeo.* at 32, n. 29; *modified by* D.99-06-060, *mimeo.* at 22-23, Ordering Paragraph 2(a).)

The Supreme Court's decision reinstating Rule 315(b) – and the need to ensure that UNE platforms are provided on reasonable terms and conditions while the disputes surrounding Rule 315 are sorted out – now leads us to conclude that the sum-of-the-service-order-charges approach should be adopted. Accordingly, as shown in the illustrative calculations set forth in Appendix C to this decision,[122] Pacific and other ILECs that are required to provide existing UNE platforms to CLECs are entitled to receive as compensation for doing so, the sum of the service order charges applicable to all of the UNEs in the platform.[123]

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[122] Appendix C furnishes illustrative calculations of combination situations because we still believe, as suggested in D.98-12-079, that it would not be an effective use of Commission resources to try to set forth charges for all of the possible platform and combination situations that might arise under the interconnection agreements we have approved since 1996. We do believe, however, that the illustrative calculations in Appendix C are sufficiently numerous so that the parties should be able to determine charges for virtually all of the combination situations described therein without dispute.

[123] In the case of OSS, this requires some explanation. As a network element, OSS is comprised of pre-ordering, ordering, provisioning, maintenance and billing. For the purpose of calculating the sum of the service order charges in a migration situation, the

Footnote continued on next page

Of course, CLECs are likely to want other types of UNE combinations besides those already assembled on a pre-existing platform. For example, some CLECs may want to purchase UNEs on an individual basis and then have the ILEC combine them. In that situation, we believe the stand-alone non-recurring charge approach we described in D.98-12-079 provides fair and reasonable compensation. If, for instance, a CLEC with collocation facilities wants to offer a basic business service such as Measured Rate Business (1 MB) service, the CLEC could lease an Expanded Interconnection Service Cross-Connect (EISCC) and loop from the ILEC. In this case, the compensation the ILEC would receive for combining these elements would be the sum of the full stand-alone non-recurring charges for the EISCC and the loop.[124]

The final and most complicated combination situation arises where a customer who initially "migrates" on an "as is" basis from the ILEC to a CLEC subsequently decides to purchase additional features or services from the ILEC. In that case, the correct approach is to require the CLEC (which has already paid the ILEC the sum of the service order charges applicable to the migration) the stand-alone non-recurring charges for each additional feature or service ordered from the ILEC.

We recognize that this last situation raises some legal issues, because the parties to the Supreme Court case are currently litigating in the

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relevant service order components would consist of pre-ordering, ordering and billing. For the purpose of calculating the sum of the stand-alone non-recurring charges in a non-migration situation, the relevant OSS components would be pre-ordering, ordering, provisioning, maintenance and billing.

[124] Although technically a Network Interface Device (NID) is also needed in this example, the cost of the NID was included within the TELRIC loop costs that we adopted in D.98-02-106. Pacific would therefore provision the NID along with the loop.

Eighth Circuit over whether the effect of reinstating Rule 315(b) was, as a practical matter, to reinstate Rules 315(c)-(f) as well.[125] GTE and the RBOCs have taken the position that these rules were not included within the petitions for certiorari, so that the Eighth Circuit's decision setting them aside remains intact.[126] AT&T and other intervenors, on the other hand, contend that (1) Rules 315(c)-(f) *were* included within the petitions for certiorari, (2) the Supreme Court's reasoning in upholding Rule 315(b) logically extends to Rules 315(c)-(f) as well, and (3) the Eighth Circuit should entertain additional briefing on the

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[125] Rules 315(c)-(f) provide as follows:

> (c) Upon request, an incumbent LEC shall perform the functions necessary to combine unbundled network elements in any manner, even if those elements are not ordinarily combined in the incumbent LEC's network, provided that such combination is (1) technically feasible; and (2) would not impair the ability of other carriers to obtain access to unbundled network elements or to interconnect with the incumbent LEC's network.
>
> (d) Upon request, an incumbent LEC shall perform the functions necessary to combine unbundled network elements with elements possessed by the requesting telecommunications carrier in any technically feasible manner.
>
> (e) An incumbent LEC that denies a request to combine elements pursuant to paragraph (c)(1) or paragraph (d) of this section must prove to the state commission that the requested combination is not technically feasible.
>
> (f) An incumbent LEC that denies a request to combine elements pursuant to paragraph (c)(2) of this section must prove to the state commission that the requested combination would impair the ability of other carriers to obtain access to unbundled network elements or to interconnect with the incumbent LEC's network.

[126] The Eighth Circuit's ruling concerning Rules 315(c)-(f) appears at 120 F.3d 813. The contentions of GTE and the RBOCs with respect to Rules 315(c)-(f) are set forth in the Motion of the Local Exchange Carriers Regarding Further Proceedings On Remand, filed February 17, 1999 in No. 96-3321 et al., the same Eighth Circuit docket numbers as the original *Iowa Utilities Board* case.

question.[127] In its June 10, 1999 Order in *Iowa Utilities Board*, the Eighth Circuit accepted this invitation and asked that the parties' briefs address whether the Eighth Circuit "should take any further action" with respect to Rules 315(c)-(f).[128]

Whatever their positions in the Eighth Circuit, all parties seem to agree that the Supreme Court's decision did not automatically reinstate Rules 315(c)-(f). Technically, this may leave a gap in the combination authority

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[127] *See* Intervenors' Response To Local Exchange Carriers' Motion Regarding Further Proceedings on Remand, filed March 2, 1999, pp. 12-15. On the issue of whether the Supreme Court's reasoning with respect to Rule 315(b) applies to Rules 315(c)-(f) as well, the Intervenors state:

> "[I]n upholding Rule 315(b), the Supreme Court rejected the construction of § 251(c)(3) that was the basis for the [Eighth Circuit's] conclusion that Rules 315(c)-(f) were invalid. In particular, the Court held that, rather than require new entrants to combine elements, § 251(c)(3) prohibits LECs from providing elements to new entrants on terms that are less favorable than those on which the LECs use those elements . . . This is the principle that the FCC implemented not only when it adopted Rule 315(b) (prohibiting the separation of previously combined elements), but also when it adopted Rules 315(c)-(f) (requiring LECs to combine elements that are not currently combined when entrants pay the costs). Indeed, both sets of rules rest on the single set of findings that new entrants otherwise would incur higher costs than the LEC did itself." (Intervenors' Response, p. 14; citations omitted.)

[128] In its papers before the Eighth Circuit on the proper scope of remand, the FCC took the position that Rules 315(c)-(f), as well as other rules not specifically discussed in the Supreme Court's decision, should be remanded to the FCC for further consideration. *See* Response of Federal Respondents To Local Exchange Carriers' Motion Regarding Further Proceedings on Remand and Motion For Voluntary Partial Remand, filed March 2, 1999, pp. 18-19.

In the Revised UNE List Order issued on November 5, 1999, the FCC has decided not to resolve the status of Rules 315(c)-(f), because that issue is currently before the Eighth Circuit. However, the Revised UNE List Order expresses the view that the Supreme Court's reasoning in reinstating Rule 315(b) applies to Rules 315(c)-(f) as well. *See* ¶¶ 482-83.

conferred on state commissions by the First Report and Order, and raises the issue whether – as assumed above – we have authority under California law to order an ILEC to combine network elements in ways that the ILEC may not use itself.[129]

We think this question must be answered in the affirmative. As several parties have pointed out in their post-hearing briefs, Pub. Util. Code § 709.2(c)(1) directs us to ensure that this proceeding results in "fair unbundling of exchange facilities." As the Supreme Court noted in *AT&T-Iowa*, the most

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[129] In their comments on the PD, both Pacific and GTEC urge us not to address the issue of our authority to order UNE combinations under state law. Pacific, after noting that it has voluntarily agreed to honor its existing interconnection agreements during the pendency of remand proceedings, argues that "the PD's discussion of the discrimination aspects of combinations . . . disposes of the matter without [the need to] reach[] the question of independent state authority." (Pacific Opening Comments, p. 13.) GTEC argues that our conclusion about the scope of our combination authority under state law amounts to an unlawful reimposition of Rules 315(c)-(f), because "regardless of how broadly written the state law may be, it cannot be relied upon to achieve a result inconsistent with federal law as interpreted by the federal court having exclusive jurisdiction over the issues." (GTEC Opening Comments, p. 6.)

We do not find either of these arguments persuasive. In view of our objective to promote commercial stability between Pacific and CLECs while the status of Rule 319 is sorted out, we think it makes no sense to postpone deciding the scope of our state law authority to order combinations where the exercise of such authority may help to fill in gaps in the combination provisions of existing interconnection agreements.

GTEC's arguments against deciding the scope of our combination authority amount to a claim of pain without injury. First, we are not setting UNE prices for GTEC in this decision. Second, as pointed out in footnote 121, GTEC takes the position that it cannot be compelled to offer UNE combinations, because the Supreme Court's vacation of Rule 319 leaves up in the air the question of which network elements GTEC is obliged to offer. Third, GTEC's assertion that our conclusion about the scope of our state law authority is "inconsistent with federal law" is based on its litigation position that the FCC and the CLEC respondents failed to appeal from the Eighth Circuit ruling that vacated Rules 315(c)-(f). This argument is circular, because – as shown in the text – that issue is now before the Eighth Circuit.

commonly accepted definition of "unbundling" is "to give separate prices for equipment and supporting services." (119 S.Ct. at 737.) This generally-understood meaning of unbundling, the Court continued, made unreasonable the ILECs' argument that references in the Act to "unbundled" network elements meant "physically separated" elements. (*Id.*) We agree with this analysis, and conclude that our unbundling authority under California law includes the power to order ILECs to combine network elements in innovative ways (provided the requested combination is technically feasible, does not prejudice the rights of other CLECs, and results in adequate compensation for the costs of providing the requested combination).[130]

Because many parties commented on the version of Appendix C that appeared in the PD, we think it is appropriate to close this section by describing briefly the changes we have made in response to their comments. First, as Pacific and several other parties pointed out, the version of Appendix C in the PD did not show separate connect and disconnect charges for the combination scenarios described. This was inconsistent with the notation on each page of Appendix B that non-recurring charges for connects and disconnects were to be recovered separately and at the time of occurrence. We have corrected the Appendix C scenarios to show separate connect and disconnect charges.

Second, the version of Appendix C attached to this decision is more extensive than the one that appeared in the PD. The PD version contained six scenarios, one with a variation. The version attached to this decision contains

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[130] We also note that to the extent collocation arrangements (and other indirect ways of combining UNEs) may raise issues of service degradation, we have ample authority under Pub. Util. Code § 761 to anticipate such problems, and to order that they be fixed. (*City of Los Angeles v. Public Utilities Commission*, 7 Cal.3d 331, 350 (1972).)

seven scenarios, three with variations. Scenarios 6, 6a, 7, and 7a of the version we are adopting here all deal with "extended link" situations.[131]

AT&T/MCI and Pacific have disagreed sharply over whether extended link scenarios should be included in Appendix C. AT&T/MCI argue that they should be in order to avoid "unnecessary future disputes." (AT&T/MCI Opening Comments, p. 21.) Pacific argues that extended link scenarios should not be included, because (1) the extended link has not been adequately defined, and (2) it is not required by any existing interconnection agreement. (Pacific Reply Comments, p. 9.)

For two reasons, we believe that AT&T/MCI have the better of the argument on this issue. First, the Pacific-MCI interconnection agreement (which many other parties have opted into) clearly contemplates that Pacific will provide extended links. *See* Pacific-MCI Interconnection Agreement, approved pursuant to D.97-01-039, Attachment 6, Appendix A, lines 3 & 4. Second, including extended link scenarios is consistent with the requirement in our recent decision on Pacific's § 271 application, D.98-12-069, that Pacific provide an extended link. (*Mimeo.* at 149.)[132]

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[131] AT&T/MCI describe the extended link as the combination of "an unbundled loop connected to unbundled transport, [which] is used to 'extend' the unbundled loop via transport from an office in which a carrier does not have collocation to a neighboring office at which collocation does exist[,] or to another new point of interconnection." (AT&T/MCI Opening Comments, p. 21, n. 47.)

[132] As noted elsewhere in this decision, the FCC's November 5, 1999 Revised UNE List Order requires that local circuit switching be treated as a UNE -- even when used to serve business customers in Zone 1 of the 50 largest Metropolitan Statistical Areas of the United States – *unless* the ILEC offers an enhanced extended link to CLECs. ¶¶ 278, 288-89.

