

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

MPOWER COMMUNICATIONS CORP., FORTE COMMUNICATIONS, INC.,
CIMCO COMMUNICATIONS, INC., XO ILLINOIS, INC., AND MCI, INC.,

Plaintiffs-Appellants,

v.

EDWARD C. HURLEY, ERIN M. O'CONNELL-DIAZ, KEVIN K. WRIGHT,
and LULA M. FORD, as Commissioners of the Illinois Commerce Commission,
in their official capacities and not as individuals,

Defendants-Appellees, and

ILLINOIS BELL TELEPHONE CO., INC.,

Plaintiff/Intervenor-Appellee-Cross-Appellant.

Appeals from the United States District Court for the Northern District of Illinois,
Eastern Division, Case Nos. 04 C 6909 and 04 C 7402 (consolidated)
Hon. Ruben Castillo

**COMBINED RESPONSE BRIEF AND BRIEF ON ITS CROSS-APPEAL
OF ILLINOIS BELL TELEPHONE COMPANY**

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Jurisdictional Statement

Illinois Bell Telephone Company (“SBC”) states that the jurisdictional statement of Mpower Communications Corp., et al. is complete and correct.

Issues Presented for Review

1. After conducting a generic pricing proceeding authorized by the 1996 Act and the FCC’s implementing rules that was open to all carriers, the Illinois Commerce Commission (“Commission”) issued an Order adopting rates for SBC’s unbundled loops. All parties agreed to that process, and the appellants’ Section 252 interconnection agreements with SBC specifically require incorporation of the rates set in such generic proceedings. Under these circumstances, was the Commission’s Order consistent with the 1996 Act and the FCC’s implementing rules?

2. After reviewing the competing expert testimony, the Commission required SBC to increase its fill factors to a level that would better reflect a forward-looking network, as the law requires. The FCC and other state commissions have endorsed such an approach. Was the Commission’s decision arbitrary and capricious?

3. After reviewing the competing expert testimony, the Commission adopted SBC’s financial reporting depreciation lives as the best approximation of economic depreciation lives under the governing law. The FCC has stated that financial reporting lives can comply with that standard. Was the Commission’s decision arbitrary and capricious?

4. In computing a cost of capital for SBC, the Commission employed a capital structure that did not reflect the full risks of a competitive market. The district court reversed because the FCC’s pricing rules for unbundled network elements require

state commissions to adopt a cost of capital that accounts for the riskiness of a hypothetical competitive market. Did the district court commit legal error?

Statement of the Case

This appeal involves review of the district court's decision ("*Decision*") on review of an Order of the Commission ("*Order*").¹ The Order approved new rates for SBC's "unbundled loops," which are the wires that connect an end-user to SBC's switch, 47 C.F.R. § 51.319(a)(1). SBC must lease such loops to other carriers to enable them to provide competitive telecommunications service. *Id.* The Commission proceeding was temporarily abated by state legislation, but this Court enjoined that legislation and ordered the Commission "to reinstate the proceeding . . . and to proceed to decision as expeditiously as possible." *AT&T Comms. of Illinois, Inc. v. Illinois Bell Tel. Co.*, 349 F.3d 402, 411 (7th Cir. 2003). Following that directive, the Commission reopened the case and issued its final decision in June 2004, resolving dozens of contested issues regarding the inputs to SBC's prices.

Both SBC and competing local exchange carriers ("CLECs") challenged aspects of the Commission's Order. The district court upheld the Commission on most issues but reversed on two points that are relevant here. First, the court found that the capital structure the Commission adopted for SBC's cost of capital (the only issue SBC had appealed) did not comport with the FCC's binding pricing methodology. *Decision* at *41. Second, the court found that the mix of IDLC and UDLC equipment to be reflected in SBC's cost studies (an issue the CLECs had appealed) had to be 100% IDLC because

¹ The Commission's *Order* is at Tab 2 of appellants' separate appendix, while the district court's *Decision* is at Tab 1. These are the versions SBC will cite herein.

the FCC's Wireline Competition Bureau had required use of 100% IDLC in an arbitration in Virginia. *Id.* at *51-52. SBC has appealed the IDLC issue and the CLECs have appealed four issues.

Statement of Facts

A. The 1996 Act.

In 1996, Congress passed the federal Telecommunications Act of 1996 ("Act" or "1996 Act") to promote telecommunications competition and deployment of new infrastructure and services. Pub. L. 104-104, 110 Stat. 56. The Act authorizes the Federal Communications Commission ("FCC") to require "incumbent" local exchange carriers ("ILECs"), like SBC, to "unbundle" certain of their "network elements" by leasing them to CLECs, which then use those elements in providing competitive local telephone service. 47 U.S.C. §§ 251(c)(3) & 251(d)(2). The issues here concern inputs to the prices for SBC's unbundled local loops.

B. The FCC's TELRIC pricing methodology.

The 1996 Act requires state utility commissions to set the prices for unbundled network elements. 47 U.S.C. § 252(d)(1). In doing so, state commissions must apply the FCC's "total element long-run incremental cost" ("TELRIC") pricing methodology, which the FCC established to implement the 1996 Act. 47 C.F.R. §§ 51.505-51.511; *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 385 (1999). TELRIC is a "forward-looking" methodology that seeks to establish prices that "replicate[], to the extent

possible, the conditions of a competitive market.”² The theory is that such prices will send the correct economic signals to promote efficient competitive entry. *Local Competition Order* ¶¶ 679, 685; *TELRIC NPRM* ¶¶ 2-3.³ In order to approximate competitive conditions, TELRIC requires state commissions to set prices for unbundled network elements based on the costs the incumbent LEC would incur if, using the most efficient equipment and configurations available today, it built a new network to serve foreseeable demand⁴ in its service territory. 47 C.F.R. § 51.505(b); *Local Competition Order* ¶ 685.

The courts and FCC have emphasized that “TELRIC is not a specific formula,” but rather is a collection of “methodological principles.” *AT&T Corp. v. FCC*, 220 F.3d 607, 615-16 (D.C. Cir. 2000). Accordingly, “enormous flexibility [is] built into TELRIC,” leaving the states “wide latitude” and “considerable play in the joints.” *Id.*; *Sprint Comms. Co. v. FCC*, 274 F.3d 549, 556 (D.C. Cir. 2001); *AT&T Comms. of Illinois, Inc. v. Illinois Bell Tel. Co.*, 349 F.3d 402, 405 (7th Cir. 2003). This means that for any given input there will be a “range of reasonable answers” that can comply with TELRIC. *AT&T Comms.*, 349 F.3d at 405; *WorldCom, Inc. v. FCC*, 308 F.3d 1, 7 (D.C.

² *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd. 15499 ¶ 679 (1996) (“*Local Competition Order*”) (subsequent history omitted).

³ *Review of the Commission’s Rules Regarding the Pricing of Unbundled Network Elements*, 18 FCC Rcd. 18945 (2003) (“*TELRIC NPRM*”). The *TELRIC NPRM* is a notice of proposed new TELRIC rules. The portions of the NPRM cited by SBC, however, reflect the FCC’s statement of the law as it exists today.

⁴ *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, 18 FCC Rcd. 16978 (2003) as modified by *Errata*, 18 FCC Rcd. 19020 ¶ 670 (“*TRO*”) (subsequent history omitted).

Cir. 2002) (“TELRIC is not a single rate but a ratemaking methodology that may yield a rather broad range of rates.”). TELRIC cases “are extremely complex” and “the issues at stake [are] ones involving a high level of technical expertise in an area of rapidly changing technological and competitive circumstances.” *TELRIC NPRM* ¶ 6; *Sprint Comms.*, 274 F.3d at 556.

C. The Commission’s Order.

After the FCC required SBC to unbundle its loops in 1996, the Commission conducted its first TELRIC pricing proceeding, Docket Nos. 96-0486/0569, and issued a final decision in 1998. That decision established nearly the lowest unbundled loop prices in the country. In late 2002, SBC filed for an increase.

SBC presented detailed cost studies and extensive testimony in support of the new prices. The Commission’s Staff and numerous CLECs and consumer groups responded with lengthy testimony of their own. The proceeding ultimately involved thousands of discovery responses concerning SBC’s costs, thousands of pages of prefiled testimony, a full week of live cross-examination, and five rounds of legal briefs. *Order* at 2-5.

In its 299-page Order, the Commission granted SBC a moderate rate increase. The Commission specified that these new rates would be available only to CLECs that enter into (or previously had entered into) interconnection agreements with SBC. *Id.* at 293-94. This matched the terms of SBC’s agreements with the CLECs in this case, each of which required incorporation of the new prices. SA2, 14, 17, 23.⁵

⁵ Citations to “SA__” are to SBC’s Separate Appendix.

D. The District Court's Decision.

Both SBC and certain CLECs challenged the Order in district court. With respect to the claims the CLECs raise here, the district court first rejected their theory that the Order unlawfully bypassed the procedures used to establish interconnection agreements under the 1996 Act. The court held that (i) the FCC's *Local Competition Order* allows UNE rates to be set in such generic, industry-wide proceedings; (ii) the CLECs had agreed during the Commission proceeding that "a generic pricing docket is permissible under the Telecommunications Act"; and (iii) the new prices would be available only to CLECs that entered new interconnection agreements or incorporated them into existing agreements, and nothing in the Commission's order prevents a CLEC from seeking to negotiate different prices. *Decision* at *11-14.

The district court also rejected the CLECs' argument that the fill factors adopted by the Commission were arbitrary and capricious. A fill factor measures the spare capacity an efficient carrier would maintain in a TELRIC network. *AT&T Comms.*, 349 F.3d at 411. SBC proposed to use its current actual fill factors as the best estimate of forward-looking fill factors. The Commission, however, found that fill levels would be higher in a forward-looking network due to increased efficiency, and thus required SBC to use higher fills. *Order* at 67. This benefited CLECs by lowering the final loop rates, since higher fills lead to lower prices. Nevertheless, the CLECs claimed that the Commission's adjustments were arbitrary. The district court disagreed, holding that the Commission's decision was supported by substantial evidence and a deliberate, principled reasoning process. *Decision* at *22-23.

