STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Bell Telephone Company	)	
	)	Docket No. 02-0864
Filing to increase Unbundled Loop	)	
And Nonrecurring Rates	)	

REPLY BRIEF ON EXCEPTIONS OF
MPOWER COMMUNICATIONS CORP.

Richard E. Heatter
Vice President Legal & Regulatory Affairs
Mpower Communications Corp.
3300 N. Cimarron Road
Las Vegas, NV 89129
(702) 310-1224
rheatter@mpowercom.com

Eric J. Branfman
Michael P. Donahue
Philip J. Macres
SWIDLER BERLIN SHEREFF FRIEDMAN, LLP
3000 K Street, N.W., Suite 300
Washington, D.C. 20007
(202) 424-7500 (Telephone)
(202) 424-7645 (Facsimile)
ejbranfman@swidlaw.com
mpdonahue@swidlaw.com
pjmacres@swidlaw.com

Counsel for Mpower Communications Corp.

Dated: May 24, 2004

TABLE OF CONTENTS

EXECUTIVE SUMMARY

SBC has not offered a rational basis to modify the Proposed Order or to adopt any of SBC's recommendations. Accordingly, the Commission should reject all of SBC's proposed modifications and affirm the Proposed Order consistent with the Joint CLECs' Brief on Exceptions.

Contrary to SBC's contentions, the FCC has never stated that the cost of capital must reflect a fully competitive marketplace with pervasive facilities-based competition. Rather, it has explained that the cost of capital should reflect the risks of a competitive market *only* to the extent the other assumptions used in determining UNE rates reflect a forward-looking theoretical least-cost network. The Proposed Order is consistent with this requirement.

The Commission is also not bound to establish a cost of capital based on a market value capital structure simply because the FCC's Wireline Competition Bureau did so in conducting an arbitration governing interconnection in Virginia. This Commission is free to do what is justified by the record in this proceeding and is best for Illinois consumers; the Wireline Bureau does not prescribe final FCC policy nor does it set legal precedent for FCC or Commission decisions. In addition, SBC's proposed market based capital structure fails to consider, among other things, the fact that ratemaking based on a market value capital structure runs afoul of the Supreme Court's decision in *Hope Natural Gas.*

Furthermore, SBC's characterization of the Proposed Order as reflecting traditional ratemaking is unfounded. The determinations made in the Proposed Order regarding capital structure are not all traditional and, as the record demonstrates, reflect what the optimal forward-looking capital structure should be.

Moreover, SBC's attack on the reasonableness of the 51% capital structure equity ratio established in the Proposed Order is misleading. SBC fails to reveal that the equity ratio of 51% is approximately 13 and 6 percentage points *higher* than Verizon Communications and Verizon New England's capital structures, respectively. Not only that, but the 51% equity ratio is 6 percentage points *higher* than what the New Hampshire Public Utilities Commission recently ordered in its cost of capital proceeding.

SBC further argues that the Proposed Order did not fully consider competitive risks associated with provisioning legacy loop facilities as UNEs. Contrary to SBC's contentions, the Proposed Order recognizes the appropriate amount of risk associated with offering these facilities. Significantly, the United States Supreme Court recognized that there is very little risk associated with provisioning UNE loops because ILECs have an "almost insurmountable competitive advantage" in offering them. Thus, if anything, the cost of capital used in determining legacy UNE loop rates that are established in this proceeding should be low and reflect such lower risk.

With respect the cost of capital that is established for other UNEs, the Commission can recognize the increased risk associated with offering them when they are investigated (which will be at some later date) and assign the appropriate risk to them then. It should not inflate the cost of legacy UNE loops to subsidize more risky UNE offerings and the FCC agrees. Given this, Joint CLECs proposed 7.54% cost of capital, as further explained in their Brief on Exceptions, is far more appropriate than the 12.19% SBC recommends for UNE loops.

With respect to the depreciation lives prescribed in the Proposed Order, the FCC has not endorsed financial reporting lives for depreciation, as SBC claims, or even indicated that this is the preferred rate of depreciation for developing TELRIC rates. In fact, in the *TRO*, the FCC specifically rejected the request of SBC and other ILECs that the FCC mandate the use of financial lives in establishing depreciation expense under TELRIC. Because the FCC could not, on the record before it in the Triennial Review proceeding, determine which set of depreciation lives more closely reflects the actual useful life of an asset, the FCC concluded that "state commissions continue to have discretion with respect to the asset lives they use in calculating depreciation expense." Based upon the record in this proceeding, the Proposed Order appropriately used that discretion to select the FCC's regulatory lives for depreciation.

The FCC depreciation lives adopted by the Proposed Order account for growing competition and the decline in value that would be anticipated in a competitive market. In fact, the FCC has stated that its depreciation rates were intended to be forward-looking, and the Supreme Court specifically found the FCC's asset lives to be a reasonable starting point for developing depreciation expense to be used in setting UNE rates, noting that "We have been informed of no specter of imminently obsolescent loops requiring a radical revision of currently reasonable depreciation." The Proposed Order likewise found no specter of imminently obsolescent loops in this proceeding finding it unrealistic that SBC's copper network will become obsolete in five years, as SBC claims.

SBC mischaracterizes the FCC's policy on fill factors and the Seventh Circuit's decision in *Illinois Bell*, as endorsing the use of actual fill factors. In fact, the FCC statement cited by SBC is actually a series of questions posed by the FCC for comment in its *TELRIC NPRM*. These questions are hardly an endorsement. Similarly, the *Illinois Bell* decision observed that current fill factors *could* be used *if* they were found to be efficient. SBC has not demonstrated that the perceived inefficiencies found by Staff do not exist or that Staff was incorrect in finding some upward adjustment to SBC's actual fills is necessary to reflect the efficient network contemplated by TELRIC pricing. Accordingly, the Proposed Order was correct in rejecting the use of SBC's actual fills without adjustment.

