

Options for Separations

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

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Introduction

The state members of the Separations Joint Board believe that the five year freeze adopted by the Commission¹ provides an opportunity to examine, and redefine if warranted, the jurisdictional division between state and federal authority over telecommunications services. The "glide path" developed here is an attempt to frame the debate by articulating various jurisdictional alternatives, and assessing their various strengths and weaknesses. We encourage all interested members of the public and the industry to provide their insights and concerns on this issue, and similarly encourage our federal colleagues to seek comment and bring their own expertise and perspectives.

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

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

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

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

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

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

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

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

³ As we said in the 1998 Report,

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

I. The Changing Environment

A. Technology changes

1. Declining Cost. Costs of transport and switching have declined dramatically, the former due to greater use of fiber optics, and the latter due to decreasing prices for all computer equipment.
2. Distributed Intelligence. The intelligence of the public switched network is becoming more distributed.
 - a) Some of that intelligence is moving into the periphery. Dumb concentrators are being replaced by smart remote switches. More electronics are migrating out of central offices, moving the switching function closer to the end user.
 - b) Conversely, some network intelligence is becoming more concentrated. SS7 networks use signal control points in faraway locations. Databases also provide more services, such as E-911, from remote locations, even from other states. The expected deployment of soft switches will provide for integrated routing and switching functions with full network intelligence at the Class 5 office level and will blur the boundaries between circuit switched and packet traffic.
 - c) The concept of "local calling" is less technologically meaningful. Local calls, particularly "EAS calls" now sometimes involve use of tandems that are tens or hundreds of miles away. Even short-haul calls can involve use of remote SS7 signal control points and faraway databases. Some wireless carriers offer plans that do not distinguish between local and toll calls.
3. Packet networks. The existence of new packet networks challenge separations, which was designed solely for the circuit switched environment. Significant voice and data traffic now travel on these packet networks. No generally accepted method exists to develop usage factors that reflect both packet traffic and switched usage. The separations manual was originally designed to accommodate packet networks or fiber technology.

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

B. Economic Changes

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

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

C. Legal Changes

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

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

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

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

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

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

D. Jurisdictional Changes

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

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

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

E. Political Changes.

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

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

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

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

II. Broad Questions

A. What's Next?

1. We seek comment on the best transition path or "*glide path*" that will take separations from the current regime under the freeze to whatever systems are needed in the new environment.
2. Several broad questions need to be addressed.
 - a) Can Separations be abolished altogether? If so, what other things would need to change, if any?
 - b) If Separations is to remain after the freeze, what changes should be made to it?
 - c) What methods can be used to arrive at the next phase of Separations without creating unwanted consequences, such as large transition costs or customer dissatisfaction?

B. Broad Goals

1. We suggest the following broad goals will guide the development of answers to these questions.
 - a) Separations should have some meaningful relationship to how prices are actually set: i.e., it should, if perpetuated, actually make a difference to consumers.
 - b) Separations should be simpler.
 - (1) Simpler and easier to administer and audit.
 - (2) Lower overhead cost.
 - (3) Reasonable accuracy of result still important if separations continues.

- c) Separations should be capable of addressing new architectures and technologies.
 - d) Separations should evolve with competitive markets.
 - e) Cost responsibility should follow jurisdictional responsibility.
2. We also suggest that the following goals are of reduced importance:
 - a) Accuracy of cost allocations.
 - b) Obtaining contribution to loop costs from interstate services.
 3. Proposals.
 - a) Below are presented a series of seven proposals for a "glide path" to a post-freeze system. We seek comment on these proposals.

III. Option #1 – Extend The Freeze

A. Background

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

B. Proposal

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

C. Advantages

1. Eliminates the need for basic studies and traffic studies.
2. Prevents further misallocation of costs associated with dial-up Internet traffic to the state jurisdiction, assuming this traffic continues to grow.
3. Recognizes the disconnect between separations and pricing.

D. Disadvantages

1. Does not reflect increased interstate usage which could offset or mitigate the effects of the dial-up internet effect.
2. Fails to correct any existing misallocation problems.
3. Fails to reflect the impact of new technologies.
4. When all measurements are lost, we will be unable to know or measure, in the future, the impacts of moving to other options.

E. Questions

1. How long should the freeze remain in place?
2. Should there be any rule changes during the freeze period?
3. Should waivers be granted during the freeze period?
4. Does a freeze prohibit adoption of any other option and stay in place until there is no need for separations?