The next issue involved depreciation lives, which are the number of years over which a given piece of equipment will be depreciated. The FCC has stated that depreciation lives based either on a company's financial reporting depreciation lives or on the FCC's prescribed lives for "universal service" funding⁶ purposes can be acceptable under TELRIC. *TRO* ¶ 688; *TELRIC NPRM* ¶ 96. The Commission adopted SBC's financial reporting lives. *Order* at 77. The CLECs claimed that this finding was unsupported. The district court disagreed, explaining that the Commission had weighed the competing expert evidence on depreciation and applied a deliberate, principled reasoning process to support its conclusion. *Decision* at *30.

SBC challenged the Commission's decision on the capital structure aspect of its overall cost of capital. SBC argued that Commission violated TELRIC by adopting a capital structure (the relative percentages of debt and equity in SBC's hypothetical capitalization) that did not account for increased competitive risks in the hypothetical competitive market that TELRIC assumes. The district court agreed and reversed the Commission on this legal point. *Id.* at *41.

The CLECs appeal these four rulings. SBC has cross-appealed one issue, which is addressed separately *infra*.

Summary of Argument

Preemption. The CLECs' contention that the Commission's Order establishing rates for SBC's unbundled loops is inconsistent with the 1996 Act and the FCC's implementing rules is a red herring. To begin with, each of the parties to this appeal

⁶ The FCC's universal service program requires carriers to pay into a fund to ensure telephone service is widely available. 47 U.S.C. § 254.

expressly *agreed* in their Section 252 interconnection agreements that the Commission would set prices in future generic pricing proceedings and that the rates established in those proceedings would be incorporated into their agreements. Under federal law, having agreed to such procedural arrangements in their binding, Commission-approved agreements, the CLECs may not now renege on that commitment simply because they do not like the prices set by the Commission. In any event, even if the parties had not so agreed, the Order is fully consistent with federal law because (i) the Commission proceeding that gave rise to the Order was authorized by, and consistent with, the 1996 Act and the FCC's implementing rules and (ii) the prices established in that Order are available only to CLECs that have Section 252 interconnection agreements with SBC.

Fill factors. The FCC prescribes no specific fill factors, TELRIC provides no formula for computing fill factors, and the FCC has approved a wide range of fills as TELRIC-compliant. The CLECs claim that the Commission's fill-factor ruling was arbitrary, but the Commission simply did what it was supposed to do, thoroughly evaluating the competing proposals and adopting a considered estimate of forward-looking fills. This is the same course followed by several neighboring commissions, and was not arbitrary and capricious.

Depreciation. The FCC has found that financial reporting depreciation lives can satisfy TELRIC. After reviewing battling expert testimony, the Commission adopted such lives (as have many other commissions) and explained its rationale. The CLECs' claim that this decision was arbitrary ignores the record, and their assertion that financial reporting lives must meet a special evidentiary burden has no legal support.

Cost of capital. The district court correctly reversed the Commission on this legal issue. TELRIC requires a cost of capital to reflect the increased risks of the competitive market that TELRIC assumes. The Commission, however, adopted a capital structure based on only limited competition. TELRIC precludes such an approach, as several courts have held.

Argument

I. Standard of Review.

The Commission's legal conclusions are reviewed *de novo*. *Indiana Bell Tel. Co. v. McCarty*, 362 F.3d 378, 383 (7th Cir. 2004). The Commission's factual determinations are reviewed under the arbitrary and capricious standard, which requires deference to the Commission because it "has a substantial body of expertise in the area of rate-setting and because of the flexibility built into the [TELRIC] method." *TDS Metrocom, LLC v. Bridge*, 387 F.Supp.2d 935, 939 (W.D. Wis. 2005). The fill factor and depreciation issues are factual. The preemption and capital structure issues involve questions of law.

II. The CLECs' Preemption Argument Is Without Merit.

A. The Parties' Section 252 Interconnection Agreements Require Incorporation of New Prices Established in Generic Commission Pricing Dockets.

Under Section 252 of the 1996 Act, any CLEC seeking access to an incumbent carrier's network may request an opportunity to negotiate an interconnection agreement. 47 U.S.C. § 252(a). Section 252 interconnection agreements are "the vehicles chosen by Congress to implement the duties imposed in § 251" of the 1996 Act and they are

“federally mandated agreements.” *Verizon Maryland, Inc. v. Global Naps, Inc.*, 377 F.3d 355, 364 (4th Cir. 2004). Section 252 “sets up a preference for negotiated interconnection agreements.” *AT&T Corp.*, 525 U.S. at 405 (Thomas, J., concurring in part and dissenting in part). Only if the parties cannot reach a negotiated agreement on all of the terms of their agreement does the state commission step in to arbitrate “open issues.” 47 U.S.C. § 252(b)(1). After all of the terms are set, either through negotiation or arbitration, the agreement must be presented to the state commission for approval. 47 U.S.C. § 252(e)(1)-(2). “Once the agreement is approved, the 1996 Act requires the parties to abide by its terms.” *Verizon Maryland*, 377 F.3d at 364.

Each of the CLECs in this appeal availed itself of the opportunity either to negotiate with SBC to form a Section 252 interconnection agreement or to adopt a previously approved agreement. Each party subsequently entered into an agreement, which the Commission approved. Each of those Commission-approved agreements contains a negotiated provision that specifically addresses UNE rates. As the CLECs represented to the Commission:

Typically, those interconnection agreements provide that if the Commission enters an order setting new rates of general applicability for services and products covered by the interconnection agreement, the agreement will be amended to incorporate those new prices. Thus, the agreements recognize, in essence, that UNE prices will be set (or updated) in Commission proceedings of general applicability (of which this is one), *rather than on individual bases for each CLEC in its interconnection negotiation or arbitration with SBC.* [SA28 (emphasis added)].⁷

⁷ All four CLEC appellants in this case were appellees and filed a joint brief in the prior, related appeal in *AT&T Comms.*, 349 F.3d 402. All but Mpower participated, and filed joint comments, in the proceedings on remand to the Commission that led to the Order challenged here. Excerpts from the opening and reply comments in that proceeding are in SBC’s Separate Appendix.

In fact, SBC's agreements with each of the CLECs in this appeal mandate the incorporation of new Commission-established rates into the parties' interconnection agreements. For example, SBC's agreement with Mpower provides:

Certain of the rates, prices and charges set forth in the applicable Appendix Pricing have been established by the appropriate Commissions in cost proceedings or dockets initiated under or pursuant to the Act. If during the Term that Commission or the FCC changes a rate, price or charge in an order or docket that applies to any of the Interconnection, Resale Services, Network Elements, functions, facilities, products and services available hereunder, the Parties agree to amend this Agreement to incorporate such new rates, prices and charges, with such rates, prices and charges to be effective as of the date specified in such order or docket (including giving effect to any retroactive application, if so ordered). [SA2, § 2.11.3].

See also SA14, Forte-SBC Agreement § 2.11.3 (“Certain of the rates, prices and charges set forth in the applicable Appendix Pricing have been established by the appropriate Commissions in cost proceedings or dockets initiated under or pursuant to the Act. If during the Term that Commission or the FCC changes a rate, price or charge in an order or docket that applies to any of the Interconnection, Resale Services, Network Elements, functions, facilities, products and services available hereunder, the Parties agree to amend this Agreement to incorporate such new rates, prices and charges, with such rates, prices and charges to be effective as of the date specified in such order or docket (including giving effect to any retroactive application, if so ordered”); SA17, Cimco-SBC Agreement § 2.11.3 (“Certain of the rates, prices and charges set forth in the applicable Appendix Pricing have been established by the appropriate Commissions in cost proceedings or dockets initiated under or pursuant to the Act. If during the Term that Commission or the FCC changes a rate, price or charge in an order or docket that applies to any of the Interconnection, Resale Services, Network Elements, functions, facilities,

products and services available hereunder, the Parties agree to amend this Agreement to incorporate such new rates, prices and charges, with such rates, prices and charges to be effective as of the date specified in such order or docket (including giving effect to any retroactive application, if so ordered”); SA23, XO-SBC Agreement § 28.4 (“In the event that any of the rates, terms, and conditions herein . . . are invalidated, modified or stayed by any action of any state or federal regulatory or legislative bodies . . . the affected provisions shall be immediately invalidated, modified, or stayed, consistent with the action of the legislative body, court, or regulatory agency”).

Both the language of the CLECs’ contracts and their course of conduct prior to the Commission’s Order belie their contention that the Commission’s procedures somehow violate federal law. If the CLECs had any qualms about the legality of such procedures, they had ample opportunity to raise such concerns. Instead, the CLECs consistently agreed to – and, indeed, endorsed in this Court and in the Commission (*see* SA26, SA28-30) – the propriety of the very proceeding at issue here. Thus, it is not surprising that after this Court ordered SBC to submit a supplemental brief in which SBC explained that the parties’ interconnection agreements provided for incorporation of rates established in future Commission consolidated rate proceedings, the Court directed the Commission to reinstate the generic proceeding that had been abated and to “proceed to decision as expeditiously as possible.” *AT&T Comms.*, 349 F.3d at 411.

In sum, each of the parties to this appeal expressly *agreed* in their Section 252 interconnection agreements to revise outdated UNE rates by incorporating the results of consolidated pricing orders into their existing arrangements. As a result, the CLECs cannot deny that the *parties themselves*, acting squarely *within the Section 252 process*,

endorsed the very procedures used by the Commission to establish UNE rates as consistent with the 1996 Act.

B. The Commission Docket and Order Are Fully Consistent with the FCC's Rules and This Court's Prior Decisions.

As demonstrated above, the fact that the parties to this appeal *agreed* in their Commission-approved Section 252 interconnection agreements to be bound by the rates established by the Commission in future generic ratemaking proceedings definitively refutes the CLECs' contention that the proceedings giving rise to the Commission Order were inconsistent with the 1996 Act. But even absent those agreements, the CLECs' preemption argument would be wrong, because the Commission docket and Order are fully consistent with the FCC's rules and this Court's prior decisions.