On other issues, however, we agree with Pacific's criticisms of the combination scenarios in the PD. Pacific is correct, for example, that since the loop UNE already includes the NID, Scenario 1 in Appendix C of the PD was erroneous. (Pacific Opening Comments, p. 23.) We have therefore deleted it.

We also agree with Pacific that the PD erred in assuming (in Scenario 5) that the change of an existing POTS line to ISDN service represents an "as-is migration" situation. As Pacific points out, the provisioning requirements necessary to make this change result in breaking apart the UNEs connected in the POTS platform. (*Id.* at 23.) In order to provide the ISDN service contemplated by Scenario 5, Pacific must combine a stand-alone ISDN loop with an ISDN port. Under the compensation approach set forth herein, the correct compensation for combining these elements is the sum of the stand-alone non-recurring charges for the ISDN loop and the ISDN port. We have corrected Scenario 5 to reflect this.

We also agree with Pacific that it is appropriate to delete what appeared as Scenario 6 in the PD's version of Appendix C.[133] As Pacific points out, this scenario effectively assumed the migration of an existing combination of UNEs from one CLEC to another. We agree with Pacific that in this situation, "it is completely out of the ILEC's control whether the incumbent CLEC will disconnect the UNEs and break apart the existing platform of UNEs prior to the changeover." (*Id.* at 23-24.) We agree that rules regarding changeovers between CLECs are needed before such a scenario can be described.

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[133] As noted in the text, Scenario 6 in the version of Appendix C attached to this decision deals with an extended link situation.

Finally, we have revised Scenario 3 – which assumes the leasing of UNEs including SS7 signaling – to reflect the SS7 non-recurring costs set forth in Appendix B. In the version of Scenario 3 that appeared in the PD, the non-recurring charges for the SS7 element were based on dedicated transport, since Section V.C. (both in this decision and in the PD) uses dedicated transport *recurring* costs as surrogates for the *recurring* costs of SS7 signaling. We have now concluded, however, that it is inappropriate to use non-recurring charges taken from SS7 surrogates when SS7-specific non-recurring charges are available. Accordingly, the SS7 non-recurring charges set forth in Appendix B have now been substituted in Scenario 3.

3. Pacific Must Continue Furnishing All UNE Combinations Provided For In Any Interconnection Agreement Signed Prior to the Supreme Court's Decision For the Remaining Life of the Interconnection Agreement, or For As Long As the Agreement Remains In Effect

Finally, we turn to the discrimination issue created by Pacific's agreements with AT&T, MCI and Sprint to continue providing UNE combinations during the remaining lives of those carriers' respective interconnection agreements without imposing additional combination fees.

As noted in Section VI.A.3., Pacific agreed to do this in the three Memoranda of Understanding that it signed in the Spring of 1998. The Memorandum of Understanding with AT&T states that Pacific has agreed to do this notwithstanding "what [Pacific] believes to be its legal right to require AT&T to combine UNEs and [Pacific's] contractual right to renegotiate the UNE Combination provisions of the Interconnection Agreement . . ." (Ex. 143, p. 1.) Pacific agreed to continue providing UNE combinations for AT&T "for the remainder of the term of the Interconnection Agreement," notwithstanding "any regulatory, legislative, or judicial change or ruling unless such continued

compliance is expressly prohibited by a change in the law subsequent to the date of this Memorandum of Understanding." (*Id.* at 2.)[134]

In light of the Supreme Court's decision in *AT&T-Iowa*, this last clause assumes special significance. The promise in the AT&T Memorandum of Understanding to continue providing UNE combinations is unconditional except for one contingency, *viz.*, the case in which a "regulatory, legislative or judicial change or ruling" *prohibits* Pacific from continuing to provide such combinations.

Clearly, the Supreme Court's decision does not prohibit ILECs from providing UNE combinations; to the contrary, it reinstates the FCC's Rule 315(b). Thus, the one contingency that might have prevented performance by Pacific under its Memorandum of Understanding with AT&T has not come to pass. Moreover, the language in this Memorandum of Understanding about Pacific's obligation to continue providing UNE combinations is otherwise so unconditional that it can be read as overriding Pacific's rights as spelled out in other portions of the AT&T interconnection agreement to renegotiate terms in the event that a court decision or regulatory action "allows but does not require discontinuance" of "any [UNE], Ancillary Service or Combination thereof" that Pacific has agreed to provide.[135]

Under this interpretation of the AT&T Memorandum of Understanding, AT&T would be entitled to continue receiving UNE combinations notwithstanding the Supreme Court's ruling that FCC Rule 319 is invalid and must be reconsidered. (119 S.Ct. at 734-36.) In that case, AT&T (and

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[134] The Memoranda of Understanding with Sprint and MCI contain comparable but not identical language.

[135] *See* Pacific-AT&T Interconnection Agreement, ¶ 2.4, *filed pursuant to* D.96-12-034.

MCI and Sprint under their Memoranda of Understanding) would be entitled to continue receiving UNE combinations even if Pacific could avoid providing UNE combinations to other CLECs on the ground that there cannot be a lawful obligation to provide such combinations until the underlying list of network elements to be unbundled has been properly defined.[136]

Although the discrimination problem that this scenario raises is different from the one that the FBC assumed in their Opening Brief, we agree that it is an issue we are obliged to deal with:

> "If Pacific can afford to combine UNEs at no charge for AT&T, MCI and Sprint, the cost of combining UNEs . . . cannot possibly be large; what it is willing to do for free for the three largest ILECs it should also do for other carriers as well." (FBC Opening Brief, pp. 82-83.)

We think it is clear that under the Telecommunications Act and our own Resolution ALJ-174, we have the power to reform interconnection agreements to prevent unlawful discrimination. The starting point for analysis is § 251(c)(3) of the Act, which imposes on each ILEC:

> "The duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions

[136] SBC's February 9, 1999 letter to the Chief of the FCC's Common Carrier Bureau, which is described in Section I.D. of this decision, appears to eliminate this hypothetical possibility. In the February 9 letter, SBC has agreed (apparently on behalf of itself and its subsidiaries) to continue honoring existing interconnection agreements, and to negotiate in good faith regarding new interconnection agreements, notwithstanding the Supreme Court's decision in *AT&T-Iowa* to vacate Rule 319 and remand that rule to the FCC.

> that are just, reasonable, and nondiscriminatory in accordance with the terms and conditions of the agreement and the requirements of this section and section 252. An [ILEC] shall provide such [UNEs] in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service."

In *AT&T-Iowa,* the Supreme Court expressly relied on this provision in upholding FCC Rule 315(b), concluding that "the rule the Commission has prescribed is entirely rational, finding its basis in § 251(c)(3)'s nondiscrimination requirement." (119 S.Ct. at 737.)

Of course, § 251(c)(3) is not the only provision in the Act making clear that UNEs and interconnection must be offered on a nondiscriminatory basis. Section 251(c)(2) requires ILECs to offer interconnection to requesting carriers "on rates, terms and conditions that are just, reasonable, and nondiscriminatory, in accordance with the terms and conditions of the agreement and the requirements of this section and section 252." And § 252(i) of the Act (on which the Supreme Court relied in reinstating the "pick and choose" rule) provides that an ILEC must make available "any interconnection, service or network element provided under an agreement approved under this section to which it is a party to any other requesting telecommunications carrier upon the same terms and conditions as those provided in the agreement."[137]

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[137] The Telecommunications Act also requires that rates for UNEs must be nondiscriminatory. Section 252(d)(1) provides that such rates:

> "(A) shall be (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and (ii) nondiscriminatory, and

Footnote continued on next page

In the portion of its brief devoted to UNE combinations, Pacific argued that the Commission cannot incorporate the terms of the Memoranda of Understanding into a tariff, because the Commission lacks authority under the Telecommunications Act to set forth in tariffs the rates, terms and conditions applicable to UNEs. (Pacific Opening Brief, pp. 68-69, 70-73.) The basis for Pacific's argument was that making UNEs available in this manner would amount to a reimposition of the "pick and choose" rule that the Eighth Circuit had vacated. (*Id.* at 72-73.)[138]

Of course, the Supreme Court has now reinstated the FCC's "pick and choose" rule (47 C.F.R. § 51.809), finding that the interpretation of § 252(i) that the rule embodies "is not only reasonable, it is the most readily apparent." (119 S.Ct. at 738.) While it is unclear how the "pick and choose" rule will ultimately affect the process of negotiating interconnection agreements, it seems clear that -- quite apart from the Supreme Court's decision to reinstate Rule 315(b) – the revival of the rule has deprived Pacific of the best objection it had to making the terms of the Memoranda of Understanding available to all CLECs.

Because it is necessary to remedy discrimination forbidden by the Act, and because it is consistent with the reinstatement of Rule 315(b), we will require Pacific to continue providing combinations of UNEs to any carrier with which Pacific has signed an interconnection agreement providing for such

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"(B) may include a reasonable profit."

Section 252(c)(2) of the Act requires state commissions to ensure that any interconnection disputes it resolves through arbitration are consistent with the pricing standards incorporating this nondiscrimination requirement.

[138] GTEC made a similar argument at pages 44-45 of its Opening Brief.

combinations, notwithstanding the uncertainty created by the Supreme Court's decision to set aside Rule 319.[139] Although the original consideration for the Memoranda of Understanding was the agreement of AT&T, MCI and Sprint to convert from the CABS to the CRIS billing system, the cost-based combination charges we are adopting in this decision (based on the costs adjudicated in D.98-12-079) will adequately compensate Pacific for the work involved in

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[139] In its comments on the PD, the Telecommunications Resellers Association (TRA) argues that our ruling requiring Pacific to continue making UNE combinations available to carriers with whom it entered into an arbitrated interconnection agreement prior to the decision in *AT&T-Iowa* is too narrow, and is based upon an erroneous reading of the anti-discrimination provisions of the Telecommunications Act. TRA urges that the PD should "be modified to firmly establish that all carriers, whether currently parties to arbitrated interconnection agreements or not, are permitted to obtain and maintain, without unlawful limitation or restriction, any UNE combinations, as well as any other interconnection, services, and UNEs, that are made available to any other carrier." (TRA Comments, p. 4.)

We do not believe that the Act's anti-discrimination provisions empower us to grant the relief TRA is seeking. As noted in the text, Pacific's duty to provide combinations of UNEs logically presupposes that there is a legally-valid list of network elements that must be offered for sale on an unbundled basis. Although the FCC issued the text of its Revised UNE List Order on November 5, 1999, that order is not yet final.

Until the Revised UNE List Order becomes final, we believe that we have power under the Act to prevent the discrimination that would otherwise result between the signatories to the Memoranda of Understanding (on the one hand) and all other carriers with arbitrated interconnection agreements (on the other) if only the former were to be able to continue purchasing UNE combinations under their interconnection agreements (which are based on the original version of Rule 319). Parties who have not yet entered into an interconnection agreement, or whose voluntarily-negotiated interconnection agreements do not provide for UNE combinations, cannot make such a discrimination claim.

With respect to parties who have not yet entered into an interconnection agreement, we note that under the terms of the February 9, 1999 letter from SBC to the Chief of the FCC's Common Carrier Bureau, SBC has apparently agreed on behalf of Pacific to "continue to negotiate in good faith with any party seeking to enter into a new local interconnection agreement". *See* Appendix B to Pacific's Opening Comments.

continuing to provide all the combinations called for in the interconnection agreements subject to this requirement.

The obligation we are imposing here will continue for the remaining life of any arbitrated interconnection agreement that was signed prior to January 25, 1999 and that requires Pacific to provide UNE combinations. When we speak of "remaining life," we do not mean merely the three-year term that most of the interconnection agreements provide for. These agreements also seek to ensure commercial stability by providing that if the parties have not negotiated a new interconnection agreement by the end of the three-year term, the old agreement will continue in effect until a new agreement is reached. For example, paragraph 3.1 of the Pacific-AT&T interconnection agreement provides in pertinent part:

> "This Agreement shall be effective for a period of three (3) years, and thereafter the Agreement shall continue in force and effect unless and until a new agreement, addressing all of the terms of this Agreement, becomes effective between the parties."