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

A. Background

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

B. Proposal

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

C. Advantages

1. Eliminates traffic studies.
2. Simplifies audit and review of separations practices.

3. If the factor were set statewide or nationally, it would simplify separations issues surrounding sale of exchanges.
4. Recognizes disconnect between separations and pricing.

D. Disadvantages

1. General loss of accuracy in separations. This proposal essentially eliminates the link between a utility's use and assignment of plant and associated costs. A substantial portion of plant costs may be assigned to the state jurisdiction even though the plant had only minimal or incidental state use.
2. Separations may be slower to respond to changes in the way the network is used.
3. Variations in network usage among different carriers may not be reflected in separations, i.e., some or all carriers would be using the same TS separations factors even if their network usage was different.
4. The transition from usage-based separations factors to fixed TS allocators could result in significant jurisdictional cost shifts for carriers that have usage-based TS allocators that are different from the new fixed allocators.
5. Without usage studies, it may be difficult or impossible to determine whether plant and facilities were used for non-regulated activities and, if they were, whether a proper allocation of costs was assigned to the non-regulated activities. Similarly, once the new system was in place, carriers would likely no longer keep the usage records needed to allow for knowledgeable update of the fixed TS factors.

E. Questions

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

- b) Is anything gained by setting the factor at the regional or state level? Is there a correlation between separations factors like DEM and readily-available figures such as population or area? Could some other figure be used as a proxy?
- c) If the appropriate geographic scale for the separations factor is the study area, should the factor be simply equal to historic TS allocators, and thus amount to a perpetual freeze? Could the factor be revenue-based, or would this introduce inappropriate circularity into separations? What procedure should be used to select the fixed allocator(s) and how should updates be handled?
- d) How often should the fixed allocator(s) be adjusted?
- e) What conditions, if any, should be imposed if a carrier uses fixed allocators? Should the carrier be required to report network usage data? What consumer protection measures would be useful?
- f) Will any adjustment to the universal service mechanism be needed to reflect the new fixed allocator.
- g) Should concurrence by state commissions be a prerequisite?

V.Option #3 - Total Company Revenue Requirement

A. Background

1. Not all incumbent local exchange carriers separate their costs according to the detailed procedures of Part 36. Due to their size and limited resources, many small carriers were allowed to become "average schedule" companies. In place of performing a jurisdictional cost study, an average schedule company determines its interstate revenue requirement based on a simplified formula. The interstate average schedule formula is derived from the characteristics of cost companies and is reviewed by the FCC.
2. Some average schedule companies do not conduct separations studies, and their state commissions set intrastate revenue requirements on a residual basis.⁷ In other words, federal receipts are an offset to a total "unseparated" revenue requirement, and all the rest of that revenue requirement must be recovered from intrastate rates. State rates thus are set on a "residual" revenue requirement.

B. Proposal

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

1. Under this proposal, states would set rates for all incumbent carriers based upon the "residual" method. The FCC would set rates for interstate services, and carriers would record the resulting interstate revenues. States would then set intrastate rates so that all of the company's unseparated revenues (including its interstate revenues) are sufficient to meet its unseparated revenue requirement for regulated services. The carrier would not report any embedded costs to the FCC, nor would it perform any traditional separations studies.
2. Critical to this proposal is an acceptable method for the FCC to set interstate rates. Two possibilities may warrant consideration:
 - a) Set rates based upon the output of a cost model ("cost model"), such as the existing "average schedule" formula or an extension of the Hybrid Cost Proxy Model that has been used for universal service purposes.
 - b) Set rates based upon a price cap mechanism by which existing rates are adjusted only incrementally, and existing pooling mechanisms continue to operate.

C. Advantages

1. Eliminates individual company separations studies and reporting, and thus is much simpler.
2. The averaged schedule mechanism has been in existence for a number of years and is well understood by the industry.
3. If interstate revenues are greater than expected (possibly due to increased demand), the state gains the ability to lower state rates.
4. Avoids having costs assigned to one jurisdiction but revenues assigned to the other jurisdiction.
5. Some state commissions, including Maine and Utah, currently set state rates or set universal service funding levels on a residual basis, thereby demonstrating that this general approach is workable.

D. Disadvantages

1. If a cost model is used to set federal rates:
 - a) Developing that cost model may be controversial and time consuming.
 - b) It may be difficult to maintain a cost model. If no companies are under a "cost based" system for their interstate revenue requirement, data reporting will decrease. The separations freeze will also reduce the currency of some data that might be used to update a model.