1. The Supreme Court repeatedly has recognized that the FCC's broad authority to "prescribe such rules and regulations as may be necessary in the public interest" extends to "implementation of the local-competition provisions" of the 1996 Act. *AT&T Corp.*, 525 U.S. at 377-78; *see also Verizon Communications, Inc. v. FCC*, 535 U.S. 467, 501-23, 539 (2002) (upholding FCC's authority to choose TELRIC methodology that state commissions must follow in setting UNE rates); *cf. Permian Basin Area Rate Cases*, 390 U.S. 747, 790 (1968) ("We must reiterate that the breadth and complexity of the Commission's responsibilities demand that it be given every reasonable opportunity to formulate methods of regulation appropriate for the solution of its intensely practical difficulties"). Indeed, both in *AT&T Corp.* and in *Verizon*, the Court rejected numerous challenges to the FCC's authority to promulgate "rules to guide the state-commission judgments," including with respect to the FCC's "jurisdiction to

design a pricing methodology.” *AT&T Corp.*, 525 U.S. at 385. *Accord Verizon*, 535 U.S. at 494-95.

In its role as the primary expositor of the general procedural and substantive requirements of the 1996 Act, *see AT&T Corp.*, 525 U.S. at 378-84, the FCC not only established TELRIC as the methodology for the computation of UNE rates, but also gave guidance concerning the types of proceedings that state commissions could employ to set TELRIC-compliant rates. In particular, as the district court correctly held, *Decision* at *7-9, the FCC placed its imprimatur on the type of proceeding that the Commission used to set the prices at issue in this appeal.

As the FCC recognized, “[t]he prices of interconnection and unbundled elements, along with prices of resale and transport and termination, are critical terms and conditions of any interconnection agreement.” *Local Competition Order* ¶ 618. If parties cannot reach a negotiated agreement with respect to the price terms of their agreement, “states must set prices for interconnection and unbundled network elements based on the forward-looking, long-run, incremental cost methodology we describe below” and must do so “[i]n arbitrations of interconnection agreements, or in *rulemakings* the results of which will be applied in arbitrations.” *Id.* ¶ 620 (emphasis added); *id.* ¶ 693 (“States may review a TELRIC economic cost study in the context of a particular arbitration proceeding, or *they may conduct such studies in a rulemaking and apply the results in various arbitrations involving incumbent LECs*”) (emphasis added). The FCC’s rules expressly and unambiguously authorized such generic rate proceedings, stating that a state commission may set rates if it “has given full effect to the economic cost based pricing methodology” under the Act “in a state proceeding that meets the requirements of

paragraph (e)(2) of this section,” which requirements include “notice and an opportunity for comment to affected parties” and “the creation of a written factual record that is sufficient for purposes of review.” 47 C.F.R. § 51.505(e)(1)-(2). In short, as the CLECs previously told this Court, “[t]he FCC’s rules allow states . . . to conduct a ‘rulemaking’ in which rate issues common to multiple arbitrations are decided in this consolidated proceeding and in which the ‘results’ (final rates) are then applied in ‘various arbitrations.’” SA26.

Since the inception of the 1996 Act, UNE prices in Illinois (and every other state of which we are aware) have been established through consolidated proceedings as authorized by the FCC’s Rules. In reviewing that history in its opening brief on remand from this Court, the CLECs explained that

SBC’s initial UNE rate case following enactment of the Telecommunications Act of 1996, Dockets 96-0486 & 96-0569 (Cons.), reflected recognition by SBC, CLECs, and this Commission that setting prices for UNEs in each individual SBC-CLEC interconnection agreement negotiation and/or arbitration was impractical – due both to the multiplicity of proceedings and the severe time constraints of the Section 252 process – and that a generic approach was needed. [SA29].

See also Verizon, 535 U.S. at 471 (“TELRIC rate proceedings are surprisingly smooth-running affairs, with incumbents and competitors typically presenting two conflicting economic models supported by expert testimony, and state commissioners customarily assigning rates based on some predictions from one model and others from its counterpart”). The same was true for the subsequent UNE rate case, Commission Docket 02-0864, that gave rise to this federal case. In that case, the CLECs fully concurred with SBC that the 02-0864 proceeding was “*permissible under the Telecommunications Act.*” SA32 (emphasis added); SA28. The Commission agreed, noting that “this is

substantively a proceeding to establish UNE prices under Section 252 of [the 1996 Act] and the FCC’s TELRIC pricing rules,” *Order* at 9, and observing that “there was consensus among the parties that the Commission could move forward with this proceeding as a generic rate investigation under the [1996 Act],” *id.* at 291-92.

As the district court held (*Decision* at *7-9), the rules promulgated under the FCC’s broad authority to implement the local competition provisions in Sections 251 and 252 of the 1996 Act – in particular, paragraph 693 of the *Local Competition Order* and FCC Rule 51.505(e)(1)-(2) – provide ample basis for the generic UNE ratemaking proceeding that the parties’ interconnection agreements contemplated and that the Commission undertook after giving all parties notice and an opportunity to participate. The time for challenging those rules under the Hobbs Act (28 U.S.C. § 2342) has long since passed, and those rules accordingly are not subject to collateral attack by the CLECs at this time and in this Court. *See FCC v. ITT World Comms., Inc.*, 466 U.S. 463, 468 (1984). And there is not one iota of support for the CLECs’ inexplicable contention (at 22-23) that paragraph 693 of the *Local Competition Order* and Rule 51.505(e)(1)-(2) somehow must be read as confined to Section 252(g) of the 1996 Act.⁸ To begin with, nothing in either paragraph 693 or Rule 51.505(e)(1)-(2) makes any reference whatsoever to Section 252(g), and the FCC’s general rulemaking power to implement Sections 251

⁸ While the district court held that the generic proceeding at issue here was fully authorized by paragraph 693 and Rule 51.505(e)(2), it also determined that the proceeding was not authorized by Section 252(g). *Decision* at *8. Even if that latter determination were correct, it in no way undermines the district court’s dispositive holding regarding paragraph 693 and Rule 51.505(e)(2) (*see id.* at *7-9), as we explain in the text above. Interestingly, the CLECs themselves apparently do not agree with the district court about Section 252(g). As they told the district court in the *AT&T Comms.* case in a brief adopted by all of the appellants here, generic ratemaking proceedings such as the one at issue here are “authorized by Section 252(g).” SA26b.

and 252 of the Act provides more than ample authority to promulgate procedures for establishing loop rates. *See Verizon*, 535 U.S. at 494-95, 501-02; *AT&T Corp.*, 525 U.S. at 378-85. Moreover, the CLECs' suggestion is completely contrary to the language and structure of Rule 51.505(e)(1)-(2), which clearly contemplates – and provides independent authorization for – generic “notice and comment” proceedings that are subject to judicial review. And neither paragraph 693 nor Rule 51.505(e)(1)-(2) in any way suggests that the validity of the “proceedings” authorized by the FCC turns in any way on the how those proceedings are characterized – that is, whether they are labeled “tariff” proceedings or something else – as a matter of state law.

2. The CLECs' attempt (at 18-19) to manufacture a conflict between the procedures employed by the Commission and the procedures approved by this Court in *Wisconsin Bell, Inc. v. Bie*, 340 F.3d 441 (7th Cir. 2003) is misplaced. The fundamental holding of *Bie* is that a state commission may not “bypass the federally ordained procedure[s]” for creating access and interconnection rights and obligations set forth in Section 252 of the 1996 Act. *Id.* at 442-45. In *Bie*, this Court invalidated a state commission order that completely bypassed the 1996 Act by establishing a set of free-standing obligations, implemented through a state tariff, without any negotiation or arbitration, and without even requiring carriers to have an interconnection agreement. *Id.* As the Court explained, the commission order circumvented the “procedures established by the federal act” by “authorizing a parallel proceeding” and raising the specter of an appeal “to a state court – even though Congress, in setting up the negotiation procedure, explicitly excluded the state courts from getting involved in it.” *Id.* at 444.

Here, by contrast, the Commission acted entirely within the Section 252 process in establishing the rates at issue. Each of the parties in this case already had progressed through the negotiation and arbitration phases and had a Commission-approved interconnection agreement with SBC before the Commission commenced the proceeding that gave rise to the Order challenged here. In those Commission-approved Section 252 interconnection agreements, the CLECs agreed that future rate changes resulting from consolidated pricing proceedings before the Commission would flow automatically into their Section 252 agreements. Thus, the Commission pricing docket not only adhered to the procedures expressly authorized in ¶ 693 of the FCC’s *Local Competition Order* and FCC Rule 51.505(e)(1)-(2), but actually carried out the express terms of the parties’ Commission-approved interconnection agreements. Moreover, as the Commission noted, its pricing proceeding “concern[ed] only a question of federal law” – namely, which prices and inputs best comply with the federal TELRIC standard. *Order* at 294. The ensuing Order thus would be reviewable “by federal courts and only federal courts,” *id.*, thereby avoiding *Bie*’s concern over state commission orders evading federal review.

The CLECs’ suggestion of inconsistency between SBC’s prior advocacy in *Bie* and its position in this case is mistaken. As the excerpt from SBC’s brief in *Bie* that the CLECs quoted in their brief states, “*there are no exceptions to the section 252 process.*” CLEC Br. at 17. This Court has agreed. *Indiana Bell Tel. Co. v. Indiana Utility Reg. Comm’n*, 359 F.3d 493, 497-98 (7th Cir. 2004); *Bie*, 340 F.3d at 445. And, applying that principle here, the Commission proceeding giving rise to this case was *part of* the Section 252 process and the Order challenged here imposed no obligations that deviate from that process.

The Commission's Order likewise does not conflict in any respect with this Court's decision in *Indiana Bell*. In that case, the Court invalidated a state commission order that made an "end run around the Act" by "impos[ing] on [SBC] unnegotiated obligations" for the provision of local service that were available to SBC's competitors without regard to "the process for interconnection agreements for local service under sections 251 and 252." 359 F.3d at 497-98.