We think this provision deals with the problem that might otherwise arise if the current generation of interconnection agreements began to expire before the FCC's Revised UNE List Order becomes final, because the obligation to continue providing UNE combinations will be extended along with the term of the old interconnection agreement. We presume that most parties will prefer not to sign a new interconnection agreement until the list of UNEs that must be offered pursuant to § 251(c)(3) of the Act is fully enforceable.

4. When Fully-Mechanized Non-Recurring Charges Should Go Into Effect

In the PD's discussion of the UNE combination issue, the assigned ALJ pointed out that there are significant differences among the fully-

mechanized, semi-mechanized and manual non-recurring charges in Appendix B that would be applicable to UNE combinations (and in other situations). The ALJ asked the parties for comment as to whether the lowest (*i.e.*, fully-mechanized) charges should be available to all carriers immediately, or should be phased-in over a period of time. (PD, *mimeo.* at 130, n. 107.)

Pacific, GTEC, AT&T/MCI, Sprint and Northpoint all commented on this issue. Sprint urges, as it did in its Opening Brief, that until the fully-mechanized Electronic Data Interface (EDI) ordering system becomes available, CLECs should pay only the low, fully-mechanized charges, regardless of which ordering system they use. When EDI becomes available, Sprint contends that the charges should depend on whether the CLEC uses EDI or manual processes. Sprint argues that this approach is necessary as an incentive, because "implementation of EDI has been delayed by the ILECs. Accordingly, Sprint urge[s] the Commission to use EDI costs as a basis for OSS prices as an incentive for the ILECs to meet deadlines to implement EDI." (Sprint Opening Comments, p. 4.) Northpoint joins in this recommendation. (Northpoint Reply Comments, pp. 2-3.)

AT&T/MCI take a slightly different tack. They argue that "non-recurring charges must reflect the *forward-looking, long run* costs that new entrants cause the incumbent to bear," and that since these new entrants who are developing electronic interfaces "are not causing the incumbents to bear costs for manual or semi-manual ordering processes *in the long-run*," they should have to pay only fully-mechanized charges. (AT&T/MCI Reply Comments, p. 12; emphasis in original.)

Not surprisingly, the ILECs argue that, with some exceptions, it would be premature to put fully-mechanized prices into effect at this time. Pacific argues that if both manual and semi-mechanized ordering processes are

available and the CLEC orders manually, "the manual charges should apply since the CLEC cho[se] the manual ordering process . . ." Pacific argues that the Commission should not go beyond this at this time, because "the issue of OSS implementation and testing is before the Commission in other proceedings," and because electronic flow-through of orders – which Pacific considers the predicate to fully-mechanized prices and which is being implemented for a list of elements agreed to in D.98-12-069 -- will not be feasible for some types of orders. Consistent with this position, Pacific contends that Sprint's "incentive" argument is without merit and should be rejected. (Pacific Reply Comments, p. 12.)

GTEC's position is similar to Pacific's. GTEC argues that there needs to be a transition period, during which the non-recurring charges a CLEC would pay would depend upon which type of ordering system the CLEC is currently using. GTEC urges that fully-mechanized charges should be available only when the CLEC "interface[s] on an electronic/mechanized basis in full compliance with OBF's standards and where the CLEC has implemented and tested its capabilities with the ILEC . . ." (GTEC Opening Comments, p. 18.) To allow CLECs to pay low, fully-mechanized charges before this point is attained, GTEC argues, "amounts to pricing on the basis of a hypothetical, yet-to-exist network." (*Id.*)

To a considerable extent, the positions the parties have taken on the issue raised in the PD reiterate positions they have taken in other Commission proceedings. In Ordering Paragraph (OP) 5 of D.98-12-079, for example, we asked the parties to comment on whether Pacific's Local Service Request Exchange (LEX) ordering system, a proprietary system originally developed by SBC, "should be classified as a fully mechanized system for costing purposes." In the comments it filed in response to this request on January 19,

1999,[140] Pacific has stated that "products ordered via LEX[[141]] that are or will be provided flow-through[[142]] treatment should reflect costs associated with a fully mechanized system[, but] products which are ordered via LEX that will not have flow-through capability and require manual intervention should appropriately reflect the semi-mechanized costs." (Pacific LEX Comments, pp. 2-3.) Pacific contends that our recent decision on Pacific's § 271 application, D.98-12-069, sets forth in Appendix B thereof the UNEs and combinations for which Pacific is obliged to provide flow-through in LEX.[143] Semi-mechanized costs are appropriate in non-flow-through situations, Pacific concludes, because "the costs

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[140] Comments of Pacific Bell Pursuant to Ordering Paragraph 5 of D.98-12-079 Regarding the Classification of the LEX OSS System As A Mechanized System For Costing Purposes (Pacific LEX Comments), filed January 19, 1999.

[141] In its comments, Pacific describes LEX as "a graphical user interface provided by Pacific that provides access to ordering functions for resale services and [UNEs]. It has developed to the point where it has the capability of providing [electronic] flow-through for services and elements where it makes economic sense to do so." (Pacific LEX Comments, pp. 1-2.)

[142] In D.98-12-079, we defined flow-through as follows:

> "Electronic flow-through allows the CLC to directly enter orders for UNEs and resale into the IELC's service order databases for provisioning. With the exception of fall-out, there is no order entry required by the ILEC because this function is now performed by the CLC. The order is thus said to bypass or "flow[]-through for provisioning." (*Mimeo.* at 25.)

[143] Under Appendix B of D.98-12-069, Pacific is required to implement flow-through for loop and port combinations, 2-wire basic and assured loops with and without Local Number Portability (LNP), directory service requests, standalone LNP and resale. By the end of 1999, Pacific must also submit a plan for implementing flow-through for xDSL-capable 2-wire loops with and without LNP. Pacific is also required to report by the end of 1999 on relaxing or eliminating exceptions to flow-through. *See* D.98-12-069, Appendix B, *mimeo.* at 3-4.

associated with Pacific's Local Service Center . . . personnel's efforts to complete the order[] must be accounted for." (*Id.* at 2.)

In their joint comments in response to OP 5 of D.98-12-079,[144] a CLEC group argues that Pacific has effectively admitted that LEX is the equivalent of EDI, that D.98-12-079 determined fully-mechanized NRCs for many UNEs not covered by the flow-through obligations set forth in D.98-12-069, and that unless LEX is treated as a fully-mechanized ordering system equivalent to EDI, the Commission will be rewarding Pacific for its delay in developing EDI:

> "The Commission should reject [Pacific's position on LEX] because it would reward Pacific for its failure to develop – indeed, even for continuing to fail to develop – OSS through which CLCs can order UNEs with full flow-through. CLCs have no control over the speed and timing with which the ILECs develop and introduce OSS with more extensive flow-through. It would be unfair to make CLCs pay higher rates to the ILECs because of the ILECs' failure to develop OSS with full flow-through for UNE and resale orders." (CLEC LEX Comments, p. 8.)

In view of the complexity of the issues raised by the parties' comments in response to OP 5 of D.98-12-079, and the overlap of those issues with the recommendations in the comments here, we believe that our ruling here on when fully-mechanized non-recurring charges should go into effect should be limited to those matters on which the parties appear to agree, and that the remaining issues should be resolved in future decision(s) as indicated below.

Pacific and the CLECs apparently agree that for those UNEs and combinations for which flow-through is required by Appendix B of

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[144] Opening Comments of NEXTLINK, ICG and CCTA In Response To Ordering Paragraph 5 of D.98-12-079, filed January 19, 1999 (CLEC LEX Comments).

D.98-12-069, it is appropriate that CLECs placing orders through LEX or EDI should pay no more than the fully-mechanized non-recurring charges set forth in Appendix B of this decision. It also appears from a recent filing in R.97-10-016/I.97-10-017, our proceeding for monitoring the performance of OSS systems, that flow-through for all of the UNEs and combinations specified in Appendix B of D.98-12-069 was scheduled to be achieved by October 31, 1999.[145] We will therefore order Pacific to reflect, in the amendments to interconnection agreements it is being directed to file pursuant to OPs 3 and 4 of this decision, the fully-mechanized non-recurring charges set forth in Appendix B hereto for those UNEs and combinations covered by the flow-through obligations in Appendix B of D.98-12-069, in cases where a CLEC places its order via LEX or a form of EDI. For UNEs and combinations ordered via LEX or a form of EDI that are not included within Appendix B of D.98-12-069, the semi-mechanized non-recurring charges set forth in Appendix B will apply for the time being. In those cases where a CLEC orders UNEs or combinations through manual processes, the manual non-recurring charges set forth in Appendix B of this decision will apply.

Although this approach is reasonable for now, we recognize that it does not address the ultimate issue raised in the comments of Sprint and other CLEC parties, *viz.*, whether there is a need for a more aggressive schedule for achieving flow-through for a larger number of elements than the list specified

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[145] *See* Attachment A to Comments of AT&T, Sprint, MCI, ICG, Northpoint, CCTA and MediaOneTelecommunications of California, Inc. On Proposed Decision of ALJ Walwyn, filed July 21, 1999. A very similar schedule for achievement of the flow-through required by D.98-12-069 is set forth in the affidavit of Christopher Viveros, Pacific's Director of OSS Design and Support, submitted recently in Pacific's § 271 compliance filing in response to D.98-12-069.

in D.98-12-069. The proposal of these parties that CLECs should pay only fully-mechanized non-recurring charges until flow-through for additional elements (and resale services) becomes available is, as noted above, now pending in the OSS/NRC phase.

The CLECs making this proposal have asked that if the Commission believes it needs additional information before adopting the proposal, the Commission should give all parties an opportunity to submit an additional round of comments on the question.[146] We would like to afford all parties an opportunity to address the issues raised by this CLEC proposal. We will therefore direct the ALJ assigned to the OSS/NRC phase to issue a ruling setting forth a schedule for submitting such comments, and indicating those issues that the ALJ believes should be addressed in the comments. After such additional comments have been received, we will issue a decision in the OSS/NRC phase of this docket that determines when and in which additional situations, if any, it is appropriate that a CLEC ordering UNEs or combinations via LEX or a currently-available form of EDI should pay the fully-mechanized non-recurring charges set forth in Appendix B hereto.

VII. SHOULD THE PRICES FOR UNBUNDLED NETWORK ELEMENTS ESTABLISHED IN THIS PROCEEDING BE SET FORTH IN TARIFFS?

An important issue that arose at the March 16, 1998 PHC was whether the UNE prices to be developed in this proceeding would simply be substituted for the interim prices in existing interconnection agreements,[147] or whether these

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[146] CLEC LEX Comments, p. 10.

[147] All parties agreed that under Resolution ALJ-174, adopted June 25, 1997, the prices set in this proceeding will supersede all of the interim prices currently set forth in Pacific's arbitrated interconnection agreements. Resolution ALJ-174 provides in pertinent part:

Footnote continued on next page

UNE prices should be set forth in traditional tariffs. The parties divided sharply on this issue, with the FBC arguing that traditional tariffs were both lawful and necessary, while Pacific, AT&T and Worldcom argued that traditional tariffs were inconsistent with and preempted by the Telecommunications Act. (March 27, 1998 ALJ Ruling, *mimeo.* at 11-12.)

The ALJ concluded that while "the issue of whether traditional state tariffs that set forth the price, terms and conditions on which [UNEs] . . . can be purchased is an important one," it could not be resolved without briefing by the parties. (*Id.* at 11.) To hedge against the possibility that the Commission might order tariffs, the ALJ directed parties to submit testimony that "set[s] forth the prices, terms and conditions on which the UNEs specified in 47 C.F.R. § 51.319 should be offered, . . . includ[ing] model tariff language." (*Id.* at 13.)

As it turned out, only Pacific made any attempt to offer model terms and conditions with its testimony, in the form of an appendix that Pacific proposed to include with interconnection agreements. However, at the close of the hearings, the ALJ directed the parties to brief the issue of the Commission's authority to require that UNE prices be set forth in tariffs.

As discussed below, we think that the Supreme Court's ruling in *AT&T-Iowa* reinstating the "pick and choose" rule has largely mooted this controversy. Nonetheless, we briefly summarize the parties' positions before stating how we intend to proceed.

"[W]e will continue to require that all agreements arbitrated before the [OANAD] pricing decision goes into effect will include interim rates for unbundled elements which will subsequently be revised on a forward basis. Therefore, we will order that all agreements arrived at by arbitration include the provision that all arbitrated rates for unbundled elements will be subject to change in order to mirror the rates adopted in the Commission's OANAD pricing decision or decisions." (Page 2.)