The FCC has stated that that while current demand may include a reasonable amount of excess capacity to accommodate short-term growth, calculation of distribution fill factors that serve *ultimate* demand (as SBC proposes to do) is expressly forbidden. SBC designed its network based upon forecasts and projections of future growth that have, over time, proven wrong in some instances. Staff proposed to increase SBC's actual usage to a level that would reflect a reasonable estimate of the existing level of these inefficiencies, which would result in a more efficient use of facilities, less excess capacity and more forward-looking fill factors. This result is consistent with TELRIC. Accordingly, the Proposed Order's adoption of Staff's proposed 15% and 7.5% upward adjustments to SBC's distribution and feeder fill factors is appropriate and should be affirmed.

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Bell Telephone Company	)	
	)	Docket No. 02-0864
Filing to increase Unbundled Loop	)	
And Nonrecurring Rates	)	

REPLY BRIEF ON EXCEPTIONS OF MPOWER COMMUNICATIONS CORP.

Mpower Communications Corp. d/b/a Mpower Communications of Illinois ("Mpower"), through undersigned counsel and in accordance with Section 200.830 of the Illinois Commerce Commission's Rules, 83 ILL. ADMIN. CODE § 200.830, hereby submits its Reply Brief on Exceptions in the above-referenced proceeding. For the reasons set forth below, the Commission should reject all of SBC's exceptions and proposed modifications to the Proposed Order and direct SBC to recalculate its UNE rates based upon the conclusions reached in the Proposed Order.

INTRODUCTION

Rather than responding in detail to all of the exceptions raised by SBC and other parties, Mpower will focus herein on several critical issues as to which Mpower believes it is particularly important that the Commission reject SBC's proposed modifications to the Proposed Order. For the Commission's convenience, Mpower will respond to the arguments raised in SBC's Brief on Exceptions in the order presented by SBC.

SBC raises no factual or legal basis to modify the Proposed Order or to implement any of SBC's proffered modifications to the Proposed Order. Indeed, many of the arguments SBC raises are little more than a restatement of the rejected arguments it raised in its initial and reply briefs. In other cases, SBC mischaracterizes the Proposed Order's findings in order to attack those findings as unreasonable or inappropriate. SBC fails to demonstrate that its proposed modifications are consistent with TELRIC pricing or that they will produce forward-looking UNE costs.

The Proposed Order is the culmination of a lengthy proceeding involving numerous parties and issues and thousands of pages of testimony and exhibits. Despite the volume of evidence and other data submitted in this proceeding, the Proposed Order finds that in many cases, SBC either did not provide any support for or did not provide sufficient evidence to justify a particular rate or rate component. In those circumstances, the Proposed Order was forced to either adopt the recommendation of another party or develop, based upon the evidence in the record, the recommendation it found to be more likely to produce forward-looking TELRIC rates. While Mpower does not necessarily agree with all of the Proposed Order's recommendations in these circumstances, Mpower asserts that SBC is hard-pressed to argue that the Proposed Order is in error when SBC failed to provide sufficient evidence to warrant a finding in its favor.[1] Indeed, SBC has not demonstrated that the Proposed Order's recommendations are wrong and should be rejected or that SBC's proposals are more appropriate.

In short, SBC has failed to offer a rational basis for modifying the Proposed Order. Accordingly, the Commission should reject SBC's exceptions.

---

[1] Significantly, the FCC's rules place on SBC the burden of presenting evidence to support its UNE rates. 47 C.F.R. § 51.505(e). The Proposed Order is correct in deciding to reject SBC's proposed rates if SBC does not satisfy this burden.

ARGUMENT

I. Cost of Capital (Section III.B.4 of the Proposed Order)

In its Brief on Exceptions, SBC claims that the 8.94% cost of capital established in the Proposed Order is unlawfully low, arguing that the Proposed Order should have used a market value capital structure in deriving the cost of capital. SBC contends that the Proposed Order erred in not adopting a market value capital structure, which would result in a the cost of capital of 12.19%, and in any event, no less than 10.95%. SBC argues that the capital structure established in the Proposed Order (1) does not reflect the risks associated with a fully competitive marketplace; (2) fails to abide by the determinations made by the FCC's Wireline Competition Bureau in setting the cost of capital in Virginia; (3) is inconsistent with TELRIC pricing principles; (4) reflects traditional ratemaking practice; (5) has an equity ratio that is far less than certain benchmarks; and (6) produces results that are too low.

As shown below, SBC's arguments fail and its requested modifications to the Proposed Order should be rejected. If anything, the cost of capital that is established for legacy UNE loops should reflect the reduced risk associated with offering these UNEs and should be 7.54%, and no more than 8.47%, as Joint CLECs proposed in their Brief on Exceptions.

A. The FCC Never Stated that TELRIC Requires a Fully Competitive Market.

SBC's primary argument regarding the cost of capital established in the Proposed Order is that "it is not based on market values and therefore does not account for the risks that TELRIC requires it to reflect."[2] SBC submits that "the FCC went out of its way in the *Triennial Review Order* to instruct state commissions that they *must* assume a fully competitive market and reflect

---

2 SBC Brief on Exceptions at 11.

the significant risks of such a market in the cost of capital."[3] SBC explains that "While the FCC may not have used the word 'fully,' its intent is plain."[4] The FCC's intentions, however, are not at all as SBC characterizes them.