Here, unlike in *Indiana Bell*, the Commission's Order does not make an "end run" around the federally authorized procedures. The use of a consolidated pricing docket was both approved by the FCC and expressly contemplated by the terms of the parties' Section 252 interconnection agreements. And the validity of such a consolidated docket under federal law is in no way affected by the CLECs' repeated characterizations of the docket as a so-called "tariff" proceeding under state law. The FCC was silent with respect to the particular state law mechanisms that could be used to set generic prices, except for requiring "notice and an opportunity for comment" and the compilation of a "written factual record," 47 C.F.R. § 51.505(e)(2), – both of which the Commission indisputably honored. Thus, not surprisingly, the CLECs advised the Commission that "nothing in *Bie* or otherwise prevents this case from proceeding as a review of SBC's proposed UNE tariffs to consider whether SBC's existing UNE tariffs should remain in effect or be revised, and (if supported by the record) to establish new UNE tariffed rates (whether higher or lower than the current rates) – which would then be incorporated into existing interconnection agreements per the terms of those agreements." SA30.

This Court's decision in *AT&T Comms.* confirms that the Commission's proceeding does not constitute an "end run" around the 1996 Act. That case involved a

challenge to an Illinois statute that abated the very Commission Docket that gave rise to the Order at issue here. 349 F.3d at 408. This Court affirmed a district court order enjoining the statute on the ground that it conflicted with TELRIC pricing rules. *Id.* at 411. And having been advised that the parties' interconnection agreements provided for incorporation of rates established in future Commission consolidated rate proceedings, this Court directed the Commission "to reinstate the proceeding in its Docket 02-0864, which the state law had terminated, and *to proceed to decision as expeditiously as possible.*" *Id.* (emphasis added). The Court further admonished the Commission to act "speedily," because "a rate that is long out of date, as this 1997 rate is, frustrates the goals of TELRIC every bit as much as does a rate generated under the flawed state legislation." *Id.* *AT&T Comms.* thus reaffirms that (i) state proceedings must be consistent with Section 252, and (ii) the pricing proceeding in Commission No. 02-0864 satisfied that test.

In view of this Court's disposition in *AT&T Comms.*, it is telling that the CLECs did not request rehearing to press their current theory that the case should have been remanded to permit the parties to commence carrier-specific pricing negotiations. Nor did the CLECs ever take the position on remand in the Commission that federal law precluded the Commission from setting prices for all carriers in a generic pricing docket. To the contrary, the CLECs expressly "accept[ed] SBC's characterization of this proceeding as a generic pricing docket that is *permissible under the Telecommunications Act*" and agreed that "this proceeding is *not precluded by Bie.*" SA32 (emphasis added).⁹

⁹ In fact, the only procedural reservation articulated by the CLECs in its briefs in the Commission – that the Commission proceeding should not be treated as "a tariff

It was not until the Commission approved higher prices for SBC's loops that the CLECs objected to the Commission's procedures.

The CLECs complain that the "practical result" of the Commission proceeding and Order is that the price that "the Commission found was appropriate" will be reflected in existing and new interconnection agreements. CLEC Br. at 19-22. But that result is neither surprising nor unlawful. Indeed, the fact that each of the parties here *agreed* to have their UNE rates automatically updated on the basis of future Commission rate proceedings provides strong evidence that the parties believed that a process in which the Commission set rates on a global basis, after notice and an opportunity to comment by all interested parties, was the only reasonable way to proceed. Given that the actual Commission-established prices must comply with the controlling federal TELRIC pricing standard, the notion that rates (or other terms and conditions) that have been approved by a state commission would be used in existing or future agreements is hardly objectionable.

Finally, as this Court stressed in *AT&T Comms.*, carriers are entitled at all times to rates that comport with federal law. 349 F.3d at 411. Accordingly, rates that are "out of date" must be "updated" in a timely fashion. *Id.* The reality is that if the updated rates established here had favored the CLECs, they would have adhered to their prior position that generic rate proceedings are entirely consistent with the Act's procedural requirements. It is only because the new rates disappointed the CLECs that they are grasping at straws to find ways of undoing those rates.

investigation and suspension under Section 9-201 of the [Illinois Public Utilities] Act" (*id.*) – concerned a matter of state law that is not at issue in this appeal. SA32.

In sum, the CLECs' tariff preemption "Hail Mary" must fail. The Commission's Order used FCC-authorized procedures to set rates that will be incorporated into previously negotiated, arbitrated, and approved Section 252 interconnection agreements – and, in particular, agreements that by their terms contemplate revision in future state commission rate proceedings – and thus obviously does not evade the Act's procedures. To the contrary, the Commission worked within the Section 252 process, giving effect to the negotiated provisions of the parties' agreements to establish rates that are to be used exclusively in Section 252 interconnection agreements, and it did so in an Order that is reviewable only in federal court.

III. The District Court Correctly Affirmed the Commission's Fill Factor Ruling.

One cost model input under TELRIC is a "fill factor," which measures the spare capacity an efficient provider would maintain in a newly constructed network. *See AT&T Comms.*, 349 F.3d at 405. Maintaining substantial spare capacity is necessary because "[a]ny sensible carrier builds more network capacity than can be used at the moment; that way capacity will be available as additional customers demand service, without waiting for the arrival of new equipment, excavating streets to lay new wire, and so on." *Id.* at 405. Because it is impossible to instantly reconstruct SBC's entire network, TELRIC fill factors are not directly observable. So the Commission, in its expert judgment based on the record before it, started with the current, actual fills of SBC's network and then made adjustments to reflect its projection of fills in a TELRIC network. *Order* at 67. As the district court held, that is not arbitrary or capricious.

This court has explained that TELRIC does not prohibit the use of current fills: “If SBC’s current fill factors are the efficient ones (or are within the range that a student of the subject might think a reasonable estimate of that figure), then they are exactly the right figures to use.” *AT&T Comms.*, 349 F.3d at 411. SBC demonstrated before the Commission that its “current fill factors are the efficient ones” because they are the result of the same efficient engineering practices and regulatory conditions that would exist in any forward-looking network. *See, e.g.*, SA305-311, 387-405, 411-415, 429-437.

The Commission, however, did not adopt SBC’s actual fills. Instead, it concluded that adjustments were required because SBC’s actual fills reflect “ex post inefficient capacity” – *i.e.*, spare capacity that may have been efficiently deployed but, “due to imperfect forecasts or changed circumstances,” turns out to be unnecessary. *Order* at 62. To account for such “innocent mistakes,” the Commission adopted its Staff’s recommendation to reduce SBC’s actual distribution and feeder plant capacities by 15% and 7.5%, respectively. *Id.* at 63. This increased SBC’s fill factors and thus decreased the ultimate loop prices.

A. The Commission’s Adjustment Was Not Arbitrary.

The CLECs admit (at 27) that the record supports the “concept” of adjusting SBC’s actual fills, but suggest that the particular “15% and 7.5% figures” chosen by the Commission are arbitrary and capricious because they are not the result of a “specific calculation.” The CLECs are wrong.

Staff witness Dr. Liu proposed the percentage adjustments adopted by the Commission, and presented testimony to support them. *See Order* at 57-58, 67. Dr. Liu testified at length regarding the alleged flaws of SBC’s and the CLECs’ fill proposals,

e.g., SA224-278, including the alleged “ex post inefficient components” of SBC’s current fills. SA206-222, 224-279. Staff concluded that those inefficiencies could not be directly measured, so instead recommended adjustments based on certain “general principles.” SA213-218, 278-279.

The lack of a “specific calculation” for Staff’s adjustments does not make the Commission’s decision arbitrary and capricious, for “TELRIC does not contain an algorithm for determining the fill factor.” *AT&T Comms.*, 349 F.3d at 405. Rather, the FCC requires only “‘reasonably accurate’ estimates” and has “‘accepted a wide range of fill factors as consistent with TELRIC principles’”; thus, “state commissions have discretion to select fill factors from a range of appropriate percentages.” *TDS Metrocom*, 387 F.Supp.2d at 943-44. This discretion includes making upward adjustments from actual fills. *See* SA50, 58, 66 (other states adopting various increases to SBC’s actual fills). For example, the FCC upheld a Georgia commission decision to increase the incumbent’s actual fills by 5% in order to satisfy TELRIC. *Georgia 271 Order*, 17 FCC Rcd. 9018, ¶¶ 69-70 (2002).

There was ample support for the Commission’s adoption of Staff’s adjustments. As the Commission explained, it lacks “comprehensive information about all future network demand,” and therefore must “predict and estimate” forward-looking fills. *Order* at 60. Moreover, “[a]s a practical matter, this projection is difficult to construct from existing data.” *Id.*; *see Bie*, 340 F.3d at 445 (TELRIC requires state commissions to make “stabs in the dark” when predicting future network usage). Because “[t]he only hard numbers are SBC’s actual network fills,” the Commission concluded that it would adjust SBC’s actual fills to account for “ex post inefficient capacity.” *Id.* at 60, 62.

Recognizing that it would be infeasible to “examin[e] . . . every segment of SBC’s network for each network component” and “compar[e] old forecasts and assumptions regarding future demand against the realizations of these forecasts,” the Commission approved Staff’s reliance on guiding principles to make reasonable adjustments to SBC’s actual fills. *Id.*

In short, the Commission applied the TELRIC framework using a deliberate, principled reasoning process, and did its best to project, based on the evidence before it, a hypothetical, forward-looking fill for a network that does not actually exist. That determination was supported by detailed Staff testimony, *Order* at 57-58, and was neither arbitrary nor capricious.

B. The Commission Had No Duty to Adopt “Target” Fills.

The CLECs also claim (at 24, 27) that the Commission did not sufficiently explain its decision to depart from the “target” fills adopted in its 1998 TELRIC decision. They are wrong. The 1998 decision “did not determine that target fill must be used in future rate proceedings”; indeed, it held that “target fills are not synonymous with the fill level achieved in an efficient, forward looking network.” *Order* at 59, 64. The Commission adopted target fills in 1998 only because it was the better of two options presented, neither of which was based on actual fills. *Id.* at 59. On the more robust record and different proposals here, including those based on actual fills, the Commission expressly rejected target fills and took a new approach. *Id.* at 62-64. There is nothing arbitrary or capricious about that. *See TDS Metrocom*, 387 F.Supp.2d at 944-45 (approving decision to adopt new fill factors even though commission had previously used target fills). The Commission is not bound by its prior decisions and has the “power

to deal freely with each situation as it comes before it, regardless of how it may have dealt with a similar or the same situation in a previous proceeding.” *City of Chicago v. People of Cook County*, 478 N.E.2d 1369, 1373 (1st Dist. 1985).

