

**JSI NEWSLETTER 2000 NUMBER 6: AUGUST 22**

**FEDERAL-STATE JOINT BOARD RECOMMENDS  
SEPARATIONS FACTOR FREEZE**

Late last month, the Federal-State Joint Board reviewing jurisdictional separations reform made several significant recommendations to the Federal Communications Commission (FCC). The Joint Board recommended that the FCC institute a five-year freeze of all Part 36 category relationships and allocation factors for price-cap carriers and a freeze of the jurisdictional allocation factors for rate-of-return carriers. The Joint Board indicated that its recommendations were intended to provide simplification and stability to the separations process until such time as the FCC adopts comprehensive reform.

Specifically, the Joint Board recommended the adoption of a freeze based on a carrier's data for the twelve months prior to the FCC's issuance of an order in this proceeding. Thus, if the FCC were to order a freeze of separations categories and/or factors in Dec. 2000, consistent with the Joint Board's recommendation, carriers would use data for the twelve-month period ending Nov. 30, 2000 to establish frozen categories and/or factors. JSI notes that freezing factors for rate-of-return carriers on anything other than a calendar-year basis will force carriers to conduct two studies to establish their settlements with the National Exchange Carrier Association.

The Joint Board also recommended that in the event the FCC rules that Internet usage is jurisdictionally interstate in nature, as a result of the remand by the U.S. Court of Appeals in its recent Reciprocal Compensation ruling, the local Dial Equipment Minutes (DEM) factor should be frozen at some substantial portion of the base-year level determined. In essence, the Joint Board is saying that carriers should be allowed to restate the local DEM factor to exclude the impact of Internet usage to the extent that it can be determined. If the actual level of Internet usage contained in the frozen local DEM factor cannot be determined, the Joint Board

recommended the use of a default factor based on 95 percent of minutes from the twelve months preceding the implementation of the freeze. Moreover, the Joint Board recommended that if the local DEM is reduced by the level of Internet usage determined by the FCC to be interstate in nature, the unweighted interstate DEM factor should be recalculated and frozen.

The FCC released a Public Notice on Aug. 15 seeking comments on the Joint Board's recommended decision. Comments are due Sept. 25, and replies are due Oct. 10. While JSI

intends to file comments, we believe the FCC will follow the Joint Board's recommendation and order that separations factors for rate-of-return carriers be frozen. If the FCC renders such a decision before the end of this year, JSI anticipates that factors would be frozen at calendar year 1999 or 2000 levels.

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**EIGHTH CIRCUIT COURT DECIDES ON THE MERITS  
OF THE FCC LOCAL COMPETITION RULES**

On July 18, the U.S. Court of Appeals for the Eighth Circuit issued its decision regarding the Federal Communications Commission's (FCC's) pricing rules for interconnection and unbundled network elements (UNEs). The decision resulted from the court's review of the merits of challenges to the FCC's rules. Previously, the Eighth Circuit Court had vacated the FCC's pricing rules based on its conclusion that the authority for setting interconnection and UNE pricing belonged to the states. The U.S. Supreme Court disagreed with this jurisdictional assessment and remanded the pricing issues to the Eighth Circuit for a review on the merits.

**Pricing Methodology**

First, the court evaluated the challenge that the FCC's pricing methodology was: a) hypothetical, b) forward-looking, c) inconsistent with universal service policy, and, d) unconstitutional. In addressing the hypothetical network standard central to the FCC's Forward Looking Economic Cost (FLEC) pricing standard, the court found that the concept of a hypothetical, most efficient network design violates the plain meaning of the Telecommunications Act. However, the court affirmed the FCC's decision to apply forward-looking cost, or perhaps better phrased, "projected cost." While the elimination of the hypothetical network pillar central to the FCC's FLEC methodology may appear to be a victory for incumbent local exchange carrier (ILEC) interests, JSI believes the prudent course for carriers is to wait for the FCC's response to the court's decision before taking any action.

The court's language rendered it far from clear exactly what methodology should be used to develop interconnection prices. The FCC could issue new rules or appeal the Eighth Circuit Court's decision to the Supreme Court, although it is uncertain whether the Supreme Court would agree to hear an appeal. FCC and industry reaction to the Eighth Circuit decision will largely shape the ultimate pricing methodology to be used by ILECs for interconnection.