Indeed, in echoing the sentiments made by CLECs and Staff earlier in this proceeding, the FCC never stated in the *Triennial Review Order* ("*TRO*") that that the cost of capital "must assume a *fully* competitive market"[5] or that a capital structure based on market values be used. Rather, the *TRO* stated:

> First, we clarify that a TELRIC-based cost of capital should reflect the risks of a competitive market. The objective of TELRIC is to establish a price that replicates the prices that would exist in a market in which there is facilities-based competition. In this type of competitive market, all facilities-based carriers would face the risk of losing customers to other facilities-based carriers, and that risk should be reflected in TELRIC prices.
>
> . . . Because the objective of TELRIC pricing is to replicate pricing in a competitive market, and prices in a competitive market would reflect the competitive risks associated with participating in such a market, we now clarify that states should establish a cost of capital that reflects the competitive risks associated with participating in the type of market that TELRIC assumes. The Commission specifically recognized that increased competition would lead to increased risk, which would warrant an increased cost of capital. Although paragraph 702 states that there was limited competition for network elements at the time, it is clear from our discussion of the TELRIC methodology that future competition must be considered in assessing risk.[6]

Contrary to SBC's mischaracterizations of the *TRO*, the FCC never referred to *full* competition in these paragraphs of the *TRO* or required or even suggested that "the risks of fully

---

3 SBC Brief on Exceptions at 7.

4 SBC Brief on Exceptions at 11.

5 SBC Brief on Exceptions at 16.

6 *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket Nos. 01-338, 96-98, 98-147, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, 18 FCC Rcd 16978, ¶¶ 680-81 (2003) ("*Triennial Review Order*" or "*TRO*") (subsequent history omitted).

competitive marketplace with pervasive facilities-based competition"[7] should be assumed when calculating the cost of capital. In the *TRO*, the FCC stated only that it was providing a clarification and was *not* setting a new cost of capital standard different from the one that existed at the time of the Commission's TELRIC I Order.

To further demonstrate what it meant, the FCC recently clarified in its TELRIC Notice of Proposed Rulemaking that the cost of capital should reflect the risks of a competitive market *only* to the extent the other assumptions used in determining UNE rates reflect a forward-looking theoretical least-cost network. The FCC emphasized that the importance of the clarification in the *TRO* cited by SBC,

> was to confirm that state commissions must use a *consistent set of assumptions* when they calculate the three components of rates (operating expenses, cost of capital, and depreciation expenses). That is, if the network assumptions are based on projections about what a network would look like in the long-run assuming facilities-based competition, the same approach should be followed in developing the cost of capital.[8]

In the case at hand, the Proposed Order reflects a level of competition in the cost of capital that is consistent with the degree of efficiency that was proposed to be assumed in the the other components of UNE rates.[9] Furthermore, if the Proposed Order is modified as the Joint CLECs requested in their Brief on Exceptions, the Order would remain consistent as

---

7 SBC Brief on Exceptions at 2.

8 *In the Matter of Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, Notice of Proposed Rulemaking, FCC 03-224, ¶ 84 (rel. Sept. 15, 2003) ("*TELRIC NPRM*") (emphasis added) (citing the *Triennial Review Order*, at ¶¶ 682, 689). The FCC's Wireline Competition Bureau noted the same thing in ¶ 63 of the *Virginia Arbitration Award* (noting that "the Commission clarified that a TELRIC-based cost of capital should reflect the same competitive assumptions that are used to determine network investment."). *See Petition of Worldcom, Inc. Pursuant to 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia, Inc., and for Expedited Arbitration*, CC Docket No. 00-218, Memorandum Opinion and Order, DA 03-2738, ¶ 63 (Chief, Wireline Competition Bureau, rel August 29, 2003) ("*Virginia Arbitration Award*"). Significantly, the Georgia federal district court decision cited by SBC that serves to interpret what the FCC meant in the *TRO* regarding the risks that should be considered when deriving the cost of capital cannot be squared with the FCC's own clarifications.

9 Proposed Order at 82-83.

contemplated by the FCC.[10]

B. The Determination Made By the FCC's Wireline Competition Bureau is Not Commission Precedent and the Commission has the Flexibility to Order What it Deems Appropriate in Illinois.

Beyond SBC's recurring mischaracterizations of what the FCC said in the *TRO* in its Brief on Exceptions, SBC repeatedly cites an order rendered by the FCC's Wireline Competition Bureau ("Bureau") in a arbitration setting rates for a single state (Virginia). SBC contends that the rulings made in the Proposed Order must be consistent with the Bureau's determination to use a market value capital structure when deriving the cost of capital. Contrary to SBC's suggestion, what the Bureau implied, stated, or concluded in the *Virginia Arbitration Award* does not constitute a ruling of the FCC or suggest that the Bureau's approach is the only way for this Commission to derive the appropriate capital structure in this proceeding. Indeed, the Bureau does not prescribe final FCC policy nor does it set legal precedent for Commission decisions.[11] Moreover, the evidence considered by the Bureau "reflected a somewhat stale record and was based on data from June 2000 – three years prior to date the FCC issued the *Virginia Arbitration Award*."[12]

Notably, the New Hampshire Public Utilities Commission ("NH PUC") and an

---

[10] Joint CLECs' Brief on Exceptions at 113-15.

[11] *See Entercom Seattle License, LLC*, Memorandum Opinion and Order, 2004 WL 1077881, P. 12 (rel. May 14, 2004) (stating "the Commission is not bound by, nor does it necessarily agree with, Bureau precedent.").

In its alternative request, SBC cites the Bureau's decision and argues that a 79% equity ratio for the capital structure be adopted because the Proposed Order is inconsistent. SBC argues that the Bureau ordered that to be consistent, it was necessary to use a market value capital structure since it derived the cost of equity based on the CAPM model. SBC Brief on Exceptions at 19. Although the Bureau's decision is not binding on the Commission, SBC's argument has no merit and should be rejected. The Proposed Order does "maintain consistency between the capital structure and costs of capital components." Proposed Order at 83. It consistently utilizes Staff's Telecom sample in deriving the ideal cost of equity and capital structure and adopts Staff's proposed 12.44% cost of equity that is an average of the results obtained under the DCF and CAPM methodologies based on Staff's Telecom Sample group. In addition, the Proposed Order consistently adopts Staff's recommended capital structure that is based on the interest coverage ratios of the company's in Staff's sample.

[12] AT&T/MCI Joint Ex. 2.2 (Murray Surrebuttal) at 20.