A. Positions of the Parties

In their post-hearing briefs, Pacific and AT&T/MCI both opposed setting forth UNE prices in tariffs, although for somewhat different reasons.

Pacific argued that for a variety of reasons, requiring UNE prices, terms and conditions to be set forth in tariffs would "conflict with the terms and structure of the Act." (Pacific Opening Brief, p. 70.) Pacific argues that the Act seeks to encourage negotiation and voluntary agreement on the terms of interconnection, and that the powers of state commissions under the Act have been delineated with these goals in mind. For example, when arbitration is necessary, state commissions can decide only those issues the parties place before them; "the Act [does] not want state commissions interfering with terms and conditions the parties [have] already agreed upon." (*Id.* at 71.) Similarly, a state commission can reject an *arbitrated* agreement only if it finds that the agreement is inconsistent with the duties set forth in § 251 of the Act, or the pricing and interconnection standards set forth in § 252. Finally, a state commission can reject a *voluntarily negotiated* agreement only if (1) it is found to discriminate against a carrier not a party to the agreement, or (2) its implementation would be inconsistent with the public interest, convenience and necessity. (*Id.* at 71-72.)

In its brief, Pacific placed special reliance on the argument that requiring the terms and prices of UNEs to be set forth in tariffs would essentially reinstate the "pick and choose" rule vacated by the Eighth Circuit:

> "[A] UNE tariff would likely take the form of a series of provisions from which competitors could pick and choose some, but not all, UNEs. CLECs would be able to choose some UNEs from the tariff and other UNEs from previously negotiated interconnection agreements. The Eighth Circuit correctly held that such a situation would be inconsistent with the statutory structure of the Act, which reveals a preference for voluntarily negotiated Interconnection Agreements. A 'pick and choose' rule would 'thwart the negotiation process

> and preclude the attainment of binding interconnection agreements.' The Act prohibits states from imposing regulations or requirements on a telecommunications carrier that are inconsistent with the Act." (*Id.* at 72-73; footnotes omitted.)[148]

AT&T/MCI also opposed tariffing UNEs. After noting that § 252(h) of the Act requires all interconnection agreements to be open for public inspection -- a requirement that helps ensure the prices in such agreements will be made available to other requesting carriers on the same terms and conditions -- AT&T/MCI emphasized the potential for mischief that could result from tariffs that deviate from these negotiated or arbitrated agreements:

> "Requiring the filing of tariffs would be inconsistent with the construct contemplated by the Act, and invite potential confusion and mischief. Pacific could, if required or allowed, file tariffs which differ from or seek to modify the prices, terms and conditions for provision of [UNEs] incorporated in approved interconnection agreements. Pacific should not be permitted to use this vehicle to circumvent its contractual obligations under approved interconnection agreements, nor to limit its obligation to negotiate in good faith . . ." (AT&T/MCI Opening Brief, p. 70.)

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[148] Pacific also notes that the failure of other parties to offer terms and conditions for the leasing of UNEs would make the creation of appropriate tariffs difficult:

> "[P]rice is not the only term and condition that must be specified when UNEs are provided to CLECs. Terms related to maintenance, repair, replacement of UNEs, access to UNEs, the ability of parties to modify their networks, to name just a few, must also be specified. The record in this proceeding does not address these issues sufficiently to allow the Commission to adopt a tariff containing all necessary terms and conditions." (*Id.* at 73.)

Attachment C to Mr. Hopfinger's direct testimony (Exhibit 110) sets forth terms and conditions for the purchase of UNEs that Pacific claims would be appropriate.

The argument in favor of requiring UNE tariffs was made most forcefully by the Facilities-Based Coalition. The FBC argued that §§ 489, 491, and 495 of the Pub. Util. Code require tariffing, and that this requirement is not preempted by the 1996 Telecommunications Act. (FBC Opening Brief, pp. 54-61.) However, the FBC also argued that these statutory provisions give the Commission:

> ". . . discretion to prescribe the form of tariffing, requiring only the tariffing of rate schedules and classifications and not necessarily terms and conditions. Thus the Commission can require Pacific merely to file rate schedules and limit the provision of UNEs to certificated or registered telecommunications carriers." (*Id.* at 56.)

Finally, the FBC argued that requiring Pacific to file UNE tariffs would act as a "safeguard" against future "secret undertakings" such as the Memoranda of Understanding discussed in Section VI.A.3. of this decision. (*Id.* at 61.)

B. Discussion

As noted above, one of Pacific's principal arguments against the tariffing of UNEs was that such a requirement would effectively resurrect the "pick and choose" rule invalidated by the Eighth Circuit.

In its decision in *AT&T-Iowa*, the Supreme Court *did* reinstate the "pick and choose" rule (47 C.F.R. § 51.809)[149] Although the Court agreed with the

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[149] The pick and choose rule provides in full:

> "(a) An incumbent LEC shall make available without unreasonable delay to any requesting telecommunications carrier an individual interconnection, service, or network element arrangement contained in any agreement to which it is a party that is approved by a state commission pursuant to section 252 of the Act, upon the same rates,

Footnote continued on next page

respondents that the pick and choose rule could be viewed as "threaten[ing] the give and take of negotiations," it concluded that the rule must be upheld because "it tracks the pertinent statutory language almost exactly," and is "the most readily apparent" interpretation of § 252(i) of the Act. (119 S.Ct. at 738.) Further, the Court noted, the exceptions to the pick and choose requirement in cases where (1) providing the same interconnection, service or UNE arrangement to another carrier would be either more expensive than to the original carrier, or (2) would be technically infeasible, both go beyond the requirements of § 252(i). (*Id.*)

It seems clear that in light of the Supreme Court's decision, the debate over whether UNEs should be tariffed is now largely moot. Whether they are called "tariffs"or something else, the statements of prices, terms and conditions that ILECs will have to file in order to comply with the pick and choose rule are likely to bear a very strong resemblance to traditional tariffs.

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terms, and conditions as those provided in the agreement. An incumbent LEC may not limit the availability of any individual interconnection, service, or network element only to those requesting carriers serving a comparable class of subscribers or providing the same service (*i.e.*, local, access, or interexchange) as the original party to the agreement.

"(b) The obligations of paragraph (a) of this section shall not apply where the incumbent LEC proves to the state commission that: (1) the costs of providing a particular interconnection, service or element to the requesting telecommunications carrier are greater than the costs of providing it to the telecommunications carrier that originally negotiated the agreement, or (2) the provision of a particular interconnection, service, or element to the requesting carrier is not technically feasible."

"(c) Individual interconnection, service, or network element arrangements shall remain available for use by telecommunications carriers pursuant to this section for a reasonable period of time after the approved agreement is available for public inspection under section 252(f) of the Act."

The question remains, however, whether we should order Pacific to make an immediate filing of the tariff-like documents that may be contemplated by the pick and choose rule, or wait for the FCC to clarify just what additional documentation that agency believes is necessary to comply with the rule. The discussion of the documentation issue in the First Report and Order is hazy, indicating that the FCC regarded the public availability of interconnection agreements pursuant to § 252(h) of the Act as sufficient (¶ 1320), and leaving it to the states to determine "the details of the procedures for making agreements available to requesting carriers on an expedited basis." (¶ 1321.) However, in its recent filing in the Eighth Circuit, the FCC has requested a remand to itself of those rules not expressly reinstated by the Supreme Court, and has reiterated its powers to reconsider any of the rules in the First Report and Order upon an appropriate showing.

Given the FCC's apparent inclination to have a fresh look at some of the issues considered in the First Report and Order,[150] and the fact that the first generation of interconnection agreements approved pursuant to § 252 of the Act begin expiring at the end of this year, we do not think it would be a good use of our resources or the parties' resources to require now the filing of UNE tariffs. As AT&T/MCI have pointed out, § 252(h) of the Act requires all existing interconnection agreements to be available for public inspection. The prices we are determining in this decision (as set forth in Appendices A, B and C) are also matters of public record. Under these circumstances, we think that competing carriers will have more than enough information available to them to determine

[150] Of course, the Supreme Court's decision obliged the FCC to reconsider whether the original list of UNEs set forth in Rule 319 satisfies the "necessary and impair" standard of § 251(d)(2) of the Act.

the prices, terms and conditions on which UNEs have been made available to other carriers.

However, despite our decision not to require the filing of UNE tariffs at this time, several parties have strongly urged us to clarify the future purposes for which the prices developed here will be used. For example, Sprint states:

> "At the conclusion of the complex and lengthy process required for the determination of UNE prices, the Commission will have established a set of prices that it has determined to be consistent with the pricing standards of the Act. Thus, it is appropriate, and in fact, necessary, that the Commission utilize these rates as the source for the UNE prices in any future requests for arbitration submitted by CLECs on this issue until such time as a material change in Pacific's underlying costs or other circumstances can be demonstrated. Moreover, if such changes are identified, they should be considered in the context of a generic proceeding. The considerable time and resources required to establish UNE prices consistent with the standards of the Act, as well as the broad implications of such determinations, makes imperative the filing of an application through which the interests of all affected parties can be considered. A statement in this decision as to how the Commission intends to apply and modify UNE prices determined in this proceeding in the future will be of assistance to all parties in their continued efforts to develop competition in local markets." (Sprint Opening Brief, p. 62.)

We agree with Sprint that there is a need to address the future status of the prices we are determining here. Accordingly, we hereby state that the UNE prices determined in this proceeding will serve as the benchmark for network element prices even after expiration of the interconnection agreements into which the prices are being substituted pursuant to Resolution ALJ-174.

Unless the FCC requires an overall review of the TELRIC costs that state commissions have determined for UNEs pursuant to the Act, it is unlikely

that we will be able to undertake a general reexamination of network element costs during the next three years.[151] Thus, when interconnection agreements are submitted to us for arbitration, we will normally expect the prices for the elements in the disputed agreements to be the same as those set forth in the appendices to this decision.

However, we also recognize that the TELRIC costs we adopted in D.98-02-106 are based largely on data that has not been updated since 1994, and that there is evidence that some of these costs may be changing rapidly.[152] Accordingly, even though we agree with Sprint that any general reexamination of Pacific's TELRIC costs should take place in a generic proceeding in which all parties can be represented, we also believe that there is a need for an interim procedure to reexamine individual UNE costs where a CLEC or Pacific can demonstrate that there has been a very substantial cost change. We have decided that the best vehicle for doing this is an annual cost reexamination proceeding, which will consider no more than two of the UNEs that have been nominated for reexamination.

The procedure for determining which UNE costs should be reexamined will be as follows. If a requesting carrier believes that a UNE price lower than the one adopted herein is justified for a particular network element based upon a reduction in the costs for that element of at least 20% from the costs

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[151] In D.98-12-079, we also noted that we did not intend to revisit the issue of non-recurring costs for three years. (*Mimeo.* at 18.)

[152] For example, in her reply testimony on behalf of AT&T/MCI, Ms. Murray noted that one of the arguments Dr. Hausman made in favor of an adder to UNE prices to account for the risk of stranded investment was that per-line switching investments have declined significantly since 1993, at an annual rate of 8% per year. (Ex. 616, p. 48.) Pacific has not contested this assertion.

approved in D.98-02-106 (and related compliance filings), the CLEC may nominate that UNE as a candidate for reconsideration. The nomination should be made in a filing that is submitted between February 1st and March 1st of each year beginning in 2001,[153] and that includes a brief summary of the evidence supporting the asserted cost reduction. Similarly, if Pacific believes that a higher price is justified for a particular UNE owing to an increase in the costs for that network element of at least 20% over those approved in D.98-02-106, Pacific may nominate that UNE as a candidate for reexamination during the same February 1-March 1 window.[154] Based upon the nominations submitted, the Commission will choose no more than two UNEs for the annual cost reexamination, which will then be conducted in the latter half of each year, beginning in 2001.[155]

All parties are invited to participate in this annual cost reexamination proceeding. Unless and until we approve a UNE cost change resulting from the annual reexamination proceeding, the prices that parties submit to us for inclusion in arbitrated interconnection agreements should be those set forth in the appendices to this decision.

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[153] Because there are many other telecommunications matters vying for the Commission's limited resources, it is not feasible to hold a UNE cost reexamination proceeding until the year 2001.