With respect to the challenge to the FCC's reliance on forward-looking cost, the court rejected the argument that the FCC should instead use "historic" cost. The court reasoned that "it is current and anticipated cost, rather than historical cost, that is relevant to business decisions to enter markets." Thus, the court affirmed as reasonable the use of forward-looking cost as long as it is not based on a

hypothetical network. The court also did not find that arguments against the constitutionality of the FCC's actions were ripe for review because a takings claim cannot be based on the ratemaking methodology, but rather it must be based on the rate itself.

JSI believes that the short-term consequence of the Eighth Circuit Court's ruling on pricing methodology for interconnection agreements may be that ILECs will seek to discard existing, FLEC-based rates. Such a tactic would lead to the opening of additional fronts in the already hotly contested interconnection battles in the state regulatory arena. Pending the issuing of final, appeals-proof pricing rules, one possible interconnection strategy for ILECs is to propose interim rates to span the confusion between the appeals process and any final rules.

### **Wholesale Rates**

The court addressed the contentious debate over avoided versus avoidable costs, finding that the avoidable cost method adopted by the FCC is contrary to the Telecommunications Act. The court ruled that the law requires that wholesale rates result from discounts on retail rates, based on the costs that are actually projected to be avoided. This is a likely victory for ILECs, especially rural ILECs experiencing a wave of resale requests from competitors. Depending on state-specific methodology development, wholesale discounts will either remain the same or trend downward. JSI will continue to monitor this avenue of competitive entry into ILEC areas.

### **Proxy Prices**

In its Local Competition Order, the FCC adopted proxy prices as default rates applicable to interconnection requirements, pending the establishment of state proxy prices or negotiated rates. The court vacated the FCC's proxy prices, reasoning that while the Supreme Court held that the FCC has jurisdiction to design a pricing methodology, it does not have jurisdiction to set the actual prices for state commission use. Setting specific prices goes beyond the FCC's authority to design a pricing methodology and intrudes on the states' rights to set the actual rates pursuant to the statute. However, this ruling has only minor consequence because many states adopted versions of proxy or default rates during the first court challenge to the issue.

### **Unbundling Rules**

The Eighth Circuit Court largely reiterated portions of its original decision regarding the FCC's unbundling rules and, again, vacated several parts of them. The three areas affected are: the identification of additional (UNEs); superior quality rules; and, the additional combinations rule.

#### *Identification of Additional UNEs*

The Eighth Circuit Court vacated the FCC's Section 51.317 rule on the identification of additional UNEs because it relies on the same unnecessary and impair standard the Supreme Court found to be too broad and unreasonable when it vacated the Section 51.319 rules on specific UNE requirements. The impact of this decision is insignificant since the FCC will address this rule in its proceeding on the necessary-and-impair standard.

#### *Superior Quality Rules*

The superior quality rules required an ILEC to provide, upon request, interconnection and UNEs that are superior in quality to that which the ILEC provides to itself. The Eighth Circuit Court vacated these rules because it found such a standard unreasonably surpasses the plain language of the Act requiring interconnection at least equal in quality.

#### *Additional Combinations Rule*

The Eighth Circuit Court reiterated its earlier decision to vacate the FCC's Section 51.315(c)-(f) rules requiring ILECs, when requested, to create additional combinations of UNEs. The court noted that the Act stipulates that it is the duty of the requesting carrier to combine such elements.

### **Rural Exemption**

The court addressed three rules related to the rural exemption: prerequisites for terminating an exemption; undue economic burden; and, the burden of proof. In each of these areas, rural ILECs won significant victories.

#### *Prerequisites for Terminating an Exemption*

The FCC rule required an ILEC to offer evidence that the application of the requirements under Section 251(c) would be likely to cause undue economic burden beyond the economic burden that is typically associated with efficient competitive entry (emphasis added). The court found that this rule impermissibly disregards two of the three statutory requirements. Further, it found that if a state commission were looking only upon this rule, the sole termination requirement would be the undue economic burden test and not the other two requirements of technical infeasibility and inconsistency with universal service principles. The FCC must revise the rule to include all three statutory requirements. As noted below, however, the FCC cannot simply add the two omitted requirements; the court also rejected the foundation of the FCC's undue economic burden test.

#### *Undue Economic Burden*

The FCC interpreted the statutory standard of unduly economically burdensome as undue economic burden beyond the economic burden that is typically associated with efficient competitive entry. The court ruled this interpretation failed to allow that state commissions could consider the total actual economic burden that competitive entry could impose on a small or a rural ILEC.