Administrative Law Judge in California recently issued Orders that have recognized this fact and have required that the book value capital structure be used or at least be considered in deriving the cost of capital that will be used in establishing UNE rates.[13]

To be clear in this regard and although the Proposed Order did not adopt a book value capital structure, a capital structure based on book value does not, as SBC suggests, defy TELRIC. This type of capital structure recognizes that if a competitor replicated the telecommunications assets utilized by SBC to provide UNE service, the competitor would strive to raise capital in a manner that would minimize costs consistent with the FCC's TELRIC standard.

In particular, the book value reflects how a "reasonable and prudent manager" for a specific company actually raises capital for current and future investments, and how trade-off computations are made to determine the overall cost of capital.[14] Because equity costs more than debt and since the return on equity is subject to income taxation while the return on debt is not (interest expense is tax deductible), good management strives to use the smallest amount of common equity that is reasonably practical. In doing so, competent management recognizes that a reasonable amount of common equity must be used because, absent the protection of a significant amount of equity, bond investors would be unwilling to invest at a reasonable rate of interest. The increased financial risk inherent in a capital structure that had relatively little equity would also cause the cost of equity to increase. Although in theory a company's book value

---

[13] *Verizon New Hampshire Investigation into the Cost of Capital, DT 02-110, Order Establishing Cost of Capital*, Order No. 24,265, at 49 (N.H. P.U.C. Jan. 16, 2004) ("*NH PUC Cost Of Capital Order*") (attached as Appendix 1), *appeal pending, Verizon New England, Inc. v. New Hampshire Public Utilities Commission*, Civil No. 04-CV-65-B; *Joint Application of AT&T and Worldcom et al. for the Commission to Reexamine the Recurring Costs and Prices of Unbundled Switching in its First Annual Review of Unbundled Network Element Costs Pursuant to Ordering Paragraph 11 of D.99-1-050*, Applications 01-02-024, 01-02-035, & 02-02-031, Proposed Decision of ALJ DUDA, at 148 (Cal. P.U.C. Mailed May 3, 2004).

[14] *See NH PUC Cost of Capital Order* at 50.

should reflect most efficient capital structure for a firm, it may not in reality reflect the ideal equity ratio that TELRIC requires. Staff's proposed capital structure (which is based on the interest coverage ratios of the companies in Staff's sample), however, goes to the heart of that optimal ratio and does not drift around it.

C. SBC's Requested Market Value Capital Structure Should Be Rejected Because of Its Many Deficiencies, Such as its Inconsistency with the United States Supreme Court's decision in *Hope Natural Gas*.

SBC's argument that the Proposed Order should be modified to reflect only a market value capital structure does not recognize the many deficiencies associated with taking this approach. First, a market value structure has no basis in reality and does not result in forward-looking least-cost UNE rates. Indeed, as indicated above, if a competitor were to attempt to replicate the telecommunications assets utilized by SBC to provide UNE service, a competitor with reasonable and prudent management would strive to raise the capital in a manner that would produce the lowest overall cost of capital in the long-run for the company. Otherwise said, SBC's use of a market based capitalization improperly loses sight of how capital structure is determined in the first place. In particular, a market based capitalization does not address the optimal cost of capital that is available to management either through direct computation (consistent with Staff's proposal) or indirectly thorough decisions made by management (book value market structure).

Second, SBC's assertion that certain rating agencies have chosen capital structures that reflect 70% in equity or more[15] should be accorded no weight because in the end, management's objective is to keep costs down and target the most effective least-cost capital structure that it can employ. The Proposed Order adopts this approach rather than SBC's recommendation of a less-

15 SBC Brief on Exceptions at 14-15.

than-optimal and more expensive capital structure. In rejecting SBC's proposed capital structure, the Proposed Order correctly and implicitly recognizes that if the latter approach were taken, SBC's rates to its customers would drastically increase and be "excessive";[16] however, in reality SBC's costs would not because SBC would be operating under a capital structure that is far more cost efficient for its business.

Third, SBC's market value capital structure fails to recognize short-term debt.[17] Short-term debt is a very inexpensive means of raising capital and is currently used extensively by SBC.[18]

Finally, and most importantly, the market value approach to capitalization advocated by SBC is in direct contradiction to the United States Supreme Court's holding in *Hope Natural Gas*.[19] The *Hope* decision wisely states:

> "fair value" [market price of stock] is the end product of the process of rate-making not the starting point as the Circuit Court of Appeals held. The heart of the matter is that rates cannot be made to depend upon "fair value" [market price of stock] when the value of the going enterprise depends on earnings under whatever rates may be anticipated.[20]

Thus, a market based capital structure for determining rates, defies this legal principle.

To elaborate, stock prices are substantially impacted by future expectations of earnings. If a market value capital structure is used, the higher the market price of stock (or "fair value" as expressed in *Hope*), the higher the percentage of common equity in the capital structure. As a result, the higher the percentage of common equity in the capital structure, the higher the revenue requirement (and the higher the rates). In other words, strictly using a market based capital

---

16 Proposed Order at 82.

17 Proposed Order at 79.

18 AT&T/MCI Exhibit 2.2 (Murray Surrebuttal) at 38-39.

19 *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 601 (1943).

structure to establish the revenue requirements of a company would result in an upward spiral where higher stock prices would produce a need for higher income requirements, and the higher income requirements would produce a need for higher revenue requirements and higher rates. It is this circular ratemaking that defies *Hope.*

Contrary to SBC's claims and although the TELRIC standard requires that *telecommunications equipment* reflect market costs, it does not suggest that capital structure should be market value rather than some other optimal value for the company. If it did, the Supreme Court would have struck down the FCC's TELRIC standard because it would have contravened *Hope*. But the Court did not because TELRIC is consistent with *Hope*. The *Hope* case concludes that the end result is the stock price and this end result cannot be used as the starting point (as SBC proposes) in the ratemaking process.