C. It is Appropriate for TELRIC Fills to Include Foreseeable Demand.

Next, the CLECs (at 28) claim that while the Commission adopted fills that include spare capacity “to meet future demand,” *Order* at 59, “the FCC” has “rejected that approach.” That claim fails as a matter of law.

First, the CLECs did not make this argument in the district court and thus have waived it. *Kelso v. Bayer Corp.*, 398 F.3d 640, 643 (7th Cir. 2005).

Second, far from “rejecting” fills that include spare capacity to meet future demand, the FCC has made clear that TELRIC *requires* fills to include such spare capacity. The FCC has stated that its TELRIC rules “provide[] no guidance to state commissions on this specific issue [of fill factors] beyond the general requirement that the network should be *sized to meet reasonably foreseeable demand*.” *TELRIC NPRM* ¶ 73 (emphasis added); *id.* ¶ 18 (TELRIC “assumes that the relevant increment of output is all current and reasonably projected future demand”).

Third, the decisions the CLECs cite are inapposite. They rely on the FCC’s Wireline Competition Bureau’s decision in the *Virginia Arbitration Order*.¹⁰ That decision adopted fills based on the approach in the FCC’s *Inputs Order*,¹¹ which did not require fills to account for future demand. The *Inputs Order*, however, addressed costing

¹⁰ *Petition of WorldCom, Inc.*, 18 FCC Rcd. 17722 (Wireline Competition Bureau 2003) (“*Virginia Arbitration Order*”).

¹¹ *Federal-State Joint Board on Universal Service*, 14 FCC Rcd. 20156 (1999) (“*Inputs Order*”).

for universal service funding purposes, *not* TELRIC pricing. Hence, the *Inputs Order* itself warns (§ 32) that “[t]he federal cost model was developed for the purpose of determining federal universal service support and it may not be appropriate to use nationwide values for other purposes such as determining prices for unbundled network elements.” *See AT&T Corp.*, 220 F.3d at 619 (rejecting attempt to apply *Inputs Order* to TELRIC rates); *Kansas 271 Order*, 16 FCC Rcd. 6237, § 84 (2001) (universal service pricing inputs “should not be relied upon to set rates for UNEs”). While the Bureau ignored the FCC’s directives and applied the *Inputs Order*’s holding to fills in the *Virginia Arbitration Order*, the FCC subsequently reiterated that it “discourage[d]” states from relying on the *Inputs Order* model in TELRIC cases because doing so could have “unintended and undesirable consequences.” *TELRIC NPRM* §§ 46-47. Thus, the CLECs’ reliance on the *Inputs Order* violates the FCC’s directions.

D. The Price-Squeeze Claim Has No Legal or Record Support and Has Already Been Litigated and Rejected in a Subsequent Proceeding.

Finally, the CLECs assert (at 28-29) that the Commission’s use of “markedly different fill factors for wholesale and retail rates” creates “an arbitrary and capricious ‘price squeeze’ between the wholesale rates SBC charges CLECs, and the rates it charges to its own retail customers.” The district court properly rejected this “undeveloped argument” as having no legal or record support. *Decision* at *24-25.

First, using different fills for retail and UNE rates does not create a price squeeze. Fill factors are but one of the numerous inputs that are used to develop actual rates. Accordingly, the use of different fill factors alone cannot constitute a price squeeze.

Moreover, it is no surprise that the fills used for retail service and wholesale unbundled loop rates are different, because they are set using different standards.

“Congress called for [TELRIC] ratemaking [to be] different from any historical practice” and required “that [TELRIC] rates be set ‘without reference to a rate-of-return or other rate-based proceeding,’ [47 U.S.C. § 252(d)(1)(A)(i)].” *Verizon*, 535 U.S. at 488-89. Indeed, Illinois law establishes a different standard for the fill factors used to establish retail rate floors than the fill factor standard mandated by TELRIC. Illinois’ retail “Cost of Service” rules require that retail studies be based on “utilization factors” that measure “usable capacity,” which is defined as the “maximum physical capacity of the equipment or resource less any capacity required for maintenance, testing or administrative purposes,” thus excluding capacity efficiently deployed for future demand. 83 Ill. Adm. Code §§ 791.70(d) & 791.20(n). Federal law, by contrast, requires that TELRIC fill factors reflect a network “sized to meet reasonably foreseeable demand.” *TELRIC NPRM* ¶ 73.

Second, price-squeeze claims have no place in TELRIC proceedings. In establishing TELRIC the FCC expressly rejected proposals to establish a price squeeze “imputation rule” for UNE rates, which would have required a comparison of UNE and retail rates. *Local Competition Order* ¶¶ 839, 848. And as a logical matter, one could not even begin a price-squeeze analysis until the new TELRIC prices were set, so claims during the rate-setting proceeding itself are premature. *See Order* at 289. Section 252 of the 1996 Act authorizes state commissions to set UNE rates, but nothing requires them to simultaneously investigate the relationship of TELRIC rates to retail service rates, much less adjust UNE rates based on such an analysis. *TDS Metrocom*, 387 F.Supp.2d at 954.

Third, in order to demonstrate a price squeeze, a CLEC must demonstrate that “the margin between UNE rates and retail rates precludes efficient competitors from

entering a market.” *Application of Verizon New England, Inc.*, 19 FCC Rcd. 2839, ¶ 11 (2004). To support such an analysis, a CLEC must demonstrate “the costs associated with providing service utilizing [UNEs] and the revenues available from potential customers,” and must prove that the margin is insufficient to support entry in light of the carrier’s “internal cost of entry.” *Id.* ¶¶ 12-14. The CLECs provided no evidence regarding their potential revenues and retail rates or their internal costs of providing service or the potential margins they can earn under the UNE rates established by the Commission. That failure renders their claim “materially insufficient.” *Id.* ¶ 14.

Fourth, the Commission has already rejected the price-squeeze claim on the merits. In the Order (at 289) the Commission spun off a separate docket to investigate the relationship of the new unbundled loop prices with retail service rates under state “imputation” law, which is designed to prevent price squeezes. The Commission has now completed that docket and found there is no price squeeze. Order, ICC Docket No. 04-0461, 2005 WL 1711965 at * 79, *96 (June 7, 2005). Thus, the CLECs’ claim has been heard, they lost, and no party appealed. They cannot gain a second bite at the apple here.

IV. The District Court Correctly Affirmed the Commission’s Decision to Adopt SBC’s Financial Depreciation Lives.

Depreciation expense is a primary component of any TELRIC-based price. Under TELRIC, depreciation reflects the “true changes in economic value of an asset” over time. *Local Competition Order* ¶ 703; 47 C.F.R. § 51.505(b)(3). The issue here is what time period, or “depreciation life,” to use for each piece of SBC loop equipment. The CLECs proposed the same depreciation lives that the FCC uses for the different

regulatory purpose of universal service funding (“regulatory lives”). SBC proposed the depreciation lives it uses for financial reporting to the SEC (“financial lives”). The Commission, like its sister commissions in Indiana, Ohio, and Michigan, adopted SBC’s proposal. *Order* at 77; SA52-53, 56, 71; *see* SA35-37.

TELRIC “recognizes no particular useful life as the basis for calculating depreciation costs.” *Verizon*, 535 U.S. at 519. The FCC therefore has “committed considerable discretion to state commissions on these matters” and left “plenty of room for differences in the appropriate depreciation rates.” *Id.* at 519, 521; *TRO* ¶ 688. Most importantly, the FCC has made clear that financial lives can be adopted under TELRIC and “declined to mandate” use of regulatory lives. *TELRIC NPRM* ¶ 96; *TRO* ¶ 688; *Kansas 271 Order* ¶ 76. In doing so, the FCC rejected the CLEC’s argument (at 31) that financial lives cannot be used because they are not established with TELRIC in mind. *TRO* ¶¶ 687-88.

The CLECs concede (at 31) that “[t]he FCC has not dictated to state commissions which method a Commission must choose for calculating depreciation.” Nevertheless, they claim that the record does not support the Commission’s decision because SBC failed to satisfy a heightened evidentiary burden for financial lives, allegedly established by the *Virginia Arbitration Order*. CLEC Br. at 32. But this purported “test” has no basis in the FCC’s TELRIC rules, and nothing in the FCC’s recent pronouncements on TELRIC depreciation in the *TRO* or *TELRIC NPRM* subjects financial lives to a more stringent evidentiary standard. *TRO*, ¶ 688; *TELRIC NPRM*, ¶ 96. The FCC knows how to create a special burden for using financial lives, as it did in the universal service

context, *see 1998 Biennial Review Order*, 15 FCC Rcd. 242, ¶ 25 (1999), but it did not impose such a burden under TELRIC.¹²

Moreover, SBC presented extensive evidence in support of financial lives. R.5, Tabs 17 and 18. For example, while the *Virginia Arbitration Order* (¶ 115) faulted Verizon for not describing technological advances or rebutting arguments about the effect of “DSL” technology on equipment lives, SBC’s depreciation expert thoroughly addressed those issues. SA339-341, 355-361, 376-377. SBC also made all of the “showings” that the CLECs (falsely) claim are required, as Dr. Vanston’s detailed testimony showed that financial book lives are a better measure of an asset’s actual economic life and explained in significant detail the methodologies, studies, and data that he relied on to support SBC’s forward-looking depreciation lives. R.5, Tabs 17 and 18.