The court recognized that Congress sought in the Act both to "promote competition and to protect rural telephone companies." However, the goal of promoting competition does not allow the short-circuiting of the Act's provisions on the steps necessary for the removal of a rural exemption from the requirements of Section 251(c) for interconnection, unbundled access to network elements, and resale. The Eighth Circuit Court noted, "Because the small and rural ILECs have less of a financial capacity than larger and more urban ILECs to meet such a request, the Congress declared that their statutorily-granted exemption from doing so continue unless the state commission found all three prerequisites for terminating the exemption, or determined that all prerequisites for suspension or modification were met in order to grant an ILEC affirmative relief. It is the full economic burden on the ILEC of meeting the request that must be assessed by the

state commission."

While the court's rural exemption language appears strongly in favor of small and rural ILECs, the court also concluded that continuing the exemption is not "automatic." Moreover, the court noted, "The state commission will take into judgment the fact that the ILEC will be paid for the cost of meeting the request and may also receive a reasonable profit." JSI recommends that ILECs continue a dual course of protecting their rural exemptions, while operating in such a manner that competition can be successfully met when it occurs.

#### *Burden of Proof*

The FCC required rural ILECs to satisfy the burden of proof when a *bona fide* request is made to lift the rural exemption. The Eighth Circuit Court agreed with arguments that the burden of proof should be placed on the interconnecting requestor, not the rural ILEC. The court concluded that "the plain meaning of the statute requires the party making the request to prove that the request meets the three prerequisites to justify the termination of the otherwise continuing rural exemption." This ranks as a victory for rural ILEC interests, but JSI is concerned that a rural exemption hearing could well afford CLECs an excellent opportunity for unbridled discovery of ILEC operations. Still, rural ILECs can look to their legal counsel to protect them from undue discovery requests.

In a related matter, the court was quite clear in noting that Section 251(c) interconnection requirements shall not apply to a rural telephone company until a request has been made and the rural exemption lifted. Thus, JSI points out, state orders requiring compliance with various Section 251(c) obligations prior to a *bona fide* request are unlawful.

### **Preexisting Agreements**

The court found that the FCC rule requiring all agreements to be approved by the respective state commissions is inconsistent with Section 252(a) of the Act. The court vacated the rule because it applied to agreements entered into prior to the Act. Instead, the court ruled that Section 252(a)(1) applies to "any agreement which was either (1) both negotiated and entered into pursuant to Section 251 after the Act went into effect or (2) is a interconnection agreement that was negotiated before, but not yet entered into when, the Act went into effect." Given that four years have passed since enactment of the statute, this issue is not particularly in play at this time. However, JSI believes that the ruling may be of benefit in some states, as rural ILECs respond to demands for replacement of existing EAS arrangements by interconnection agreements.

### **Summary**

On balance, the court decision is a victory for ILECs, which have triumphed on all non-pricing issues and the most significant pricing questions. On the other hand, the FCC still has the last word on pricing methodology. JSI will continue to monitor developments in this case and provide analysis in future newsletters. If you have any questions regarding the court's decision, call Douglas Meredith (dmeredith@jsitel.com) at JSI's Maryland headquarters, at 301-459-7590.

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## **RTF NEARING COMPLETION OF UNIVERSAL SERVICE RECOMMENDATIONS**

The Rural Task Force (RTF) is finalizing its recommendation to the Federal-State Joint Board on Universal Service. While the RTF report, due to the Joint Board on Oct. 1, is not yet complete, the RTF meetings provide some indication of the direction the report will take. The primary issue to be addressed is whether proxy models can or should be used to determine and distribute federal universal service support. The RTF is currently considering a proposal to reject proxy models in favor of adopting the existing funding mechanisms for rural LECs. The RTF is also reviewing other issues, including:

1. the portability of universal service support;
2. the possible disaggregation of universal service support to geographic areas smaller than a study area;
3. the removal of certain universal service funding caps;
4. the principles guiding the transfer of implicit universal service support in interstate access rates to an explicit support mechanism; and,
5. the inclusion of advance telecommunications services in a federal universal service program.

Each of these issues holds significant policy implications for rural LECs. Unfortunately, it is difficult to predict the final recommendations the RTF report will make because of the diversity of the RTF members and the interplay between issues and positions taken by the various interests. However, once the RTF report is available, JSI will provide analysis of the recommendations as they move to the Joint Board. If you have any questions regarding the RTF, call Douglas Meredith (dmeredith@jsitel.com) at JSI's Maryland headquarters, at 301-459-7590.