D. The Proposed Order Does Not Reflect Traditional Ratemaking Practice.

SBC also claims that by adopting the Staff's proposed capital structure, the Proposed Order has "not only regressed to traditional ratemaking practice, but gone farther in the wrong direction by assuming that SBC faces even less risk than a traditional regulated utility."[21] The Proposed Order did no such thing and stated that "we are not engaged in traditional ratemaking in this docket."[22] Rather, the Proposed Order identified interest rate coverage ratios to derive a capital structure that will produce the financial strength consistent with an investment grade credit rating.[23] The objective of the Proposed Order was to establish an optimal forward-looking

20 *Id*.

21 SBC Brief on Exceptions at 13.

22 Proposed Order at 82.

23 SBC Brief on Exceptions at 13.

capital structure under these circumstances. The record demonstrates that SBC's proposal fails to do that.

E. The Proposed Order is Well Above at Least One Benchmark.

SBC argues that the capital structure in the Proposed Order is unsupported because the record does not identify any single A-rated company with only 51% equity in its capital structure whether it be book or market values.[24] However, the record does reflect that Verizon's 3 to 5 year book value capital structure forecast contains 56% equity, which is very close to 51% required in the Proposed Order.[25] In addition and rather than speculate on such forecasts, the NH PUC in its cost of capital decision recently noted that Verizon New England has a capital structure that includes 44.78% equity and 55.22% debt. [26] Moreover, the final capital structure the NH PUC ordered included 45% equity, 53% long term debt and 2% short term debt.[27] Stated otherwise, the equity ratio of 51% that the Proposed Order requires is approximately 6 percentage points *higher* than Verizon New England's capital structure.

SBC further argues that the Proposed Order relies too heavily on the assertion that using 51% equity is "identical to the December 31, 2002 book value of equity of Illinois Bell Telephone, ("IBT") (IBT 2002 Annual Report)."[28] In this regard, it bears noting that the NH PUC rather did not establish the cost of capital based on Verizon New Hampshire's parent company. The NH PUC stated that adopting:

---

24 SBC Brief on Exceptions at 13-15.

25 SBC IL Ex. 12.1 (Avera Rebuttal) at 24 & WEA-7.

26 *NH PUC Cost of Capital Order* at 49. The fact that Verizon Communications can operate with of an even lower equity ratio of 37.6%, as noted in the *NH PUC Cost of Capital Order* at 49, and not lose its investment rating demonstrates the invalidity of SBC's claim that if its equity ratio went to 51% it could well lose its investment rating altogether.

27 *NH PUC Cost of Capital Order* at 57

28 SBC Brief on Exceptions at 15 (citing Proposed Order at 83).

> the capital structure of Verizon Communications…would not be a good proxy for the hypothetical prudent capital structure of Verizon NH, because the ultimate corporate parent includes substantial amount of riskier and unregulated ventures such as wireless services, which makes it too dissimilar from Verizon NH to be a reasonable proxy for setting cost of capital for the overall jurisdictional business.[29]

SBC further explains that the IBT 2002 Annual Report is incorrect and that the Proposed Order should not rely on it as a benchmark. However, even if SBC's assertions are correct (which is unlikely), the NH PUC has established a benchmark that is well below what the Proposed Order adopts and should provide the Commission with the comfort it seeks.

F. The Cost of Capital that is Established in This Proceeding Should Be Relatively Low Because it is Limited to UNE Loops, Which Inherently Have Lower Risk Than Other UNEs.

Contrary to SBC's claims that the Proposed Order did not fully consider competitive risks, the Proposed Order did. The record in this case demonstrates that "the fact that UNE rates remain regulated indicates that the rates should not reflect risk levels associated with competition unimpeded by regulatory restraints (i.e. a high degree of competition). Rather, UNE loops rates should reflect a level of competition somewhere between the low degree of competition of rate-regulated, exclusive franchise, utility services and the high degree of competition of unregulated industrial companies."[30] The focus here is on UNE loops, the provision of which is less risky than other UNEs, and should therefore have a lower cost of capital.

Significantly, the FCC explained in the *TRO* that different UNEs may have higher degrees of risk than others.[31] The United States Supreme Court has recognized that ILECs have an insurmountable competitive advantage especially when it comes to loops and therefore the risks

---

29 *NH PUC Cost of Capital Order* at 52.

30 ICC Staff Exhibit 12 at 29-30.

31 *TRO* ¶ 683.

associated with offering loops is low (and thus should have a lower cost of capital). In particular, the Supreme Court stated that the incumbent local exchange carriers have an:

> [A]lmost insurmountable competitive advantage . . . in routing calls within the exchange . . . . A newcomer could not compete with the incumbent carrier to provide local service without coming close to replicating the incumbent's entire existing network, the most costly and difficult part of which would be laying down the 'last mile' of feeder local loop, to the thousands (or millions) of terminal points in individual houses and business . . . . In an unregulated world, another telecommunications carrier would be forced to comply with these conditions, or it could never reach the customers of a local exchange.[32]

Thus, the combination of the "insurmountable" difficulty of competitors building loop facilities to compete with the regulated retail business of the incumbents and the basic important nature of telecommunications service makes SBC's provisioning of UNE loops on the low-end of the risk spectrum.

As noted above, the Proposed Order is only establishing the cost of capital that will be used for UNE loops and the Commission has the flexibility to assess other costs of capital for other UNE facilities. The FCC has specifically stated that state commissions have the "option of establishing UNE-specific costs of capital."[33] Mpower agrees that there is no basis for assuming that a carrier will face the identical risk for each type of service it provides. This is especially true when it comes to an ILEC's legacy loop facilities. In this regard, SBC's legacy loops should have a separate cost of capital that reflects the limited risks, if any, associated with offering them as UNEs.

---

32 *Verizon v. FCC*, 122 S. Ct. 1646, 1662 (May 13, 2002) (emphasis added).

33 *TELRIC NPRM* ¶ 90; *TRO* ¶ 683.