- c) Given the differences in size and characteristics of companies across the country, it may be necessary to develop more than one cost model.
 - d) If the cost model determines the federal "revenue requirement" based on a forward looking methodology, then states would become solely responsible for the recovery of any difference between legacy costs and costs developed by the model.
2. Safeguards may be needed to prevent carriers from carrying into rates imprudent capital costs and excessive expenses.
 3. If a change in FCC policy or a change in other conditions (e.g., demand) reduced interstate revenues, then state rates would probably be liable for the difference. Also, states may need to take a more proactive approach to how interstate policy changes might affect state revenue requirements.
 4. It may be difficult to allocate liability for any confiscation claim presented by a carrier. State liability may increase.

E. Questions

1. Is there a way to calculate interstate rates that will protect both state and federal interests?
2. If rates are set using a cost model:
 - a) How can the model best be developed and maintained?
 - b) Should it be based on historical costs, forward looking costs, or some other methodology?
 - c) Can the existing average schedule formula be used or adapted?
 - d) If a forward looking cost model is chosen, can the HCPM model be adapted?
 - e) How can a cost model address the differences among companies in their network configuration, services, and usage patterns?
 - f) At what scale should the cost model be applied? Company, study area, exchange, or some other area?
 - g) How should a cost model account for the sale of Unbundled Network Elements?
3. Can this system deal adequately with jurisdictionally-complex services like DSL where the same loop is used for interstate and intrastate purposes?
4. Is there a way to ensure that states will not be left with unclaimed or unallocated interstate embedded costs as a result of this approach? If a forward

looking model is used, will this lead to excessive litigation over confiscation rights?

5. Can this system meet the requirements of the constitution, and in particular *Smith v. Illinois Bell*⁸ and following cases?
6. Will state commissions willingly accept an obligation to set state revenue requirements on a residual basis?
7. Do any state statutes make residual ratemaking either impractical or unworkable? If this proposal were put into effect today, would all states have the jurisdictional authority to require appropriate adjustments to state rates?

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

A. Background

1. A new high capacity packet-switched data network parallels the switched network and is almost entirely unregulated. Packet switching is a technology, not a service, and is highly efficient. It is likely to grow in the future.
2. The switched network carries an ever-smaller proportion of total traffic, and the network model that underlies separations is therefore increasingly inadequate as a description of telecommunications, even of voice traffic. It is not necessarily true that usage of the packet network is the same as the usage of the switched network. For example, DEM factors based upon switched traffic usage are sometimes used to separate packet switching equipment. Some customers directly interact with the packet network, bypassing Class 5 switches. Packets have also changed the peak usage characteristics of the switched networks.
3. Electronic equipment has appeared at unexpected places in the network. Splitters allow packet data (including digital voice) to be stripped off telephone wires before it enters a traditional switch at all. DSLAMs now shunt data off the switched network. Remote switches can complete local calls without any direct support from a class 5 switch. Some line concentrators are actually traffic sensitive. CLEC access to the network has moved out of the central office to the concentrator panel.
4. An increasing set of services are being provided on an unregulated basis. This casts doubt on the adequacy of the existing Part 64 rules, which apply to a relatively narrow set of services. The risk is that captive ratepayers may wind up

⁸ 282 U.S. 133 (1930)

with liabilities created by unregulated activities or an inappropriately large portion of fixed costs.

B. Proposal

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

C. Advantages

1. If separations cannot be eliminated, it may be necessary to redesign separations to reflect more accurately the way the network is used.
2. Creating separations procedures that properly account for packet and non-packet services may lead to more accurate cost allocations, reducing implicit subsidies, increasing fair pricing of services, and improving the likelihood that effective competition will develop.

D. Disadvantages

1. Any system of this nature will likely be complex and controversial to develop. The more complex, the system, the more costly it will be to maintain and audit.
2. Unless there is a direct link to pricing, the greater degree of "accuracy" achieved here will be irrelevant for customers.

E. Questions

1. Is there a practical way to blend packets and switching minutes into an overall separations factor?
2. Is the new equipment easily classified as packet v. non-packet?
3. What about traditional "in-network" packet services such as frame relay?
4. How should new categories of unregulated services be treated for separations?
5. Should states have options to declare service unregulated and to allocate costs?