The CLECs (at 34) next accuse the Commission of “speculat[ing]” about increased competition and technological advances. TELRIC, however, *required* the Commission to assume a hypothetical competitive market filled with carriers using their own most-modern facilities, *TRO* ¶¶ 680-81, 689; *TELRIC NPRM* ¶ 83, which undeniably would force SBC to upgrade its network more rapidly and lead to shorter depreciation lives. *Virginia Arbitration Order* ¶ 32 (“The assumption that competition will drive incumbent LECs to deploy new technology is fully consistent with the empirical evidence.”). SBC also presented substantial evidence on the impact of competition and technological advances on depreciation. SA339-350, 355-361, 370-373,

¹² The CLECs also claim (at 31) that the district court “failed to give the proper deference to the FCC’s analysis in the *Virginia Arbitration Order*.” But the *Virginia Arbitration Order*’s decision on depreciation was not based on any legal interpretation of TELRIC, but rather on a finding that Verizon (the incumbent LEC in that case) had not provided sufficient evidence. *Virginia Arbitration Order* ¶ 116. Such evidence-weighting decisions are not binding here. *See TDS Metrocom*, 387 F.Supp.2d at 942.

376-377, 380. Thus, the Commission was not merely “speculating” about future events, and its informed projections are entitled to deference. *Western Fuels-Illinois, Inc. v. Interstate Commerce Comm’n*, 878 F.2d 1025, 1030 (7th Cir. 1989).

Finally, the CLECs assert (at 34-35) that the Commission’s rejection of regulatory lives was “based on a mistake” because it “incorrect[ly] assum[ed]” that those lives had not been updated since 1995, when in fact they were updated in 1999.

This claim is waived because the CLECs did not raise it in district court. *See* R.1, Item 35 (CLEC’s Summary Judgment Memorandum of Law at 16-19). And it also is waived because the CLECs themselves asked the Commission to adopt the same lives as in its 1998 TELRIC Order, *i.e.*, the lives from 1995 – not 1999. *See Order* at 70. They cannot fault the Commission for not adopting something they never proposed.

Moreover, the Commission’s decision was based on the substantial evidence demonstrating that the use of financial lives is the best approach under TELRIC because it “both reflects and encourages the use of new and efficient technologies, as well as investment in infrastructure.” *Id.* at 76-77. Thus, even if the CLECs had asked the Commission to adopt the FCC’s 1999 regulatory lives, there is nothing to suggest that the Commission’s decision would have been any different.

V. The District Court’s Ruling on Capital Structure Was Correct.

The cost of capital is the return the incumbent LEC must offer to investors in order to attract capital. *Local Competition Order* ¶ 700. The issue here involves the hypothetical capital structure that should be used for SBC in establishing the cost of capital input to a TELRIC price. The capital structure reflects the percentages of the

company's hypothetical capitalization that would be allocated to equity (stocks) and to debt (bonds). *Virginia Arbitration Order* ¶ 64. The district court reversed the Commission for failing to use a capital structure that reflects the riskiness of the competitive market that TELRIC assumes. *Decision* at *39-41. The Commission has not appealed that ruling, but the CLECs now claim that the Commission did account for competition. The law and the record refute them.

Unlike the fill and depreciation issues, this issue involves a question of law rather than Commission factfinding and policy judgments. TELRIC allows leeway but also sets a framework, and state commissions must stay within that framework. In this case the Commission did not, and the district court properly reversed and remanded so the Commission can apply the appropriate standard and establish a new capital structure.

A. Background.

As noted above, TELRIC seeks to create prices that mimic what the incumbent LEC could charge in a competitive market. TELRIC therefore requires state commissions to adopt certain assumptions when setting a forward-looking cost of capital. Most importantly, TELRIC assumes that the ILEC is offering UNEs in a fully competitive market, *i.e.*, one in which there is “widespread facilities-based competition” (competition from other carriers that have their own networks), where the incumbent faces a “ubiquitous competitor that uses only the most efficient technology and network configuration,” and where “all facilities-based carriers would face the risk of losing customers to other facilities-based carriers.” *Virginia Arbitration Order* ¶¶ 32, 93¹³; *TRO*

¹³ Unlike the fill and depreciation issues, where the *Virginia Arbitration Order* either departed from FCC decisions or based its decision on the specific facts before it, the *Virginia Arbitration Order*'s interpretation of the TELRIC requirement to assume a

¶ 680; *TELRIC NPRM* ¶ 83. This assumption is vital because facilities-based competition increases risk, and increased risk leads to a higher cost of capital. *TRO* ¶ 681. Accordingly, TELRIC requires the cost of capital to be “risk-adjusted” in order to “reflect[] the competitive risks associated with participating in the type of market that TELRIC assumes,” rather than the lesser risks in a regulated market or a market with only some competition. *TRO* ¶ 681; *Verizon*, 535 U.S. at 520 (TELRIC “specifically permits more favorable allowances for cost of capital and depreciation than were generally allowed under traditional ratemaking practice.”); *Virginia Arbitration Order* ¶ 102.

Generally speaking, the more competitive risk a company faces, the higher the percentage of equity in its capital structure. This allows the company to minimize the fixed-payment obligations of bonds. There were three capital-structure proposals before the Commission: SBC proposed a capital structure of 86% equity/14% debt; the CLECs proposed 66% equity/44% debt; and the Commission’s Staff proposed 51% equity/49% debt. *Order* at 85-87.

The wide difference in equity ratios was caused by parties’ different methods. SBC based its proposal on market values. The FCC’s Wireline Competition Bureau has held that market values are the “theoretically correct” values under TELRIC because “rational investors value [telecommunications company] assets at market value” and a capital structure based on other values “would not [allow investors to] earn the return that

competitive market is consistent with other FCC decisions and is entitled to deference insofar as it explains the legal requirements in establishing a TELRIC capital structure.

they require.” *Virginia Arbitration Order* ¶ 102.¹⁴ The CLECs proposal rested half on market values and half on book values – the very approach the Bureau rejected as having too low an equity ratio, because book values do not reflect competitive risk. *Id.* The Staff based its proposal on a single financial measure known as “interest coverage ratios.” SA285-91.

The Commission conceded that Staff’s method “has not been accepted by other jurisdictions” and “is not a recognized technique” under TELRIC. *Order* at 86. Nevertheless, it adopted Staff’s proposal. The Commission justified this by asserting that it did not have to adopt a capital structure that reflects the risks of “full competition” if “reality is something less than that.” *Id.* at 84. Rather, the Commission stated, “equity rates should reflect something less than full competition.” *Id.* at 84.

The district court held that the Commission’s approach violated TELRIC. As the court explained, “the Commission wrongly held that TELRIC permitted it to assume something less than ubiquitous competition” and this “erroneous assumption caused it to incorporate the current level of competition facing partially rate-regulated companies into its capital structure determinations.” This was error because “the FCC has stated that the cost of capital should not be based on the current status of competition [but rather] should

¹⁴ The district court found that TELRIC does not necessarily require the use of market values. *Decision* at *34. SBC disagrees. As explained in the *Virginia Arbitration Order* (¶ 102), TELRIC requires an assumption of a competitive market, and investors in a competitive market look to market values when deciding whether a company provides a sufficient return. Use of any other values (such as book values) understates the forward-looking cost of capital in a competitive environment. *See Southwestern Bell Tel., L.P. v. Missouri Public Serv. Comm’n*, Case No. 03-04148-CV-C-C-NKL, slip op. at 7-9 (W.D. Mo. June 17, 2004) (SA112-114). Thus, the *Virginia Arbitration Order* found that market values must be used as a matter of *law* (not as a result of baseball arbitration rules, as the district court found). The Commission concededly did not use market values for its capital structure, and could be reversed on that independent ground as well. *See id.*

‘reflect[] the competitive risks associated with participating in the type of market that TELRIC assumes.’” *Decision* at *39, quoting *TRO* ¶ 680.

B. The District Court Correctly Held That the Commission Had Not Sufficiently Accounted for Competitive Risks in Adopting a Capital Structure.

The CLECs contend that the Commission accounted for the risks of competition because the capital structure it adopted was based on Staff’s use of a “sample of telecommunications companies . . . that will be facing the same level of competition SBC will be facing.” CLEC Br. 37. That claim fails.

First off, it is a red herring. The debate has never been about the sample of telecommunications companies Staff used. Indeed, the average *market-value* capital structure of Staff’s sample companies was 79% equity/21% debt (SA178), not far off from SBC’s 86/14 proposal. Rather, the problem lay with Staff’s insistence on using a capital structure that does not reflect a robustly competitive market, even though TELRIC requires that such a market be assumed. Staff thus chose its “interest coverage ratio” method in order to develop a capital structure that would *not* reflect the full risks of a competitive market. Staff’s witness made no secret of this, asserting that:

- “equity rates should reflect something *less than full competition*”;
- “the cost of capital adopted in this proceeding should *not reflect a fully competitive market*”;
- “[t]he capital structure to be used in this proceeding should *not* be based on industrial guidelines since industrial companies *reflect full competition*”; and
- “[t]he fact that UNE loop rates remain regulated indicates that the rates should *not reflect the risk levels associated with competition unimpeded by regulatory restraints* (i.e., a high degree of competition).” [SA288-289, 293, 297-299 (all emphases added)].

This view defies the requirements of TELRIC, as expressed by the FCC in the *TRO*, *TELRIC NPRM*, and *Local Competition Order*, and by the Bureau in the *Virginia Arbitration Order*. As several courts have recognized, basing a capital structure on a market with limited competition or only the current level of competition violates TELRIC. See *Verizon New England, Inc. v. New Hampshire Pub. Utils. Comm'n*, 2005 WL 1984452, *4-5 (D.N.H. 2005) (reversing state commission for not assuming a sufficiently competitive market in establishing TELRIC capital structure); *Southwestern Bell*, SA112-114 (same); *BellSouth Telecommunications, Inc. v. Georgia Public Serv. Comm'n*, Civil Action No. 1:03-CV-3222-CC, slip op at 8-11 (N.D. Ga. Apr. 6, 2004) (SA125-128) (same), *aff'd* 400 F.3d 1268 (11th Cir. 2005). Thus, the district court was correct to reverse and remand to the Commission to recompute a capital structure based on the correct legal standard.