Indeed, as the FCC has recognized, prices for a particular UNE should ideally reflect only those costs (and risks) associated with the ILECs' provision of that UNE.[34] Currently, the traditional methods for computing the cost of capital are based on all of the incumbents' lines of business, including new cutting edge lines of business, such as the deployment of broadband facilities that is considered by some to be extremely risky business proposition. However, the costs associated with offering services that may be considered riskier ventures are not necessarily associated with UNE offerings that are far less risky, such as basic legacy loops. Therefore, the cost of capital for legacy loops should be lower than the cost of capital that is associated with riskier lines of business.

More specifically, the cost of capital associated with legacy loops should be lower than the cost of capital associated with "other" network elements, such as switching, associated vertical services, and data base services because sunk and fixed costs associated with these latter network elements do not impede competitive entry to nearly the same extent as do the cost of loops. In fact, it is quite possible that CLEC facilities-based entry could, in some cases, reduce the demand for, and utilization of, those elements. Significantly, these types of network elements are software based and have a far shorter product life than loops. Consequently, the ILEC is exposed to greater risk in offering these "other" network elements if they were deployed on the assumption of high growth and long-term demand utilization. Thus, if anything, it is more risky for an ILEC to offer these other network elements than it is to offer basic legacy loop facilities on an unbundled basis.

Given the above, the Commission should not be uncomfortable ordering a relatively low cost of capital associated with UNE loops because the Commission can adopt a higher cost of

[34] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15499, 15583, ¶ 702 (1996) ("*Local Competition Order*") (noting that "the risk-adjusted

capital for riskier UNEs at the time those costs are investigated. In the end, the cost of capital associated with basic legacy loops should be lower than the ILEC's overall average cost of capital in a TELRIC analysis and lower than the average cost of capital for the other UNEs mentioned above.

* * *

For the reasons stated above and the reasons stated Joint CLECs' Brief on Exceptions, the Commission should adopt Joint CLECs' proposed cost of capital of 7.54% for legacy UNE loops. However, as the Joint CLECs proposed in their Brief on Exceptions and if the Commission adopts Staff's 51% common equity ratio, the percentage of short and long-term debt should be 22.35% and 26.65%, respectively. This would result in an overall cost of capital no higher than of 8.47% for legacy UNE loops.

II. Depreciation (Section III.B.3 of the Proposed Order)

SBC argues that the Proposed Order improperly adopted the FCC's regulatory depreciation lives rather than SBC's proposal to use financial reporting lives.[35] SBC incorrectly claims that the FCC has questioned the use of its regulatory depreciation lives in favor of financial reporting lives (SBC Brief at 21-24) and asserts that financial reporting lives more realistically reflect the actual decline in value of SBC's assets that would be anticipated in a fully competitive market.[36] SBC's arguments are unsupported in the record and should be rejected.

---

cost of capital need not be uniform for all elements") (subsequent history omitted); *TELRIC NPRM* ¶ 90; *TRO* ¶ 683.

[35] SBC Brief on Exceptions at 3-4, 21-27.

[36] SBC Brief on Exceptions at 22-23. SBC also claims, erroneously, that the FCC has recently "questioned" whether regulatory lives reflect competitive technology and are forward-looking. SBC Brief on Exception at 23. The "questions" SBC cites are just that, questions that the FCC posed in its NPRM for which it requested public comment. (SBC erroneously cites ¶ 36, however, the language SBC quotes is from ¶ 101.) *See TELRIC NPRM* at ¶ 101. These requests do not reflect the FCC's current policy, which, as specifically stated in the *TRO*, is not to endorse any particular depreciation methodology).

Contrary to SBC's claims, the FCC has not endorsed financial reporting lives for depreciation or even indicated that this is the preferred rate of depreciation for developing TELRIC rates. Indeed, as the Proposed Order notes, the United States Supreme Court found that the FCC's TELRIC methodology "recognizes no particular useful life as a basis for calculating depreciation costs."[37] In fact, in the *TRO*, the FCC explicitly rejected the request of SBC and other ILECs that the FCC mandate the use of financial lives in establishing depreciation expense under TELRIC.[38] The FCC stated that it could not conclude, based on the record of the Triennial Review proceeding, whether one set of lives or the other more closely reflects the actual useful life of an asset. As a result, the FCC concluded that "state commissions continue to have discretion with respect to the asset lives they use in calculating depreciation expense."[39] The Proposed Order correctly refers to this analysis and the FCC's conclusion that a state commission has the discretion to select an appropriate depreciation methodology based upon the record before it, and appropriately used that discretion to select the FCC's regulatory lives for depreciation.

The Proposed Order observes that the parties only offered two options for depreciation -- SBC's financial lives and the FCC regulatory lives methodology. Noting that SBC's financial reporting methodology is intended primarily to enable shareholders to recoup their investment in the shortest possible time, the Proposed Order correctly finds that SBC's methodology does not properly reflect a competitive environment, and accordingly adopts the FCC depreciation lives. The Proposed Order's reluctance to rely upon SBC's financial reporting lives was well founded.

---

[37] Proposed Order at 71, *quoting Verizon Communications, Inc., et al. v. FCC*, 535 U.S. 467, 519 (2002).

[38] *TRO* at ¶ 688.

[39] *TRO* at ¶ 688.

The Proposed Order's decision to adopt the FCC lives was correct, and SBC has not provided any reasonable basis to change that decision.

Contrary to SBC's claim, the FCC lives account for growing competition and the decline in value that would be anticipated in a competitive market. In fact, FCC has stated that its depreciation rates were intended to be forward-looking,[40] and the Supreme Court specifically found that the FCC-prescribed asset lives were a reasonable starting point for developing the depreciation expense to be used in setting UNE prices, noting that "We have been informed of no specter of imminently obsolescent loops requiring a radical revision of currently reasonable depreciation."[41] The Proposed Order likewise found no specter of imminently obsolescent loops, stating "We find it unrealistic that the circuit-switched, copper network will begin to become obsolete in five years as suggested by SBC witness Vanston."[42] Given the problems with SBC's proposed financial reporting lives noted in the Proposed Order, the FCC assets lives are the only reasonable starting point. As the Proposed Order finds, the record demonstrates that in this case, the FCC asset lives provide the best approximation of the decline in value of SBC's assets in a competitive market.