[154] Pacific's filing should also be supported with evidence showing that the UNE's costs have increased by at least 20%.

[155] The Commission will not entertain any requests to reconsider the markup for shared and common costs in the annual cost reexamination proceeding. As explained in Section III.E. of this decision, that markup has been computed by dividing the total of Pacific's approved shared and common costs by the total of all TELRIC costs (except collocation costs) that we have approved for Pacific. Thus, reexamination of the 19% markup adopted in this decision would effectively require us to reconsider *all* of Pacific's TELRIC costs. Such a daunting task would be inconsistent with the limited annual cost reexamination proceeding we are establishing here.

VIII. HOW SHOULD PRICE FLOORS FOR PACIFIC'S COMPETITIVE SERVICES BE SET, AND HOW SHOULD THE COMMISSION'S PRICE FLOOR RULES BE APPLIED IN LIGHT OF THE ADOPTION OF THE TELRIC METHODOLOGY AND THE REQUIREMENTS OF THE TELECOMMUNICATIONS ACT OF 1996?

The last major issue considered in Pacific's UNE pricing hearings was the question of price floors. Our decisions over the years have recognized that because of the continuing dominance of ILECs in the local exchange market, it is necessary to set price *floors* as well as prices for network elements, so that the ILECs will not be in a position to thwart new entrants by imposing "price squeezes."[156] As we shall see, a large percentage of the parties' testimony and briefs were concerned with the price floor issue, and the factors that go into determining a price floor are quite complex.

A. Background

The issue of price floors first arose in D.89-10-031, 33 CPUC2d 43 (1989), where we abandoned traditional telecommunications regulation based on rate cases and reasonableness reviews in favor of what we called the New Regulatory Framework (NRF). As part of the NRF framework, we decided that all of Pacific's and GTEC's existing services should be placed in one of three pricing categories:

> "[W]e believe a framework which couples broad operational flexibility and risk with significant pricing flexibility for those services which are discretionary or subject to competitive pressures but which maintains close Commission oversight of

[156] A "price squeeze" is the situation that can result when an ILEC's tariffed rate for a so-called monopoly building block (MBB) is higher than the cost of providing that service. When the ILEC's cost of providing the MBB is lower than the tariffed rate that CLEC competitors must pay for the MBB, then the ILEC is in a position to beat the CLEC's prices for products using the MBB. *See* D.94-09-065, 56 CPUC2d 117, 228 (1994).

> pricing, terms, and conditions of basic monopoly services provides the best balance of encouraging efficient operations while protecting monopoly ratepayers.
>
> "To this end, for pricing purposes we establish three categories of local exchange services similar to those proposed by GTEC. Rates and charges for services in Category I will be set or changed only upon approval by the Commission. Pacific and GTEC will have downward pricing flexibility only (from Commission-approved caps) for services in Category II. Finally, the carriers will be allowed the maximum pricing flexibility allowed by law for those services placed in Category III." (33 CPUC2d at 125.)

We also stated that for Category II services, it was necessary to determine "price floors" that would protect ILEC competitors against predatory pricing, since Category II services were defined as "discretionary or partially competitive services for which the local exchange carrier [LEC] retains significant (though perhaps declining) market power." (*Id.* at 125.) We concluded that until studies of the incremental cost of providing local exchange service could be completed, Category II price floors should be based on direct embedded cost (DEC). (*Id.* at 127.)

In D.89-10-031, we also set forth what we referred to as an "imputation" requirement that was designed to prevent ILECs from engaging in predatory pricing toward their competitors in the emerging local exchange market. We described this imputation requirement as follows:

> "[I]n order to prevent anticompetitive price squeezes, the [LECs] should be required to impute the tariffed rate of any function deemed to be a monopoly building block [MBB] in the rates for any bundled tariffed service which includes that monopoly function. However, because of economic efficiency considerations, the [LECs] should be allowed to propose that tariffed rates reflect any cost differences between provision of the monopoly function as part of a bundled utility service and

> provision of that function on an unbundled basis. Absent such a showing, the bundled rate must be at or above the sum of tariffed rates for the bottleneck building blocks and the costs of nonbottleneck components, even if there are floors for a flexibly priced service lower than the tariffed rates." (*Id.* at 121.)

We next had occasion to consider our imputation requirement in the IRD decision, D.94-09-065. In reviewing the framework we had set forth in D.89-10-031, we noted that imputation serves two related purposes:

> "[I]mputation's primary purpose is to serve as a safeguard against potential anticompetitive abuses by the LECs. It does this in two ways. First, it ensures that the price of the LECs' bundled competitive offering at least recovers the cost of providing the service, so that customers of the LECs' regulated services do not subsidize the competitive services. Second, it promotes fair competition by preventing the LEC from underpricing its bundled competitive offerings to the disadvantage of competitors." (56 CPUC2d at 228.)

We concluded in D.94-09-065, however, that it was necessary to reformulate the imputation test in order to apply it to the toll services that were at issue in IRD. Such a reformulation was necessary, we said, because the cost studies submitted by Pacific and GTEC were not sufficiently unbundled. We described our reformulation of the imputation test -- which has become known as the "contribution" method of imputation -- as follows:

> "[DRA, Pacific and GTEC] propose an imputation formula based on the LRIC of the bundled Category II service plus the 'contribution' the LEC receives from providing the [MBB] component as the tariff rate. Contribution is defined as the difference between the tariff rate of the [MBB] and its LRIC. Pacific contends that this formula is the algebraic equivalent of the imputation standard of D.89-10-031, adjusted for the use of LRIC instead of DEC." (*Id.* at 232.)

After manipulating a series of equations that represented the original imputation rule, we agreed with Pacific that the contribution method was the algebraic equivalent of the original rule. We applied the new contribution method to the toll services at issue, but said:

> "[W]e are frustrated in our desire to progress further [on setting cost-based prices and price floors] due to the LECs' failure to perform LRIC studies on an unbundled basis. We will require such studies to be submitted in our OAND proceeding . . . In that proceeding, the LECs may propose revised price floors based on unbundled LRICs." (*Id.* at 237.)

Our next consideration of price floor issues came in D.96-03-020, one of our principal decisions in the Local Competition docket. In that decision, we set the interim resale discount for Pacific and GTEC and also reclassified, in light of emerging competitive conditions, the status of a number of local exchange services offered by Pacific. In particular, we ruled that, pursuant to the NRF framework, the following local exchange services – which had heretofore been treated as Category I services -- should now be classified as Category II, "partially competitive," services:

- Basic flat residential access line service (1 FR);
- Basic measured residential access line service (1 MR);
- Basic business access line service (1 MB);
- Business and residence ISDN feature;
- Business and residence ZUM usage;
- Business and residence local usage;
- Coin Operated Pay Telephone (COPT) service.

Although D.96-03-020 reclassified these services as Category II, the decision did not establish price floors for them. Instead, D.96-03-020 left that task to this docket, the designated vehicle for determining the LRIC of the basic network components of local exchange service. As noted elsewhere in this

decision, the Commission adopted "total service" LRICs – or TSLRICs -- for many local exchange services in D.96-08-021, but the task of deriving price floors from these costs was suspended after the issuance of the FCC's First Report and Order cast doubt upon the legal adequacy of the TSLRIC methodology.[157] In the ALJ Ruling issued in this docket on December 18, 1996, it was decided that the determination of price floors should take place in the supplementary pricing hearings that would be held after this Commission decided whether to use the TSLRIC or TELRIC methodology.[158]

Thus, by the time supplementary pricing hearings in this docket were held in May and June of 1998, it was evident that the setting of price floors would present significant issues. These issues included how TELRIC costs (which have network elements rather than services as their "cost objects") could be used to set service price floors, and which (if any) UNEs should be considered MBBs.[159]

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[157] *See* Administrative Law Judge's Ruling Suspending Briefing Schedule and Inviting Comments on the Impact of the August 8, 1996 First Report and Order of the Federal Communications Commission on Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, issued August 21, 1996, *mimeo.* at 2, 5-6.

[158] December 16, 1998 ALJ Ruling, *mimeo.* at 27-30.

[159] It was evident from discovery disputes that arose during 1997 that parties would raise these issues in their testimony. *See, e.g.*, Administrative Law Judge's Ruling Setting Out Limits of Permissible Discovery In Response to Discussion at July 1, 1997 Hearing, issued August 25, 1997. In that ruling, the assigned ALJ discussed whether, in view of the discussion in the Eighth Circuit's decision in *Iowa Utilities Board* of the "necessary and impair" standard contained in § 251(d)(2) of the Telecommunications Act, demand for UNEs should be presumed, or discovery should be permitted as to the aggregate level of demand for and the demand elasticities of particular UNEs. The ALJ ruled that reasonable discovery should be permitted as to these demand issues. (*Mimeo.* at 4-6.)

It had also become evident that in the two years since issuance of D.96-03-020, new issues related to pricing flexibility had arisen. These new issues included whether -- as contended by the FBC -- the decision in D.96-03-020 to treat Basic Network Functions (BNFs) as Category I services automatically applied to UNEs, or -- as contended by Pacific – that not allowing pricing flexibility for UNEs would be inconsistent with and preempted by the negotiated interconnection agreements contemplated by the Telecommunications Act. Another issue was whether, in light of the Commission's adoption of both TLSRIC costs in D.96-08-021 and TELRIC costs in D.98-02-106, the "contribution" version of the price floor test set forth in D.94-09-065 should be abandoned in favor of the original price floor formula contained in D.89-10-031.

B. Pacific's Position On How To Set Price Floors For the Services Specified in D.96-03-020

1. Dr. Timothy Tardiff's Testimony

As noted above, while the general issue of price floors raises many issues going to the heart of our efforts to promote competition in the local exchange market, the original reason for putting the price floor issue into this docket was the need to set price floors for the services newly-designated as Category II in D.96-03-020.

Dr. Timothy Tardiff was Pacific's principal witness on price floor and imputation issues. Dr. Tardiff contends that under generally-accepted economic principles, the basic rule for setting price floors should be as follows:

> "[P]rocompetitive price floors for [a] retail service should be equal to the forward-looking incremental cost of offering that service. In particular, volume-sensitive prices must at least cover all costs that vary with volume. In addition, the total revenue from a service

> must be sufficient to cover any non-volume sensitive costs attributable to that service alone." (Ex. 122, p. 4.)[160]

Dr. Tardiff emphasizes that shared and common costs should not be included in price floors, and that it is not necessarily a good idea to recover them through a uniform markup over a service's volume-sensitive costs.[161] Dr. Tardiff notes that in competitive markets, prices are driven toward incremental costs, and that requiring regulated firms to include "arbitrary" markups for shared and common costs in their prices is therefore liable to harm both consumers and the firms. Dr. Tardiff explains that such harm can occur in the following ways:

> "Consumers would suffer in one of two ways. First, the artificially higher price floor could divert the benefits of lower prices from consumers to firms that are able to charge more than they otherwise would under the price umbrella created by the artificially high price floor. Alternatively, if competitors of the price-regulated firm prices below the floor, those customers able to take advantage of these prices might benefit, *in the short run.* However, the regulated firm would be harmed in the process and it would be faced with the prospect of either raising prices to those customers dependent on its services or earning inadequate returns on its

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[160] The portion of Dr. Tardiff's price floor approach that deals with the recovery of non-volume sensitive costs is based on the testimony of Dr. Richard Emmerson (Ex. 106), which is considered in Section VIII.B.2., *infra.*

[161] Volume-sensitive, volume-insensitive, shared and common costs are defined on page 5 of Appendix C to D.95-12-016, which adopted the Consensus Costing Principles (CCPs) that have governed the preparation of cost studies in this proceeding. Under CCP No. 3, a volume-sensitive cost must be included in the TSLRIC for the service to which it pertains. Shared and common costs are always volume-insensitive (*i.e.*, they do not vary with changes in the quantity of output for a particular service), but some costs assignable to particular services are also volume-insensitive (*e.g.*, a license fee).

> investment. The consequences of the latter are diminished incentives to invest in its infrastructure, even perhaps to the point of withdrawing from one or more of the markets in which it competes." (*Id.* at 6.)

Dr. Tardiff argues that Pacific "should be free to recover shared and common costs like any other firm, i.e., in response to the market conditions it faces," because firms not subject to ILEC-style regulation "simply do not include arbitrary allocations of shared and common costs in their prices." (*Id.* at 6-7.) For this reason, he urges that price floors in this proceeding should be set using the TSLRIC studies approved in D.96-08-021, because – unlike the TELRIC studies approved in D.98-02-106 – they do not attempt to assign to individual network elements, costs that are shared or common among services.