VII. Option #5 – Facilities-Based Separations

A. Background

1. Incumbent LECs must follow the FCC's separations procedures. They must divide between the state and federal jurisdictions the costs and expenses of equipment and facilities that are used for both state and federal purposes. Three basic methods are used:
 - a) Facility investments and expenses are directly assigned to one jurisdiction when the facility is used solely to provide services in that jurisdiction. Similarly, some facilities are directly assigned entirely to the federal jurisdiction when they are used for "mixed" intrastate and interstate use but the intrastate use is not consequential.
 - b) Some commonly shared facilities are separated using fixed factors. In particular, loop costs are separated with 75% of costs going to the state jurisdiction.
 - c) Other commonly shared facilities are separated based upon usage. Usage factors generally apply to switches and trunks. Usage-based separation is a complex task. Carriers must collect a large amount of data and follow detailed procedures and formulas. New technology and new services have made the system even more complex.

B. The Proposal

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

separations and jurisdiction; 2) limitation on rate designs; and 3) universal service.

2. Separations and Jurisdiction

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

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

(1) Loops: All shared-use customer loops will be directly assigned to the state jurisdiction. This will end the 75-25 split that today applies to shared-use loops. States will also be assigned all "private line" loops and DSL loops, most of which are today directly assigned to the federal jurisdiction. Circuit control equipment, concentrators, digital loop carriers and DSLAMs will be assigned to the state jurisdiction.

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

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

(4) Other Plant: Other plant, such as buildings, general purpose computers, and vehicles, will be assigned using a fixed allocator,

with 75% of cost assigned to the state jurisdiction and 25% assigned to the federal jurisdiction.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

b) Example 2: Suppose states C and D, in order to keep fixed charges low, establish a fixed monthly charge of \$10 and a usage charge of \$0.01 for each originating minute of use. Suppose now that customer c in state

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

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

C. Advantages and Concerns

1. Advantages:

- a) It simplifies separations and provides an inexpensive method for incumbent LECs to continue to operate in a dual jurisdictional environment. Some separations activities will remain, such as for expenses, but these can also be simplified.
- b) It simplifies customer billing. It will eliminate the need for a "Subscriber Line Charge" to recover the federal portion of loop costs. It also eliminates the need for a separate universal service charge on SLC revenue.
- c) It increases the ability of state commissions to adjust the mix between fixed and variable charges to match local conditions.
- d) It eliminates access discrimination. It prohibits states and LECs from discriminating against interstate traffic in setting rates.
- e) By redrawing jurisdiction lines, Option 5 would largely eliminate the distinction between intrastate and interstate calling. That is, an IXC-carried call will be subject to the same rules whether it terminates in the same or a different state. At the same time, there is an opportunity to eliminate entirely the increasingly artificial distinction between toll calls and local calls. If under the new system the IXC bills its retail customer for all but the originating facilities,

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

2. Concerns.

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

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

c) Customer Acceptance.

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

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

d) Competitive issues.

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

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

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

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

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

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

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

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

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

A. Background

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

IX. Proposal 6A – One State Jurisdiction

A. Proposal.

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

B. Advantages

1. Federal-state separations would be eliminated.

- a) Some cost allocations (separations) will still be required among states for multistate companies.
2. Lower regulatory cost.
3. Technology independent.
4. Single local and access rates - less confusing, easier to understand
5. Single point of contact for all pricing within each state.
6. States have historically been responsible for the majority of rate making, including intrastate access charges.
7. States would be in better positions to take into account different circumstances and implement policies that reflect those differences.

C. Disadvantages

1. Some method to protect users of interstate services will be needed.
2. Some state regulatory commissions may not have sufficient authority under state law to implement this option.
3. Individual state pricing policies could be inconsistent across the nation, potentially raising issues regarding (i) fair treatment of customers and carriers in different states and (ii) whether the overall networks between states will continue to be interconnected in an efficient and reasonable manner.
4. Policy variations among the states may make for a complex system that would be costly to maintain and audit.
5. The FCC may insist on more direct pricing jurisdiction.

D. Questions

1. Will it be politically tolerable to have all service rates set by state commissions?
2. Probably requires passage of legislation, at least altering section 152.
3. Can the FCC and the industry be given sufficient assurance that network operations won't be harmed?

X. Proposal 6B – One Federal Jurisdiction

A. Proposal.

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

B. Advantages

1. Consistent telecommunications and pricing policy throughout the nation.

C. Disadvantages.

1. The FCC would have to enormously scale up its rate review functions or the scope of rate review would be much more limited than at present.
2. It would be very difficult for the FCC to give proper weight to the myriad of cost and service differences between states and regions within states.
3. States may insist on more direct pricing jurisdiction.

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

A. Background

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

B. Proposal

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

C. Advantages

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

D. Disadvantages

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

E. Questions

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