The FCC has stated that an appropriate depreciation rate should reflect the "actual decline in value that would be anticipated in the competitive market."[43] SBC questions the Proposed Order's reliance on the fact that the FCC lives are shorter than SBC's actual assets lives, arguing that this fact does not show that the FCC depreciation rate reflects the actual decline in value of SBC's assets.[44] SBC goes on to explain that the life of underground cable depends on "how

---

[40] *TELRIC NPRM*, at ¶ 95.

[41] *Verizon Communications, Inc. v. FCC, et al.* 535 U.S. 467, 519-520 (2002).

[42] Proposed Order at 72.

[43] *TRO* at ¶ 688.

[44] SBC Brief on Exceptions at 24.

quickly SBC Illinois converts to fiber, how fast competition strands ILEC access lines, and how soon current generation fiber is replaced"[45] in other words, how SBC actually deploys its facilities. SBC asserts that the actual market is competitive.[46] Therefore, the pace at which SBC actually replaces outdated or more expensive equipment provides a good indicator of the economic value SBC places on its assets. The FCC has suggested, and SBC agrees (SBC Brief at 24) that forward-looking costs should reflect the actual operation of an ILEC's network.[47] Therefore, SBC's actual lives are very relevant to the depreciation analysis and further, demonstrate that FCC lives, which are shorter, are appropriate.

If as SBC claims, the economic life of its facilities is less than the FCC lives, then the fact that SBC keeps equipment in place beyond the FCC lives means either that SBC is choosing to operate less efficiently with more costly, outdated facilities, or, that technology is not improving or equipment costs decreasing fast enough to warrant replacing existing equipment. Therefore, assuming SBC takes full advantage of the efficiencies technological advances or decreasing costs represent (*i.e.*, SBC replaces outdated, most costly equipment as technology changes or equipment costs decrease), SBC's actual lives account for the decline in value of SBC's facilities in a competitive market. It follows then that the FCC lives, which are shorter than SBC's actual lives and therefore permit a more accelerated depreciation, are a reasonable basis for developing the depreciation expense to be used in setting UNE prices. Accordingly, the Proposed Order correctly adopted the FCC lives for depreciation expense.

SBC's objections to the Proposed Order's rejection of SBC's forecasts for growth trends are likewise without merit. SBC claims that because there is no way to know whether current

---

45 *Id.*

46 SBC Brief on Exceptions at 26.

47 *TELRIC NPRM* at ¶ 101.

trends will continue or growth will increase, its forecasts are reasonable. As the Proposed Order notes, however, Staff pointed out that the number of CLEC lines has not increased markedly since December 2001 and the number of CLEC lines that are not cable telephony has actually decreased since December 2000. In addition, the Proposed Order reasonably relies on Staff's determination that SBC's forecast would require nearly three times as many customers to switch to wireless carriers per year as have switched to date. The Proposed Order appropriately determined that it is unlikely that current growth trends will increase to the levels claimed by SBC, and therefore that SBC's forecasts are exaggerated. SBC has not offered a reasonable basis to change this determination or to support its claim that current trends will dramatically increase. Accordingly, there is no reason to modify the Proposed Order's adoption of the FCC lives for developing depreciation expense.

III. Fill Factors (Section III.B.1 of the Proposed Order)

SBC argues that the Proposed Order erroneously rejects SBC's actual fill factors, improperly increases fills based on Staff's recommendation to remove *ex post* inefficiencies that SBC could not avoid and adopts SBC's 1998 fill data rather than the 2002 actual fill data proposed by SBC.[48] SBC also argues that Staff's proposed fill increases adopted by the Proposed Order are unrealistic and do not take into account cable breakage in cable sizing decisions.[49] These are the same arguments raised by SBC in its post-hearing briefs and rejected by the Proposed Order. SBC has not offered any new arguments to justify modifying the Proposed Order. SBC has simply not proven that its actual fill factors are TELRIC-compliant.

SBC's claim that the FCC has endorsed the use of actual fill factors is wrong and is based on a mischaracterization of the *TELRIC NPRM* and the FCC's policy. The FCC did not make

---

[48] SBC Brief on Exceptions at 27-39.

any definitive statement in the *TELRIC NPRM* regarding the use of actual fill factors. Rather, the FCC provided a series of questions for interested parties to address regarding the relevance of actual fill factors in establishing forward-looking cost.[50] In fact, contrary to SBC's claim, the FCC has expressly found that UNE rates may *not* be set using current effective fill simply because that represents the ILEC's historic practice.[51]

SBC similarly misreads the Seventh Circuit's ruling in *Illinois Bell* as support for its proposition that use of current fill factors is TELRIC-compliant. To the contrary, *Illinois Bell* did not endorse use of current fill factors in all cases, but observed that current fill factors could be used *if* they were found to be efficient.[52] As Staff found, and the Proposed Order properly concluded, while SBC may not have intentionally designed its network in an inefficient manner, there is likely unnecessary capacity and inefficiency built into SBC's network as the result of imperfect forecasts or changed circumstances.[53] SBC has not demonstrated that the perceived inefficiencies found by Staff do not exist or that Staff was incorrect in finding that some upward adjustment to SBC's actual fills is necessary to reflect the efficient network contemplated by TELRIC pricing. Thus, SBC has not sufficiently satisfied the Seventh Circuit's criteria to warrant utilizing SBC's actual fills, without adjustment, for purposes of developing TELRIC-based prices.

---

49 SBC Brief on Exceptions at 33-36.

50 At best, the paragraph SBC cites as "endorsing" the use of actual fill factors could be interpreted as a request to interested parties to state whether the FCC should adopt actual fill factors for developing TELRIC rates going forward. That is hardly an "endorsement."

51 *In the Matter of Joint Application by SBC Communications, Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Kansas and Oklahoma*, Memorandum Opinion and Order, 16 FCC Rcd. 6237, at ¶ 80 (2001).