As proof of his assertion that non-regulated firms do not include allocations of shared and common costs in prices, Dr. Tardiff points to the Transport Incremental Cost Model (TICM), which AT&T used to set price floors for its principal California subsidiary before the latter was designated as a nondominant interexchange carrier[162]. According to Dr. Tardiff, TICM assigns no shared or common costs to the incremental costs of AT&T's competitive services, and "explicitly exclude[s] certain costs that would be considered volume-sensitive under TSLRIC." (Ex. 121-S, p. 7.)

Although Dr. Tardiff believes that the starting point for setting a price floor is the volume-sensitive portion of the TSLRIC for a service, he acknowledges that under D.94-09-065, the contribution from any monopoly building block used to provide the service must also be "imputed to" – *i.e.*, included in – the service's price floor. This requirement prevents

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[162] AT&T's principal California subsidiary, AT&T Communications of California, Inc., was designated as a non-dominant inter-exchange carrier (NDIEC) in D.97-08-060.

anticompetititive price squeezes, Ex. 122, pp. 7-8, and helps to ensure that the most efficient provider can charge the lowest price:

> "The mark-up above the incremental cost of an essential facility is an opportunity cost that the ILEC foregoes when it sells its retail service in lieu of selling the essential facility to a competitor. Therefore, recognizing that cost as part of the price floor ensures that all of the costs imposed on the ILEC in offering its retail product are recognized. The imputation rule also ensures that the provider that can provide the non-essential components of the service most efficiently can charge the lowest price – a safeguard that promotes efficient competition." (*Id.* at 12.)

Although Dr. Tardiff advocates the use of TSLRIC costs for setting price floors, he acknowledges that TELRIC costs are the starting point for determining imputation:

> "TELRIC is the vehicle for setting UNE prices. For those UNEs that are essential inputs for competitors, the UNE price is one part of the formula for determining the contribution to be included in the retail price floor – specifically, appropriate contribution is the difference between the UNE's price and its TSLRIC. That contribution is added to the TSLRIC of the retail service to obtain the price floor required by the IRD imputation rule." (*Id.* at 9.)

In the final part of his discussion of the general principles that should govern price floors, Dr. Tardiff makes a strong argument against determining the price floor for a service by taking the sum of the prices of all UNEs used to provide the service. After reiterating that TSLRIC studies treat as

shared or common, costs that TELRIC studies assign directly to network elements[163], Dr. Tardiff states:

> "When the retail service uses UNEs that are not essential inputs for CLECs, the incorrect price floor that is obtained from simply adding UNE prices would include more contribution than competitors are required to pay. This is so because the prices for network elements generally exceed TSLRIC, because those prices have allocated to them shared and common costs, while TSLRIC does not. In contrast, the IRD decision clearly states the correct economic principle that the price floor equalizes the contribution paid by ILECs and CLECs.
>
> "Therefore, for those essential network elements that competitors need in order to provide their retail services, the difference between the UNE price and TSLRIC is a mark-up over cost that recovers some shared and common cost. And, in order for the retail price floor to equalize the contributions paid by ILECs and CLECs, that mark-up is the *only* contribution that must be included in the ILEC's price floors under this Commission's imputation rules." (*Id.* at 10.)

The second part of Dr. Tardiff's testimony is an analysis of which UNEs should be considered MBBs. Dr. Tardiff begins by arguing that under D.89-10-031 and 94-09-065, the term MBB appears to be synonymous with "essential facility," a term with a generally-accepted meaning in both economics and antitrust law. Dr. Tardiff continues that in antitrust analysis, whether a facility is "essential" can be determined only by examining the relevant market, a determination that involves both "a product market dimension and a geographic

[163] The reason for this, Dr. Tardiff contends, is that "TELRIC studies treat UNEs as if they are the only items being offered for sale by the firm." (*Id.* at 10, n. 9.)

market dimension." (*Id.* at 20.) In Dr. Tardiff's view, the relevant geographic dimension for local exchange competition is cities (since CLECs tend to enter the market on a city-by-city basis), and the relevant products are residential service and business service. He summarizes the basic tests for determining whether a facility is "essential" as follows:

> "Since the decisions in MCI Communications Corp.v. American Telephone and Telegraph Co. [708 F.2d 1081 (7th Cir.), cert. denied, 464 U.S. 891 (1983)] and Norman Hecht, et al. v. Pro-Football, Inc. [570 F.2d 982 (D.C. Cir. 1977), cert. denied, 436 U.S. 956 (1978)], courts have generally considered three prerequisites where the essential facilities doctrine should apply. These prerequisites are:
>
> - A firm operating in some market controls access to a critical input;
> - Access to the critical input under reasonable terms is necessary for competitors to compete in this market; and
> - Access to the critical input can be supplied to competitors under reasonable terms." (Id. at 11.)

Dr. Tardiff continues that, consistent with the approach used in the imputation discussion in D.94-09-065, he used the following practical tests for determining what are essential facilities:

> "A network element is essential when competitors *must* use that element in order to offer a service that is an alternative to an ILEC offering. A network element is not essential if (1) a firm can competitively offer retail services similar to Pacific's *using inputs (facilities) similar to those used by Pacific,* but provided by a company other than Pacific or self-provisioned; or (2) a UNE or facility similar to a UNE is not incorporated in *all* competitive retail alternatives currently offered in the market(s). In determining when this second situation applies, I identify actual competitors, some of which may use

> different production processes than Pacific (e.g., telephony over CATV), thus narrowing the range of essential facilities identified by looking at competitors that employ production processes similar to the ILEC's." (*Id.* at 15; emphasis in original.)[164]

Dr. Tardiff considered whether five of the UNEs designated by the FCC in the original version of 47 C.F.R. § 51.319 should be considered essential facilities: subscriber loops, end-office switching, transport (including tandem switching), directory assistance and operator services. (*Id.* at 22.) After describing the analysis he undertook for each UNE, Dr. Tardiff concludes that only one of these UNEs – subscriber loops – can be considered essential, and then only for residential customers and some small business customers. A brief summary of his analysis for each UNE follows.

Dr. Tardiff concluded that ***switches*** capable of providing both end-office and tandem switching are non-essential because alternatives are widely available in Pacific's territory. Based on an examination of interconnection agreements, responses to data requests and the December 1997 Local Exchange Routing Guide, Dr. Tardiff concluded that 13 CLECs own a total of 43 local switches in Pacific's service territory, the locations of which he sets forth in his testimony. (*Id.* at 24-26.) Dr. Tardiff notes that these switches (many of which offer both end-office and tandem functions) usually cover a larger

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[164] Dr. Tardiff points out that in D.94-09-065, the Commission concluded that for intraLATA toll, the essential input for IXC high-volume services was dedicated access, not the switched-access facilities that Pacific happened to use in offering its intraLATA toll services. In accordance with this analysis, the Commission required imputation of dedicated access facilities rather than the switched-access facilities. (*Id.* at 15.) From this, Dr. Tardiff concludes that in IRD, "the Commission went beyond examination of alternative services that are provisioned similar to the ILEC's retail offering (the first situation) and considered those alternatives that employed different production processes (the second situation)." (*Id.*)

geographic territory than ILEC switches, so he assumed the CLEC switches could provide service within a 50-mile radius. He notes that his conclusion of non-essentiality is consistent with this Commission's recognition that it is "access to the customers of other providers itself[,] and not the switching[,] that becomes an essential input." (*Id.* at 26.)

Dr. Tardiff also concluded that ***transport*** is not an essential facility. He states that 155 California cities are equipped to provide competitive transport, which can occur via SONET, fiber, microwave and hybrid fiber-coaxial (HFC). Although most CLECs use fiber, HFC is used by Cox and TCI/Viacom, and ICG uses microwave. Those CLECs using fiber have several different strategies. Cox and Time-Warner have concentrated on specific cities with already-existing facilities that can be expanded into growing suburbs, while ICG has leased fiber capacity from municipalities and utilities so that it can cover California from north to south. Dr. Tardiff believes that Pacific's collocation arrangements furnish additional proof that transport facilities are not essential. He notes that at the end of 1997, collocation arrangements were in place at 86 of Pacific's metropolitan central offices, which account for about 75% of Pacific's volumes in those areas. (*Id.* at 35-36.)

Of the five UNEs he studied, Dr. Tardiff devotes the most attention to ***loops***. (*Id.* at 26-35.) He concludes as follows:

> "Loops are clearly not essential for business local services in most urban areas or for medium and large customers with locations outside of urban areas. In the short run, loops may be essential for residential services in many areas[,] and for some small business services in lower density areas." (*Id.* at 26.)

Dr. Tardiff states that 14 CLECs offer competitive wireline alternatives to loops. The technologies of these wireline alternatives consist of

T1.5 digital link (offered by AT&T), fiber (offered by ELI, ICG, MFS, TCG, and Time Warner), HFC (offered by Cox and TCI), and transceivers or antennas (the "wireless fiber" local loop offered by Winstar). Dr. Tardiff states that while CLEC loops are concentrated in large population centers, they are also available elsewhere.

Dr. Tardiff has presented detailed information about the loops available from six of these alternative providers. For example, he notes that AT&T's wireline alternative – which is called Digital Link service – has experienced rapid growth, and now has local volume equivalent to what would normally be generated by 20,000 to 30,000 business lines. AT&T's Digital Link provides local calling service to large and medium business customers over existing dedicated links on the AT&T network. (Ex. 121-S, p.28.)

Expanding on his transport analysis, Dr. Tardiff claims that ICG offers facilities-based local service in 95 cities in major areas (including San Francisco, Los Angeles, Anaheim, Alameda and San Diego), and is linking its Northern and Southern California networks through leased fiber capacity. ICG has rights to lease 1200 miles of fiber-optic routes from Southern California Edison Company, along with lesser amounts of fiber capacity owned by the Cities of Burbank and Alameda. ICG owns fiber-optic networks in 55 of the 95 cities it serves, and 14 of these cities have fiber loops. (Ex. 122, pp. 28-30.)

According to Dr. Tardiff, MFS and Brooks Fiber have also constructed fiber loops in several cities. MFS owns such loops in San Francisco, Oakland, Alameda, Los Angeles, Anaheim, San Diego and Fresno; it also planned to construct a fiber network in Sacramento during 1998. MFS currently

offers local services in 101 cities in 11 Ranally Metro Areas[165] in California, and since its merger with WorldCom, has been concentrating on marketing local switched services to its Southern California business customers. (*Id.* at 30-31.) Brooks Fiber's local loops (which can bypass Pacific except for Centrex service) are available in 16 of the 24 cities Brooks serves, which include San Francisco, Sacramento, Stockton, Fresno and Bakersfield. Brooks offers flat-rate and measured business service in these cities, as well as other business services. (*Id* at 31-32.)

Dr. Tardiff also describes the "wireless" loops being developed by Winstar and the HFC loop equivalents developed by Cox. Winstar presently offers business services to small and medium-size customers in San Diego, San Francisco and Los Angeles, and it is planning to offer such service in Bakersfield. Winstar's wireless loop uses the 38 GHz frequency band, for which the company currently holds 38 licenses in 47 of the top 50 U.S. markets. This wireless loop (which uses antennas and transceivers) can completely bypass Pacific's system. According to Dr. Tardiff, Winstar's loop is the functional equivalent of fiber optic cable in terms of quality and bandwidth provided to the customer. (*Id.* at 32-33.)

Cox, which offers local service principally in the cities of San Diego and Anaheim and their environs, has developed a new HFC architecture that it is beginning to deploy in Orange County. This architecture provides two diverse paths, so that if there is a fiber cut, service can be provided through the

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[165] According to Pacific's Opening Brief, "a 'Ranally Metro Area' is Rand McNally's definition of the developed areas around each important city. Ranally metro areas inlcude one or more central cities, satellite communities, and suburbs but are not restricted to following county boundaries." (Pacific 7/10 Opening Brief, p. 87, n. 299.)

second path during repairs. In other cities such as El Cajon, Cox leases a fiber optic network. (*Id.* at 33-35.)