The CLECs next claim (at 38) that the Commission's decision was permissible because, even though the Staff's proposal "reflect[s] less than full competition," it does so with respect to all aspects of the cost of capital and thus has the virtue of consistency. But consistency does not trump basic TELRIC requirements, and the most the CLECs' claim shows is that other aspects of Staff's proposal could have been defective as well. See *Verizon New England*, 2005 WL 1984452, *4-5 (error in failing to assume competitive market affected all aspects of cost of capital ruling). Moreover, consistency should prevail across the entire TELRIC cost study, and since SBC was required to use forward-looking technology and network configurations in the rest of its cost study to mimic a robustly competitive market, it was likewise entitled to a capital structure that reflected the increased risks of such a market. See *TRO* ¶ 682.

The CLECs also argue that the Commission’s approach reflects a level of competitive risk only “slightly lower” than that of unregulated industrial companies and that “the difference between ‘less than full’ competition examined by the Staff and ‘full’ competition examined by SBC is minimal.” CLEC Br. 37-38. Hardly. The Staff proposed an equity ratio of 51% based on “less than full” competition. By contrast, SBC proposed an equity ratio of 86% based on market values and “full” competition, and other authorities put the equity ratio in a competitive market at about 80%. That difference – 30-35 percentage points – is far from “minimal.” Indeed, if SBC actually used Staff’s 51/49 capital structure its credit rating would drop to “junk” status. SA163. Staff’s 51/49 structure also was radically out of line with all the evidence of market-based capital structures of comparable companies and the equity ratios in capital structures adopted by neighboring state commissions in parallel SBC TELRIC cases, which ranged from 68% to 83%. *Virginia Arbitration Order* ¶ 104 (80% equity for Verizon); SA162 (average 82% equity in Standard & Poor’s survey of A-rated companies); SA 176 (Value Line projection of 76% to 86% equity for Verizon, SBC, and BellSouth); SA53a, 55a, 72, 89a (commissions in Indiana, Michigan, Ohio, and Wisconsin adopting 68-76% equity for SBC in TELRIC cases); SA78 (Texas adopting 81.5% equity for SBC). That gap shows the significant difference between assuming a fully open competitive market versus one with only a little competition. The district court was correct to reverse the Commission.

Conclusion

For the reasons stated, the Court should affirm the district court on all claims raised by the CLECs.

SBC Illinois' Brief On Its Cross-Appeal

Jurisdictional Statement

SBC appeals the district court's holding that the Commission was bound by a conclusion of the FCC's Wireline Competition Bureau in a TELRIC case for another ILEC in Virginia. The district court had jurisdiction to review the Commission's decision under 28 U.S.C. §§ 1331, 1337, 2201, 2202, and 47 U.S.C. § 252(e)(6). The district court issued its order resolving all issues on the merits on July 29, 2005. SBC timely filed its notice of appeal on August 26, 2005 (No. 05-3552) and the case was consolidated with No. 05-3677. This Court has jurisdiction under 28 U.S.C. § 1291.

Issue Presented for Review in Cross-Appeal

For purposes of SBC's TELRIC cost study, the Commission approved the use of 88% UDLC equipment and 12% IDLC equipment. In an unrelated TELRIC case involving a different carrier in Virginia, the FCC's Wireline Competition Bureau approved the use of 100% IDLC equipment, based on its factual finding as to the technical feasibility of unbundling loops from IDLC. Was the Commission bound by the Bureau's decision?

Statement of the Case in Cross-Appeal

For the procedural history, see *supra* p.2. In the Commission proceeding, SBC's TELRIC cost study assumed a network with 88% UDLC equipment and 12% IDLC equipment. The CLECs asserted that TELRIC requires an assumption of 100% IDLC. The Commission found that the evidence demonstrated that it is neither economic nor efficient to unbundle loops served by IDLC and adopted SBC's proposed mix of IDLC and UDLC equipment. *Order* at 106. The district court reversed, holding that the Commission was bound by a decision of the FCC's Bureau involving another carrier in Virginia. *Decision* at *51. SBC appeals.

Statement of Facts in Cross-Appeal

Telecommunications carriers today typically attach digital loop carrier ("DLC") systems to their loops. In a loop served by DLC, an individual copper loop runs from the customer premises to a location called a remote terminal. At the remote terminal, the individual loop is combined (multiplexed) together with other customers' loops, which are then sent to the carrier's central office (where its local switch is located) on a single feeder cable. *Illinois Bell Tel. Co. v. Wright*, 2003 WL 22757752, at *4 (N.D. Ill. Nov. 20, 2003).

There are two main types of DLC systems, which differ primarily in how they treat a loop once it reaches the central office. In a "Universal" DLC ("UDLC"), a device in the central office separates (de-multiplexes) the individual loops before they connect to the switch, so that each loop has an individual connection to the switch. *Order* at 104. This makes loops served by UDLC easy to unbundle and provide to a CLEC, for the wire

connecting to the switch can be disconnected and moved to connect to the CLEC's equipment in the central office. *Id.* at 106.

In an "Integrated" DLC ("IDLC"), by contrast, each group of 24 loops from the feeder cable is directly "integrated" into the switch.¹⁵ SA326. An IDLC system therefore is akin to an extension cord. Instead of needing separate cords and electrical outlets for all the appliances in a room, one can group them onto a single extension cord (the feeder cable) that plugs into a single outlet (the ILEC's switch). While this may save on cords, it prevents unplugging (unbundling) any single appliance from the outlet. As discussed below, the FCC has recognized the difficulty and expense of trying to unbundle loops served by IDLC.

A. The Commission Proceeding.

The issue in the Commission proceeding was how to reflect UDLC and IDLC in a TELRIC cost analysis. SBC explained that TELRIC supports a low percentage of IDLC because, even if loops can be unbundled from IDLC in some circumstances, IDLC loops are difficult and expensive to unbundle and therefore are not the least-cost, forward-looking design for TELRIC pricing purposes.¹⁶ *Order* at 104; SA422-425, 439-443. The CLECs asserted that TELRIC requires an assumption of 100% IDLC, arguing that IDLC loops can be readily unbundled and noting that the Bureau approved the use of 100% IDLC in the *Virginia Arbitration Order*. *Order* at 105.

¹⁵ In telecommunications lingo, the combined group of 24 loops on a single cable is called a "DS1," whereas an individual loop is called a "DS0." *Order* at 109.

¹⁶ The 12% IDLC reflects the number of unbundled loops that would be provided over a "UNE Platform," in which the CLEC leases both the loop and the switch from the ILEC, and thus does not need to have the loop connected to its switch. SA326-327.

The Commission agreed that IDLC loops are difficult to unbundle and that there was no evidence of “a currently available technology to remedy this.” *Id.* at 106. The Commission also found, consistent with prior FCC decisions, that “it is not clear how much cheaper IDLCs would be compared to UDLC.” *Id.*; *see Georgia 271 Order* ¶ 50 (“[T]here is some evidence that technical limitations associated with unbundling stand-alone loops from an IDLC system may make IDLC more expensive than UDLC in some circumstances.”); *BellSouth 5-State 271 Order*, 17 FCC Rcd. 17595, ¶ 62 (2002) (“[P]rior [FCC] orders have recognized that at least certain IDLC alternatives would likely be more expensive.”); *UNE Remand Order*, 15 FCC Rcd. 3696, ¶ 217 n.418 (1999) (methods proposed for unbundling IDLC loops “have not proven practicable” or “economical[.]” and are “very expensive.”). Indeed, the difficulties are such that even when a CLEC requests an unbundled loop served by IDLC, incumbents typically fill the order by providing a different loop, such as one served by UDLC, a practice the FCC endorses. *TRO* ¶ 297. Recognizing that TELRIC requires consideration of “not only the least cost option, but also the availability and efficiency of a particular input,” the Commission adopted SBC’s mix of 88% UDLC and 12% IDLC. *Order* at 106.

D. The District Court’s Decision.

The CLECs challenged the Commission’s decision, arguing that the Bureau’s ruling on the IDLC issue in the *Virginia Arbitration Order* trumped the Commission. Although the district court held on other issues that the Bureau’s decision did not bind the Commission, this time the court held the opposite. Specifically, the district court relied on the Bureau’s factual finding that Verizon had failed to prove it is not technically feasible to unbundle Next Generation DLC (“NGDLC”) loops and therefore that

Verizon's cost studies should assume a network with 100% NGDLC.¹⁷ *Virginia Arbitration Order* ¶¶ 314-22. The Decision did not discuss the evidence on this issue in the Commission proceeding or the Commission's analysis, instead stating that the Bureau's findings were based on a "voluminous record," so there "is no need for state commissions to continue to address [the issue]." *Decision* at *52. The Decision similarly dismissed the prior FCC decisions holding that TELRIC does not require 100% IDLC, which the Bureau did not cite or distinguish, simply because they pre-dated the Bureau's ruling. *Decision* at *51 n.26.

Summary of Argument in Cross-Appeal

This is an instance of misplaced deference. As the courts uniformly recognize, TELRIC does not dictate specific outcomes on any issue. Rather, it establishes a methodological framework that gives each state commission leeway to reach its own conclusions within a range of outcomes. The IDLC/UDLC issue is no different. Indeed, in the recent round of TELRIC proceedings throughout SBC's region, state commissions reviewing nearly identical evidence reached a spectrum of conclusions: 88% UDLC/12% IDLC (Illinois); 75% UDLC/25% IDLC (Ohio, SA75); 50% UDLC/50% IDLC (Wisconsin and Texas, SA85, 89); 40% UDLC/60% IDLC (California, SA39-40); and 100% IDLC (Indiana and Michigan, SA46, 62).

¹⁷ The *Virginia Arbitration Order* (¶ 305) defined NGDLC as the "Alcatel Litespan-2000 family of DLC systems . . . configured with the GR-303 switch interface standard." SBC defined IDLC in essentially the same way in the Commission proceeding here. SA423. Thus, this brief will not distinguish between IDLC and NGDLC as discussed in the *Virginia Arbitration Order*.

Such differences in applying TELRIC are nothing new, and they do not necessarily mean that any one state commission is right and all others wrong. Rather, as long as the state commission applies the correct TELRIC framework, its decision should be affirmed as long as it is supported by the evidence and a reasonable explanation.