52 *AT&T Communications of Illinois v. Illinois Bell Telephone Company*, 349 F.3d 402, 411 (7th Cir. 2003).

53 Proposed Order at 57.

SBC also places too much reliance upon the Proposed Order's finding that SBC had not intentionally and systematically designed an inefficient network in the past to argue that the Proposed Order should have adopted SBC's actual fills. SBC's fill factors are based upon the deployment of enough distribution capacity to serve long-term (*i.e.*, ultimate) anticipated demand in any given geographic area.[54] The FCC has concluded that "the fill factors selected for use . . . should reflect current demand . . . [not] the industry practice of building distribution plant to meet 'ultimate' demand."[55] While current demand *may* include a reasonable amount of excess capacity to accommodate short-term growth,[56] calculation of distribution fill factors that serve *ultimate* demand is expressly forbidden. The FCC has stated this point unambiguously:

> [T]he fact that industry may build distribution plant sufficient to meet demand for ten or twenty years does not necessarily suggest that these costs should be supported today . . . [B]asing the fill factors on current demand rather than ultimate demand is more reasonable because it is less likely to result in excess capacity, which would increase the model's cost estimates to levels higher than an efficient firm's costs . . .[57]

By designing a hypothetical network sufficient to serve *ultimate* demand, *and*, at the same time allocating the full cost of such an overbuilt network to CLECs that serve only *current* demand, SBC would re-create precisely the same entry barriers that the Act and the *Local Competition Order* were intended to eliminate.[58] Therefore, the Proposed Order properly adjusted SBC's actual fills to reflect projections of actual total usage consistent with FCC requirements.

---

54 Proposed Order at 28.

55 *Federal-State Joint Board on Universal Service, Forward-Looking Mechanism for High-Cost Support for Non-Rural LECs*, Tenth Report and Order, CC Docket Nos. 96-45 and 97-160, 14 FCC Rcd. 20156, at ¶¶ 190, 199 (1999), *affirmed*, *Qwest Corp. v. FCC*, 258 F.3d 1191 (10th Cir. 2001) ("*USF Tenth Report and Order*").

56 *USF Tenth Report and Order*, at ¶ 201.

57 *USF Tenth Report and Order*, at ¶¶ 199, 200.

58 *See Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, CC Docket No. 96-98, 11 FCC Rcd 15499, ¶ 672, 679 (1996) ("Local Competition Order"), aff'd in part and vacated in part sub nom. Competitive Telecommunications Ass'n v. FCC, 117 F.3d 1068 (8th Cir. 1997) & Iowa Util. Bd. v. FCC, 120 F.3d 753 (8th Cir. 1997), aff'd in part, reversed in part, and remanded sub nom. AT&T v. Iowa Util. Bd., 525 U.S. 366 (1999), aff'd in part and vacated in part on remand sub nom. Iowa Utils. Bd.*

Staff's proposal to adjust SBC's actual usage in this case is based on the same rationale underlying the FCC's distinction between current demand and ultimate demand. SBC designed its network based upon forecasts and projections of future growth available at that time in order to meet the expected growth over the long-term. Over time, those forecasts may have proven wrong in some instances, resulting in unused or underused excess capacity and therefore artificially low fill factors. This is akin to the ultimate demand scenario outlined by the FCC. To address these inefficiencies, Staff proposed to increase SBC's actual usage to a level that would reflect a reasonable estimate of the existing level of inefficiencies in the SBC network, which would result in more efficient use of facilities, less excess capacity and more forward-looking fill factors. This result is similar to the FCC's current demand scenario and is consistent with TELRIC pricing. Accordingly, the Proposed Order's adoption of Staff's proposed 15% and 7.5% upward adjustments to SBC's distribution and feeder fill factors is appropriate and should be affirmed.

Finally, SBC's actual fills, without adjustment, are by definition not forward-looking because they rely upon current usage resulting from past decisions. TELRIC pricing principles require the Commission to determine forward-looking costs and rates based upon the most efficient, least-cost technology currently available. Any difference between the most efficient cost and embedded cost is an inefficiency, regardless of the cause.[59] Use of SBC's proposed fills, which are based upon historic data, would, as the Proposed Order found, be tantamount to allowing SBC to recover its embedded costs. Such a result is strictly prohibited under TELRIC

v. FCC, 219 F.3d 744 (8th Cir. 2000), cert. granted sub nom. Verizon Communications, Inc. v. FCC, 531 U.S. 1124 (2001).

[59] *Verizon Communications Inc., et al. v. FCC*, 535 U.S. 467, 512 (2002).

and would produce inflated UNE prices and ultimately harm consumers. In order to avoid this result, the Commission must affirm the Proposed Order.

CONCLUSION

With respect to the cost of capital, depreciation and fill factor issues addressed herein, the Proposed Order is correct and supported by the record. SBC has not demonstrated a reasonable basis to modify the Proposed Order's findings or to adopt its proposals rejected by the Proposed Order. According, Mpower respectfully requests the Commission reject SBC's proposed modifications to the Proposed Order, affirm the Proposed Order in the respects described herein, and direct SBC promptly to recalculate its UNE rates based upon the conclusions in the Proposed Order.

Respectfully submitted,

Eric J. Branfman /MPO

Eric J. Branfman
Michael P. Donahue
Philip J. Macres
SWIDLER BERLIN SHEREFF FRIEDMAN, LLP
3000 K Street, N.W., Suite 300
Washington, D.C. 20007
(202) 424-7500 (Telephone)
(202) 424-7645 (Facsimile)
ejbranfman@swidlaw.com
mpdonahue@swidlaw.com
pjmacres@swidlaw.com

Counsel for Mpower Communications Corp.

Richard E. Heatter
Vice President Legal & Regulatory Affairs
Mpower Communications Corp.
3300 N. Cimarron Road
Las Vegas, NV 89129
(702) 310-1224
rheatter@mpowercom.com

Dated: May 24, 2004

APPENDIX 1