Based on his analysis, Dr. Tardiff reached the following conclusions about where and for which services Pacific's loops should be considered "essential" in the top 20 cities that comprise the relevant geographic market:

Essential Facility Determination for Loops

Top 20 Cities

	Business Market		Residential Market
City	Medium and Large	Small	
(1)	(2)	(3)	(4)
Anaheim	*Not essential*	*Not essential*	*May be essential*
Bakersfield	*Not essential*	*Not essential*	*May be essential*
Chula Vista	*Not essential*	*May be essential*	*May be essential*
Fremont	*Not essential*	*May be essential*	*Not essential*
Fresno	*Not essential*	*Not essential*	*May be essential*
Glendale	*Not essential*	*Not essential*	*May be essential*
Huntington Beach	*Not essential*	*Not essential*	*May be essential*
Long Beach	*Not essential*	*Not essential*	*May be essential*
Los Angeles	*Not essential*	*Not essential*	*May be essential*
Modesto	*Not essential*	*May be essential*	*May be essential*
Oakland	*Not essential*	*Not essential*	*May be essential*
Oxnard	*Not essential*	*May be essential*	*May be essential*
Riverside	*Not essential*	*May be essential*	*May be essential*
Sacramento	*Not essential*	*Not essential*	*May be essential*
San Bernardino	*Not essential*	*May be essential*	*May be essential*
San Diego	*Not essential*	*Not essential*	*Not essential*
San Francisco	*Not essential*	*Not essential*	*May be essential*
San Jose	*Not essential*	*Not essential*	*May be essential*
Santa Ana	*Not essential*	*Not essential*	*May be essential*
Stockton	*Not essential*	*May be essential*	*May be essential*

Pacific's price floor recommendations follow Dr. Tardiff's analysis, and so result in geographically-deaveraged price floors (but not prices) for services using loops. Pacific argues that "the Commission should require imputation of contribution from Pacific Bell only for small-business and residence customers in those cities where Dr. Tardiff has found that Pacific's facilities 'may be essential'." (Pacific Opening Brief, p. 92.) Consistent with this recommendation, Richard Scholl -- the Pacific witness who supervised the calculation of Pacific's proposed price floors -- calculated two sets of them:

> "Because Dr. Tardiff found that UNEs could be essential in one city and not in another, Mr. Scholl calculated two sets of price floors: a price floor with imputation for those cities where UNEs were monopoly building blocks[,] and a second price floor without imputation for those cities where UNEs were not monopoly building blocks." (*Id.* at 94.)

In the final portion of his testimony, Dr. Tardiff argues that neither directory assistance nor operator services can be considered an essential facility, because several companies can provide these services to wireline and wireless providers. According to Dr. Tardiff, companies providing both directory assistance and operator services include Volt, Metro One Telecommunications and InfoNXX, the last of which provides these services to the seven million wireless customers of Bell Atlantic, US West and AirTouch. Dr. Tardiff also states that TelTrust provides directory assistance and operator services to Cox Communications in California. (*Id.* at 36-37.)

2. Dr. Richard Emmerson's Testimony

Dr. Tardiff relied on the testimony of Dr. Richard Emmerson to demonstrate that setting price floors at the volume-sensitive portion of a service's TSLRIC (plus contribution from any monopoly building blocks) was

reasonable *provided* the total revenues from the service are sufficient to cover non-volume sensitive costs attributable to the service.

Dr. Emmerson's testimony, Exhibit 106, provided a series of tests designed to assure that Pacific's proposed price floors include no improper cross-subsidies. After noting that the TSLRIC studies adopted in D.96-08-021 include both volume-sensitive and non-volume sensitive costs for each service, Dr. Emmerson describes his basic cross-subsidy testing approach as follows:

> "Since neither volume-insensitive costs nor shared costs are 'caused' by any particular unit of a service, it is not appropriate to include them as part of the price floor for an individual unit of service. Volume insensitive incremental costs and shared costs should be considered only in a revenue-based cross-subsidy test . . . Essentially, these cross-subsidy tests ensure that (1) total revenues of the service cover all of the volume sensitive and service-specific volume-insensitive costs; and (2) total revenues of a shared family cover both the total incremental costs and the shared costs of that family." (Ex. 106, pp. 3-4.)

Dr. Emmerson acknowledges that testing for cross-subsidies becomes more difficult when one must take into account shared costs, since they are spread among families of services. However, he asserts that tests can also be performed for this purpose:

> "Legitimate concerns over the recovery of shared costs are properly dealt with by testing for cross-subsidies for families of services. The economic concept is precisely the same as that employed for testing cross-subsidy for a single service, except that the focus of the test is on the family of services rather than a single service. In order to pass the test, the revenue from all the services in the family [both recurring and non-recurring] must be greater than or equal to all the costs [both recurring and non-recurring] caused by the services in the family, including shared family costs . . ." (*Id.* at 6-7.)

Dr. Emmerson continues that Pacific properly performed cross-subsidy tests for about 230 individual services, which are summarized in the testimony of Mr. Scholl. He acknowledges that several of these services "do not produce revenues sufficient to cover their full incremental costs," but asserts that in virtually all of the cases where a cross-subsidy was found, the service has "been priced in response to a public policy objective," so the general validity of Pacific's price floor proposal is not undermined. (*Id.* at 8.)

Dr. Emmerson continues that in order to test for cross-subsidies among *families* of services, Pacific was obliged to use some simplifying assumptions, which he describes as follows:

> "Pacific has used an overly strong algorithm in the tests to ensure that families of services do not receive a cross-subsidy.
>
> "As the number of services provided by a company becomes large (*e.g.*, over 20) the number of possible families of services, and therefore the number of possible tests, becomes very large (*e.g.*, over a million). To deal with the large number of possible tests required in theory, Pacific has utilized two techniques to make the cross-subsidy test for families of services tractable. First, Pacific has aggregated approximately 230 services into forty service groups.[166] Second, Pacific has used a technique for allocating shared family costs to the forty service groups.[167] This allocation of costs results in an

[166] Dr. Emmerson acknowledges that not all of these 40 groups of services pass the cross-subsidy test, especially the residence access and public access service groups. However, as with individual services, those that did not pass "typically have been priced in response to a public policy objective." (*Id.* at 10.)

[167] Dr. Emmerson sets forth a formula for this allocation method on pages 10-11 of his testimony, and describes it as "similar to producing a fully distributed cost as a cross-subsidy test." (*Id.* at 10.)

> overstrong cross-subsidy test that can provide sufficient information to determine that prices are subsidy-free but cannot indicate that a cross-subsidy does exist." (*Id.* at 9.)

The Pacific approach that results in an "overstrong" subsidy test involves allocating shared family costs *pro rata* according to the contribution to cost recovery produced by a service group. However, since the resulting allocations depend on the order in which families of services are considered, Dr. Emmerson states that it is necessary to run the tests until one sequence passes, which proves that the families are subsidy-free. Dr. Emmerson states:

> "[A]ny allocation that results in all group allocated costs that are no greater than group contribution levels does indicate that there is no cross-subsidy. If the available contribution exceeds the shared cost for each family throughout at least one sequence of the families (*i.e.*, if there is at least one order in which the families can be tested that will pass the test), then the firm's prices are subsidy-free and no further tests need be performed. *This was the result for Pacific – the overly strong cross-subsidy test was passed.*" (*Id.* at 11-12; emphasis supplied.)

C. The AT&T/MCI Position on Price Floors and Imputation

The position of AT&T/MCI on the proper calculation of price floors and the application of imputation principles is set forth in the testimony of Terry Murray and Dr. Lee Selwyn, and in most respects it is the diametric opposite of Pacific's position.

Ms. Murray begins her price floor discussion by emphasizing that unless the Commission requires ILECs to include the full price of all applicable UNEs in a service's price floor, incumbents like Pacific will invariably have an advantage over new entrants who are forced to buy Pacific's UNEs:

> "Imputation is simply a requirement that the incumbent treat its price to other carriers as its price to itself. This can be done in an *accounting* sense, but not in a true economic sense. No matter what cost the incumbent shows in its books of account when it supplies [UNEs] to itself, the *economic* cost to the incumbent remains the direct economic cost of providing that essential monopoly input function. The amount by which the accounting transaction exceeds the direct economic cost of providing the input function is not a genuine cost to the incumbent, but instead is available to cover some of the indirect (shared and 'common') costs of the incumbent or to generate monopoly profits. Moreover, it is a markup that the incumbent can substitute for markups on other services – in particular, other retail services that it provides in competition with new entrants.
>
> "For the entrants, however, the direct economic cost they face for the same [UNE] that they obtain from the incumbent is the *price* the incumbent charges them, not the direct economic cost that the incumbent experiences. Essentially, the amount by which the price for the [UNEs] exceeds the direct economic cost of supplying them acts like a tax, but it is a 'tax' that only applies to entrants. The amount that is collected in that 'tax' is turned over to the incumbent, which uses those amounts to recover its indirect costs or to earn higher profits overall. Imputation simply adds this 'tax' to the retail price floor, creating pressure to increase retail prices. It does not ensure that incumbents and entrants have the same opportunity to recover their indirect costs in retail prices." (Ex. 616, pp. 62-63.)

Ms. Murray then argues that for two reasons, Pacific's pricing proposals would exacerbate the upward pressure on retail rates that imputation can create. First, she notes that Pacific is urging markups over TELRIC costs that exceed what is necessary (in most cases) to recover its shared and common costs. Second, she notes that Pacific also proposes to exclude many of these markups from its retail price floors on the ground that the elements in question are not essential facilities. Because such pricing would lead to discriminatory results,

Ms. Murray argues, the only equitable price floor approach is to require Pacific "to impute both the direct economic cost (TELRIC) and the full markup over cost in the price of each [UNE] into the retail price of every Pacific service that uses the equivalent functionality." (*Id.* at 64-65.)

Dr. Selwyn's direct testimony endorses this view, and adds that the Commission must be sure to include the TSLRICs of the competitive components of a service in its price floor:

> "[The Commission] should require Pacific Bell to impute the sum of the prices for [UNEs] and other inputs a competitor needs to acquire from Pacific to provision the service and add the TSLRIC of the competitive components of Pacific's service to establish the price floor. The 'contribution method' is no longer needed now that unbundled cost studies are available." (Ex. 611, p. 54.)

In his reply testimony, Dr. Selwyn offers a point-by-point rebuttal of Dr. Tardiff's argument that loops, switching and transport should no longer be considered essential facilities. Before setting forth specifics, however, Dr. Selwyn criticizes Dr. Tardiff's analysis for its abstract character, and for its assumption that if competitive alternatives are *beginning* to develop in areas around the state, the availability of alternatives should be assumed *throughout* the state:

> "[F]or all the facts, figures and maps he provides, Dr. Tardiff does not provide any evidence that competitors currently control more than a *de minimis* share of the market for any of the local exchange services that Pacific dominates. Indeed, mere evidence of the *presence* of competitors in no way demonstrates that those competitors are in any position to successfully *compete* in the near future or, more importantly for present purposes, supply [UNEs] in all of the geographic areas that Dr. Tardiff seeks to portray as 'competitive'. Moreover, the evidence that he does provide corroborates the extreme geographic concentration that I have found in my own analysis of the state of competition in California. Large areas of the state . . . not only have no present CLC activity,

> but have no planned future CLC activity either." (Ex. 612, p. 56; footnote omitted.)

Dr. Selwyn's opinion is that under the Eighth Circuit's reasoning in *Iowa Utilities Board,* all of the network elements designated as UNES by the FCC in the First Report and Order should be considered essential facilities. He argues that under the Eighth Circuit's discussion of the "necessary and impair" standard of § 251(d)(2) of the Telecommunications Act (120 F.3d at 813), Pacific is clearly wrong in arguing that facilities are not "essential" if alternatives are starting to become available from providers other than the ILEC.