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## **ASSOCIATIONS READY MAG PLAN FOR FCC FILING**

After recent revisions, the Multi-Association Group (MAG) Plan that has received considerable attention in *JSI News and Commentary* (See No 0005, July 10; No., 0004, June 2; and, No. 0003, May 11) now includes the option for all rural LEC study areas to move to incentive-based regulation. While this change is significant and welcomed, JSI believes that additional changes to the latest version (MAG-10, Aug. 11) are necessary to remain consistent with federal law and ensure the viability of the optional nature of the plan. JSI is in the process of evaluating MAG-10 and will provide an assessment of the new version in an upcoming newsletter. If you have any questions regarding the MAG Plan, contact Manny Staurulakis (mstaurulakis@jsitel.com) or Douglas Meredith at JSI's Maryland office, 301-459-7590.

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## DC APPEALS COURT FINDS FAULT WITH CALEA PUNCH LIST

On August 17, the U.S. Court of Appeals for the District of Columbia issued a decision vacating segments of the Federal Communication Commission's (FCC's) rules implementing the Communications Assistance for Law Enforcement Act (CALEA). Specifically, the court vacated the FBI's punch list technical capability items that carriers were to have implemented by Sept. 30, 2001 (for a description of the punch list items, see *JSI News & Commentary*, No. 0001, Jan. 17, or our home page, at [www.jsitel.com/newsletter](http://www.jsitel.com/newsletter)). The court remanded the punch list items to the FCC for further proceedings, finding that the FCC had not adequately addressed privacy and cost issues. The decision does not affect other CALEA duties, including the implementation of technical capabilities required by the Interim Standard J-STD-025 by June 30, 2000 (or any extended deadline granted to carriers by the FCC pursuant to a Section 107(c) petition).

The court specifically rejected challenges to requirements related to interception of packet-switched communications, which still must be implemented by Sept. 30, 2000, and the "location tracking" of wireless phone users. JSI recommends that clients continue with their current implementation plans with the exception of possibly delaying any separate installation (apart from that required for the Interim J-STD-025 technical capabilities) of hardware or software required for compliance with the punch list items, pending further FCC rulemaking. Regarding subsequent rules, JSI believes that there is a strong likelihood the FCC will be able to support adoption of much of the capabilities covered by the four punch list items.

One aspect of the court's CALEA order that may be of interest to small and rural LECs is the finding that the FCC had not adequately considered the impact of the cost to ratepayers for implementation of technical capability for the punch list items. JSI believes the court's findings related to cost may be of value to carriers considering filing Section 109 petitions for a determination that compliance with CALEA technical capability requirements is not reasonably achievable due to cost considerations. If you have any questions regarding CALEA issues, call Scott Duncan ([sduncan@jsitel.com](mailto:sduncan@jsitel.com)), at JSI's Maryland headquarters.

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## Seminar Reminder

The MAG debate, court decisions on interconnection pricing and CALEA, and proposals to freeze separations factors illustrate the dynamic state of change in the industry. Keeping in mind the effects of these issues on clients' operations and business decisions, JSI reminds you there is still time to register for several JSI seminars that will review these and other industry developments. The upcoming seminars are: CABS, presented by Creative Support Solutions (CSS); Accounting; and Separations and Access.

The CABS Seminar features detailed guidelines and examples of billing applications and access-related compensation. Presented by CSS President Marnell Robertson in a full-day session, the CABS session will be held on Monday, Sept. 11, at the Baltimore Marriott. The JSI Accounting Seminar includes a comprehensive review of the FCC's Part 32 and Part 64 accounting principles and applications. Scheduled over a day and a half, the Accounting Seminar will be held Thursday-Friday, Oct. 5-6, at the Marriott Riverwalk in San Antonio. Separations and Access, the final segment of JSI's 2000 Seminar Series, provides an understanding of the principles and procedures pivotal to jurisdictional separations, access charges, and the settlements process. A two-and-a-half-day program, the Separations and Access Seminar is scheduled for Monday-Wednesday, Oct. 16-18, at the Airport Marriott in Nashville.

Online registration for all JSI seminars is available on our home page, at [www.jsitel.com](http://www.jsitel.com). For more information on the program content, contact Chris Lehner; for information on registration or hotel reservations, contact Kim Johnson. Both can be reached at JSI's Seabrook, MD headquarters, at 301-459-7590.