The district court recognized this in most aspects of its Decision, and even declined to follow the *Virginia Arbitration Order* on other issues. When it came to the IDLC issue, however, the court inexplicably changed course. Instead of examining the Commission's analysis and the supporting evidence, it declared that the Commission had "violated TELRIC" by not reaching the same outcome as the Bureau. Yet the district court pointed to no FCC requirement the Commission had ignored or misapplied, nor did it say there was no evidence to support the Commission's decision, nor did it say the Bureau had announced a new legal principle. Rather, it concluded that the Bureau's evidence-weighting decision foreclosed states from reaching any other result.

That was error. It is well established that decisions from other state commissions – and the Bureau was acting in the stead of a state commission – are not binding on other state commissions. Furthermore, whatever deference might otherwise be due the Bureau's *legal* clarifications of FCC rules, it does not apply on the IDLC issue, where the Bureau's decision rested on the particular *factual* record before it and the rules of "baseball" arbitration. The district court owed deference not to the Bureau, but to the *Commission's* factual determinations based on the record before it. The Commission's thorough analysis of the evidence, including consideration of important factors the Bureau overlooked, was well-reasoned and supported by record.

Argument in Cross-Appeal

I. Standard of Review.

The district court's holding that the Commission "violated TELRIC" by not reaching the same conclusion as the Bureau on the IDLC issue is a legal conclusion reviewed *de novo*. *McCarty*, 362 F.3d at 383. The Commission's factual findings, which the district court did not address, are reviewed under the arbitrary and capricious standard. *TDS Metrocom*, 387 F.Supp.2d at 939-40.

II. The District Court Erred in Holding that the Commission Was Bound by the Factual Findings of the Bureau.

We begin by explaining the context of the *Virginia Arbitration Order*. Under 47 U.S.C. § 252(e)(5), when a state utility commission declines to determine the rates for UNEs, the FCC will step in to fill the gap. The Virginia commission declined to determine the UNE rates for the ILEC there (Verizon), so the FCC took the case and assigned it to its Wireline Competition Bureau. Thus, the Bureau "st[ood] in the stead" of the Virginia Commission and "act[ed] in [its] place" for "the limited purpose" of arbitrating issues between Verizon and two CLECs. *Virginia Arbitration Order* ¶¶ 2, 6. The Bureau emphasized that its application of the FCC's pricing rules was "narrowly tailored to the detailed evidence in the record before us, in order to resolve the numerous specific issues presented by the parties regarding their operations in Virginia." *Id.* ¶ 3. The Bureau resolved the issues using "baseball" arbitration procedures, which required it to adopt the "final offer" of either Verizon or the CLECs instead of adopting its own resolution to a particular dispute. *Id.* ¶ 24.

With regard to how much IDLC and UDLC to reflect in a TELRIC cost study, Verizon argued that it was not technically feasible to unbundle loops served by IDLC. The Bureau, however, found that Verizon failed to meet its burden of proof. Thus, under baseball arbitration procedures, the Bureau adopted the CLECs' proposal to require 100% NGDLC. *Id.* ¶¶ 313-14, 322.

The district court held that the Bureau's decision bound the Commission, and therefore reversed the Commission's adoption of a mix of IDLC and UDLC. *Decision* at *52. That decision both (i) affords too much deference to the Bureau's factual findings and (ii) ignores the Commission's own analysis and record.

First, the Bureau did *not* hold that TELRIC *always* requires 100% IDLC as a matter of law. What it actually said was that “[f]or the reasons set forth in the following subsections, we agree with AT&T/WorldCom that a TELRIC model should use 100 percent NGDLC systems and should not assume any UDLC systems.” *Virginia Arbitration Order* ¶ 312. The “reasons set forth in the following subsections” are all *factual* reasons why the Bureau thought Verizon failed to show that unbundling IDLC loops was technically infeasible. *See id.* ¶¶ 313-22. Specifically, the Bureau found that a Verizon witness had stated that IDLC loops could be unbundled, that Verizon admitted that UDLC loops were not needed for certain types of service, and that Verizon's experience in parts of its territory undermined its claim of security concerns. *Id.* ¶¶ 315-20. This discussion shows that the Bureau was not announcing any new legal interpretation of a TELRIC rule. Rather, the ruling was based its weighing of the particular facts before it and baseball arbitration rules.

The district court in Wisconsin recently recognized the distinction between the Bureau's legal and factual findings in addressing this issue, and refused to defer to the *Virginia Arbitration Order*:

[T]he Bureau concluded that Verizon, the incumbent, had failed to satisfy its burden of proving that it was not feasible to unbundle [IDLC] loops. [citation omitted] This suggests that the Bureau's conclusion did not turn on an interpretation of the Telecommunications Act or the FCC's implementing regulations to which this court would owe deference. *On the contrary, the availability of technology needed to unbundle [IDLC] loops appears to be a question of fact. Therefore, the Bureau's conclusion on this point is not binding or entitled to deference.* [*TDS Metrocom*, 387 F.Supp.2d at 942 (emphasis added).]

Similarly, the district court here recognized on other issues that not every aspect of the *Virginia Arbitration Order* gets deference. On the depreciation issue, the court found that the *Virginia Arbitration Order* was not binding because it had not announced any new legal rule and its decision was driven by the specific record before it. *Decision* at *28-30. On the capital structure issue the court found that the *Virginia Arbitration Order* was not binding because it viewed the order as the result of baseball arbitration. *Id.* at *34. These same factors apply to the Bureau's ruling on IDLC, yet the district court failed to apply the same reasoning.

Second, the district court seemed to think it had to defer to the Bureau as a result of this Court's statement in *Indiana Bell v. McCarty*, 362 F.3d at 386, that aspects of the *Virginia Arbitration Order* may receive deference as "the voice of the FCC interpreting its own rules." *McCarty* does not apply here. In *McCarty*, the issue was whether the "geographic area test" in an FCC rule (47 C.F.R. § 51.711(a)(3)) required a CLEC to actually serve or merely be capable of serving the same geographic area as the incumbent. *McCarty*, 362 F.3d at 386. Finding no case law or FCC authority on the

issue, the Court turned to the *Virginia Arbitration Order*, which had concluded that the “requisite comparison” is whether the CLEC is capable of serving the same area. *Id.* The Court found this decision to be both “persuasive” and entitled to deference. *Id.*

The circumstances here are much different. In this case the FCC itself has addressed the issue and found that TELRIC does not mandate use of 100% IDLC. In the *Georgia 271 Order*, the FCC evaluated a Georgia commission decision that did not use 100% IDLC. Stating that it was “not persuaded, based on the record before us, that a correct application of TELRIC would require 100 percent use of [IDLC],” the FCC concluded that the Georgia commission had “correctly applied TELRIC principles in adopting UNE rates and made no clear error which causes the rates to fall outside of a reasonable TELRIC range.” *Georgia 271 Order* ¶¶ 49-50. Similarly, the FCC stated in the *BellSouth 5-State 271 Order* (¶ 62) that it “remain[s] unpersuaded, based on the evidence before us, that a current application of TELRIC would require 100 percent use of [IDLC].” While these decisions rested on the particular record before the FCC, so too did the Bureau’s decision, and the district court erred in treating it as a nationally binding declaration of law.

Third, it is irrelevant that the Bureau reviewed a “voluminous record.” The Commission compiled its *own* record (*see Order* at 104-05), and in this context it is the Commission’s record that matters and the Commission’s weighing of the evidence that receives deference. SBC’s evidence showed the costliness and complexity of trying to unbundle loops from IDLC and included documents from the manufacturer of IDLC equipment and from AT&T confirming these problems. SA424, 440. The Commission evaluated that evidence and reached its own conclusion that there was no evidence that

IDLC was the most efficient technology for unbundling stand-alone loops. *Order* at 106. The Bureau's record does not supersede the Commission's.

Moreover, the Commission's analysis was more robust than the Bureau's, which stopped once it decided that loops could be unbundled from IDLC. The Bureau never analyzed whether IDLC is actually the most *cost-effective* technology for unbundling, a factor the FCC had found significant in refusing to require 100% IDLC in TELRIC cases. *See supra* p. 46. The Commission, by contrast, focused on that critical issue. *Order* at 106.

Conclusion

The TELRIC methodology gives states much leeway and allows for a variety of results on any given issue. The Commission's conclusion on the IDLC/UDLC issue was consistent with the law and amply supported by the record. The district court's finding that the Commission was bound by the Bureau's conclusion in another case involving another carrier and a different record in another state was erroneous as a matter of law and should be reversed, and the Commission's decision should be affirmed.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH
FED. R. APP. P. 32(a)(7)

Pursuant to Fed. R. App. P. 32(a)(7)(C), and under penalty of perjury as provided by 27 U.S.C. § 1746, the undersigned counsel certifies that this brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B). The brief was prepared using Word software in Times New Roman font. According to the Word count, the brief contains 13,890 words from the Jurisdictional Statement through the Conclusion.

Theodore A. Livingston

CIRCUIT RULE 30(d) CERTIFICATION

The undersigned, counsel for Plaintiff-Intervenor/Appellee/Cross-Appellant, certifies that all materials required by Circuit Rule 30(a) and (b) to be included in the required short appendix are already included in the appendix of the Appellants and therefore need not be duplicated in the appendix of SBC as Cross-Appellant. Circuit Rule 30(c).

Theodore A. Livingston

CIRCUIT RULE 31(e) CERTIFICATION

The undersigned, counsel for Plaintiff-Intervenor/Appellee/Cross-Appellant, certifies that he has filed electronically, pursuant to Circuit Rule 31(e), versions of the brief and all of the appendix items that are available in non-scanned PDF format.

Theodore A. Livingston

CERTIFICATE OF SERVICE

The undersigned, an attorney, hereby certifies that on November 23, 2005, he caused two copies of and a diskette containing the foregoing Brief for Plaintiff-Intervenor/Appellee/Cross-Appellant Illinois Bell Telephone Company, along with a copy of the Separate Appendix of Intervenor-Appellee Illinois Bell Telephone Company, to be served by messenger delivery on the parties on the attached service list.

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