Dr. Selwyn is especially critical of Dr. Tardiff's claim that there are meaningful competitive alternatives for loops. He points out that according to a recent newspaper report, Pacific installed a total of 1.44 million new lines in California during 1996 and 1997, but that the total number of loops provided by non-incumbent carriers is thought to be less than 20,000 statewide. If one assumes all the non-incumbent loops were installed during the same two years, this would mean Pacific's share of the total loop market exceeded 99.9%. (*Id* at 59.) Dr. Selwyn summarizes his critique of Dr. Tardiff's loop analysis as follows:

> ". . . Dr. Tardiff's analysis depends not upon the actual present level of competition, but on the *potential* for competition. For example, Dr. Tardiff's map depicting loop competition is based upon the assumption that CLC loop facilities can serve areas within one mile of present CLC 'on-net' buildings. In addition, he relies upon anecdotal evidence like Winstar's control of radio spectrum and Brooks Fiber's 'entry strategy' to support his claim that competitors provide loops outside major metropolitan areas.
>
> "Dr. Tardiff looks in some detail at six competitors providing loops to businesses . . . describing their market strategies and, in some cases, proprietary data regarding data usage and

> customer lines. The detail he provides, however, simply confirms the conclusion I stated in my direct testimony: What little competition there is in California is highly concentrated on business services in a few specific metropolitan areas." (*Id.* at 61-62; footnotes omitted.)

Although Dr. Selwyn asserts that switching is an essential element, he is less dismissive of Dr. Tardiff's claim that it is not essential than he is of Dr. Tardiff's arguments about loops. Dr. Selwyn bases his opinion that switching is essential on two factors: (1) the 43 switches owned by CLECs are insignificant when compared with the 783 switches owned by Pacific, and (2) the economic interrelationship between switching and loops. On the latter question, Dr. Selwyn points out that in order for a CLEC to be able to use its own switch with loops that it has leased from an ILEC, the CLEC must be collocated in the central office where the loops originate. Unless the number of loops leased in a particular central office is large, it may not be worthwhile for the CLEC to incur the costs of collocation. Therefore, Dr. Selwyn concludes, where collocation is not economically justified, even a CLEC with a switch has no practical choice but to lease the ILEC's unbundled switching facilities as well. (*Id.* at 64-65.)[168]

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[168] Ms. Murray makes a similar point in her reply testimony. She argues that if a CLEC is to be able combine its own facilities with UNEs purchased from Pacific, it needs collocation and a form of switching called Switch Unbundling Option C, which Pacific offers only on an individually-negotiated basis. Ms. Murray states that Switch Unbundling Option C is necessary if, for example, a CLEC wishes to route traffic differently from how Pacific routes traffic. After noting that AT&T and MCI's negotiations with Pacific for Option C are nowhere near completion, Ms. Murray continues:

> "Until Pacific physically makes switch unbundling option C available at a cost-based price, the 'platform' will remain virtually the only realistic option for new entrants to make use of Pacific's [UNEs].

Footnote continued on next page

Dr. Selwyn also disagrees with Dr. Tardiff that transport is no longer an essential facility. Noting that Dr. Tardiff's claim is based in part on the fact that competitors are collocated in 86 of Pacific's central offices, Dr. Selwyn states:

> "Given that Pacific has approximately 700 central office buildings in California, the presence of collocation in less than 15% of these offices clearly undermines the claim that transport is a non-essential service *everywhere* in the state. As with his other claims, Dr. Tardiff again fails to offer any evidence that competitive providers of transport have made any inroads into Pacific's dominance of this segment. He merely shows that such providers have *some* facilities and strategies for the provision of *some* transport services . . ." (Ex. 612, p. 66.)

Dr. Selwyn offers no specific rebuttal to Dr. Tardiff's claim that directory assistance and operator services cannot be considered essential elements.

AT&T/MCI continue that even under Pacific's interpretation of the Commission's price floor rules, local switching, transport and "distribution" facilities must still be considered essential facilities. Purporting to use the tests set forth in *MCI Communications v. American Tel. & Tel. Co.*, 708 F.2d 1081 (7th Cir.), *cert. denied*, 464 U.S. 891 (1983), AT&T and MCI argue:

> "Significant market power is determinative of the first element of an essential facilities case – control of an essential facility by a monopolist. The economic infeasibility of duplication of the

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"The limited availability of collocation and the nonavailability of switch unbundling option C have significant implications for Pacific's essential facilities analysis. *If the only way that new entrants can make effective use of Pacific's [UNEs] is to buy the entire 'platform,' then every element in that platform is an 'essential' element if even one element can be so classified. Dr. Tardiff's analysis, which looks at each [UNE] on a piecemeal basis, fails to account for this fact.*" (Ex. 616, pp. 69-70; emphasis supplied.)

> local network by AT&T, MCI or other new entrants is largely unchanged since the MCI case. Replication of Pacific's local network, while theoretically possible, is not practical or reasonable. Thus, the second element is met. Element three is met since the ability of Pacific to price squeeze a competitor seeking access to [UNEs] is tantamount to a denial of access. Element four, technical feasibility of providing access, is generally not at issue here." (AT&T/MCI Reply Brief, p. 104; footnote omitted.)

Finally, AT&T/MCI argue that in offering Dr. Tardiff's essential facilities analysis, Pacific is really trying to recategorize as "partially competitive" (*i.e.*, Category II), services that were designated as monopoly services (*i.e.*, Category I) in D.96-03-020. Dr. Selwyn contends that if the Commission were to allow this to happen, the likely result would be price squeezes:

> "If [the five UNEs considered non-essential by Dr. Tardiff] are reclassified to Category II, Pacific would only be required to impute their *costs* into its competitive (bundled) end user services, and would not have to impute their *prices* into its bundled service rates. It could charge competitors above-cost prices for these network resources while including only the TELRIC into its own rates. For example, Pacific could include common overhead costs in the price it charges to competitors, while excluding those common overhead costs from its own bundled service price floor. Moreover, if Pacific were able to supply the network functionality for use with its own bundled service at a lower cost than it incurs when serving a CLC, only that lower cost would have to be captured in setting the bundled service price floor. In short, to the extent that Pacific is successful in convincing the Commission that it should reclassify some or all [UNEs] as Category II non-essential services, it would acquire the ability to create and enforce a serious – perhaps even fatal – price squeeze on its rivals with respect to their use of these essential network functions." (Ex. 612, p. 52.)

D. Position of the FBC on Price Floors and Imputation

The FBC advocates that price floors be set according to the same basic formula advocated by AT&T/MCI.

The FBC witness on price floors was Dr. Marvin Kahn. The FBC Opening Brief summarizes Dr. Kahn's position on how price floors should be set as follows:

> " . . . Dr. Kahn recommends that the Commission use the imputation methodology originally adopted in D.89-10-031 and carried forward in D.94-09-065. That methodology requires the ILECs to impute the tariffed price of the UNEs into the price floor for retail services. The price floors for retail services are then set at the sum of the tariffed rates for the UNEs used to provide the service plus the TSLRIC of the competitive components of service." (FBC Opening Brief, pp. 30-31.)

The reason why this is the correct formula, Dr. Kahn argues, is that the Commission's adoption of TELRIC has made the "contribution" formula obsolete:

> "While TELRIC minimizes the potential for cross subsidy, it renders the contribution method useless for purposes of meeting imputation, precisely because much of the shared cost associated with UNEs is directly assigned by TELRIC. Because contribution is calculated as the difference between the tariffed price of the UNE and its cost, shared cost or contribution that has been directly assigned to UNEs under TELRIC is not captured using the contribution methodology. As a result, the contribution methodology when used in conjunction with a TELRIC significantly understates the contribution which must be imputed into the price floors for retail services. This understatement results in a price floor which cannot meet the Commission imputation test and which will result in an anticompetitive price squeeze." (Ex. 508, pp. 18-19.)

The FBC also argues that even if Dr. Tardiff's price floor approach[169] is conceptually sound, it would be unworkable in practice. The FBC note that the IRD price floor test "derives its effectiveness as a safeguard from the fact that it is applied prospectively, thereby minimizing from the outset the potential for harm to consumers and competitors associated with anticompetitive pricing by the LECs." (FBC Opening Brief, p. 33.) But, the FBC continues, the Tardiff/Emmerson approach -- with its reliance on revenue tests to ensure that all non-volume sensitive costs are ultimately recovered -- cannot be applied prospectively and is subject to gaming:

> "Dr. Tardiff's revenue based imputation proposal is problematic for a number of reasons. Even if it is assumed that his revenue test is a valid approach to testing for price squeezes, the revenue based test cannot be applied on a prospective basis with any certainty because it must rely upon a complex forecast. Consistent with Pacific's pricing flexibility, the forecast would be of different volumes offered at different prices above the price floor which together yielded revenues greater than or equal to the revenue floor. In addition, it would be still possible for a price squeeze to exist for some portion of the forecast period as long as over the

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[169] The FBC summarizes Dr. Tardiff's price floor position (which incorporates Dr. Emmerson's tests for detecting cross-subsidies) as follows:

> "The first prong of the Tardiff test requires that rates for retail services be greater than or equal to a price floor which equals the forward looking volume sensitive cost of the service plus any contribution from monopoly elements used by competitors to provide an equivalent service. [Tr.] at 6649-51. The second prong of the test requires that aggregate revenues for the service equal or exceed a revenue floor equal to the aggregate service volume sensitive and insensitive costs of the service plus contribution. *Id.* at 6[6]50-51. Aggregate revenues in this regard include all revenues from providing the service at tariffed rates as well as revenues from contracts for the services at rates which deviate from the tariff." (FBC Opening Brief, p. 34.)

> total length of the forecast period, revenues were sufficient to equal or exceed the revenue floor. Finally, the forecast, like all forecasts, would be subject to gaming." (*Id.* at 35.)[170]

A further difficulty that the FBC has with the Tardiff/Emmerson approach is that it must be used to test entire families of services. On this score, the FBC states:

> "[T]o demonstrate that an individual service is not receiving a cross subsidy it is necessary, according to Dr. Emmerson, to demonstrate that the aggregate revenues for the service equal or exceed the aggregate service specific volume sensitive and insensitive costs. For families of services, it is necessary to demonstrate that aggregate revenues from the family are sufficient to recover not only the service specific costs of the individual services, but the shared costs of the family as well . . . Because the cross subsidy test for a family of services is a revenue test, it, like the test for individual services, cannot be applied meaningfully on a prospective basis. Furthermore, according to Dr. Kahn, the complexity associated with the cross subsidy test for families of services renders it ineffective as a practical tool for detecting cross subsidy." (*Id.* at 38; citation omitted.)

The FBC also points out that, unlike Dr. Emmerson, Mr. Scholl conceded that the cross subsidy tests (for both individual services and families) would have to be rerun if a significant number of rates were changed or new services were introduced. (*Id.* at 39, *citing* Tr. 46: 6895.)

The FBC devotes the final portion of its price floor and imputation discussion to a fierce attack on what it characterizes as Pacific's improper attempt

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[170] The FBC points out that during his cross-examination, Dr. Emmerson conceded that the cross-subsidy tests he described require a forecast, and that this forecast is subject to gaming, at least with respect to new services. (Tr. 6063, *quoted at* FBC Opening Brief, pp. 35-36.)

to "recategorize" UNEs. The FBC argues that the issue of whether to recategorize UNEs "resides in the local competition and NRF dockets, [and] arose in this proceeding via Pacific's testimony as opposed to the provision of notice by the Commission . . ." To consider the issue in this proceeding, the FBC continues, would violate both the requirements of due process and § 1708 of the Pub. Util. Code. (FBC Opening Brief, pp. 40-41.)

The FBC relies upon three basic strands to support this argument. First, the FBCs contend that since the issuance of the original NRF decision, D.89-10-031, the Commission has repeatedly reaffirmed that the forerunners of UNEs – basic service element (BSEs) and basic network functions (BNFs) – are "by definition" monopoly elements that belong in Category I. The FBC argues that this treatment of basic network elements was left undisturbed by the IRD decision (D.94-09-065), and was most recently reiterated in D.96-03-020, 65 CPUC2d 156 (1996), a decision in the local competition docket. (*Id.* at 41-43.) The FBC places particular reliance upon the following passage from D.96-03-020:

> "We will retain Category I status for certain limited services. We shall adopt DRA's proposal to retain Category I status for the following services: public policy payphones, 911 services and basic service elements (BSEs) as well as for basic network functions developed in OANAD . . . Since BSEs represent bottleneck elements of the LEC networks, they do not exhibit the characteristics of partially competitive services and should remain in Category I." (65 CPUC2d at 190.)

Second, the FBC claims that the Commission has specifically stated that the NRF and local competition dockets, not OANAD, are the proper venues for considering recategorization. To support this argument, the FBC relies upon the following passage from D.96-05-036, 66 CPUC2d 274 (1996), a decision holding that it was unnecessary to conduct a second phase of the original NRF proceeding: