

Decision PROPOSED DECISION OF ALJ DUDA (Mailed 6/25/2008)

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Rulemaking on the Commission’s Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for network Architecture Development of Dominant Carrier Networks.

Rulemaking 93-04-003  
(Filed April 7, 1993)

Investigation on the Commission’s Own Motion Into Open Access and Network Architecture Development of Dominant Carrier Networks.

Investigation 93-04-002  
(Filed April 7, 1993)  
**(Verizon UNE Phase)**

**DECISION ADOPTING UNBUNDLED NETWORK ELEMENT REEXAMINATION PROCESS**

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## DECISION ADOPTING UNBUNDLED NETWORK ELEMENT REEXAMINATION PROCESS

### 1. Summary

In this decision, we determine that the Unbundled Network Element (UNE) reexamination process we are adopting will apply to Pacific Bell Telephone Company (Pacific Bell), d/b/a AT&T California (AT&T)<sup>1</sup> as well as Verizon California Inc. (Verizon). We adopt a price cap mechanism for annual updates to the UNE rates adopted for Verizon and AT&T, and determine that § 252 of the Telecommunications Act of 1996 requires the state to conduct periodic cost-study proceedings to update our UNE rates, based on the Total Element Long Run Incremental Cost (TELRIC) methodology. We establish a schedule for future TELRIC costing proceedings for AT&T and Verizon, and mandate the use of the HM 5.3 model in those costing proceedings.

### 2. Background

In Decision (D.) 06-03-025, we established final Unbundled Network Element (UNE) rates for Verizon California Inc. (Verizon). The rates adopted in D.06-03-025 replace interim rates adopted in D.03-03-033, and revised in D.05-01-057. The decision noted that when the Commission set UNE rates for Pacific Bell Telephone Company (Pacific Bell), formerly known as SBC, now AT&T California (AT&T) in D.99-11-050, it established a procedure for determining which UNE costs should be reexamined. Specifically, if a carrier

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<sup>1</sup> References to Pacific Bell Telephone Company (Pacific Bell), SBC, and AT&T California (AT&T) all refer to the same company. This should not be confused with references to the *Competitive Local Exchange Carrier AT&T*, which has been acquired by Pacific Bell.

believes that a UNE price lower than the one adopted for AT&T is justified for a particular UNE, based upon a reduction in the costs for that element of at least 20%, the Competitive Local Exchange Carrier (CLEC) may nominate that UNE as a candidate for reconsideration. The nomination should be made in an application submitted between February 1 and March 1 of each year and should include a brief summary of the evidence supporting the asserted cost reduction. AT&T may also nominate UNEs for reexamination during the same window if it believes a higher price is justified owing to an increase in costs of at least 20%. The Commission stated that it would choose no more than two UNEs for annual reexamination. (D.99-11-050, *mimeo.* at 168-69.)

In D.04-09-063, the Commission modified the reexamination process for AT&T, noting that the idea of a quick update proceeding had given way to “the reality of modeling difficulties, protracted discovery battles, and various delays.” (D.04-09-063 at 246.) The Commission suspended further UNE nominations for AT&T until February 2007, citing the benefits of pricing and market stability. (*Id.*)

In a November 2005 motion, the California Association of Competitive Telephone Companies (CALTEL) requested that the Commission allow for consideration of a price cap process for modification of Verizon’s UNE rates. CALTEL noted that its proposal is designed to avoid resource-intensive cost modeling proceedings by allowing adjustment of UNE rates through an annual compliance filing to adjust Verizon’s UNE rates based on inflation and productivity factors. CALTEL asks that the Commission consider its price cap proposal in the next phase of this proceeding.

In D.06-03-025, the Commission indicated that it had considered establishing a procedure for reexamination of Verizon’s UNE rates identical to

the procedure used for AT&T, but noted that there is no dispute that cost modeling proceedings have expended vast resources, and industry changes make it difficult for carriers to litigate these proceedings. The Commission granted CALTEL's November 2005 motion, stating that it would consider other options, such as CALTEL's price cap proposal in the next phase of the proceeding.

The assigned Administrative Law Judge (ALJ) held a Prehearing Conference on April 25, 2006, followed by a ruling on May 15, 2006 setting the scope and schedule for the proceeding. The scope was to include two issues: the true-up and a process for reexamining UNE rates in the future. The true-up was addressed in D.08-04-040. In this phase, the Commission is considering the following issues relating to the reexamination process:

– What process should the Commission use for future reexamination or adjustment of UNE rates adopted for Verizon in D.06-03-025 and for Pacific Bell [now AT&T] in D.04-09-063? This issue involves whether the Commission should:

- a. use a price cap mechanism, as suggested by CALTEL, to update UNE rates for both Verizon and AT&T,
- b. perform future updates of Verizon's UNE rates using the same procedure established for AT&T in D.99-11-050, and
- c. revise rates by adjusting inputs to the HM 5.3 model used in D.06-03-025 for Verizon and D.04-09-063 for AT&T.

On June 27, 2006, parties filed their true-up and rate reexamination proposals. On February 5, 2008, CALTEL filed a motion requesting the Commission to move expeditiously to begin its examination of the methodology or process to be used for future reexamination of UNE rates. Verizon responds

that the Commission should dispose of this proceeding by ruling on the proposal before it by addressing the issue posed in the Scoping Memo: “What process should the Commission use for future re-examination or adjustment of UNE rates?” According to Verizon, the law requires the Commission to consider all alternatives presented to it, including Verizon’s proposal that no reexamination process be preordained but that the matter be deferred until such time as an interested party seeks to change the effective UNE rates. Verizon asserts that the record is submitted and the Commission should issue a proposed decision. We agree that the issue needs to be resolved, and will rely on the record established in 2006 to make our decision. We grant CALTEL’s February 5, 2008 motion, at least in part, to move forward with a proposed decision as quickly as possible.

### **3. Application of Reexamination Process to AT&T**

In its Opening Comments in this phase of the proceeding, AT&T states that at the request of CALTEL, the Ruling calls for the reexamination process for AT&T to be reconsidered. Yet CALTEL has filed no Petition to Modify D.99-11-050, and no party has challenged the legality of the procedure in court or sought rehearing of the procedure. According to AT&T, consideration of CALTEL’s request is procedurally improper. If CALTEL desires a change to a Commission decision, the Commission’s rules are clear – a Petition to Modify under Rule 45 is required.

We do not agree with AT&T’s conclusion. It is true that CALTEL initially made the proposal that the reexamination process adopted in this proceeding be applied to AT&T as well. However, it is the Commission, on its own authority, that is acting to change D.99-11-050. Section 1708 of the Public Utilities Code reads as follows:

The commission may at any time, upon notice to the parties, and with opportunity to be heard as provided in the case of complaints, rescind, alter, or amend any order or decision made by it. Any order rescinding, altering or amending a prior order or decision shall, when served upon the parties, have the same effect as an original order or decision.

In other words, the Commission has the authority to amend an existing order, as long as parties are given notice and an opportunity to be heard. Items 2 and 3 in ALJ Duda's May 15, 2006 Ruling ensured that both those requirements were met.

Ruling item 2 reads as follows:

Pacific Bell Telephone Company (d/b/a AT&T) and other parties are hereby given notice and opportunity to be heard in this phase on the issue of whether the reexamination process adopted for Pacific Bell in Decision (D.) 99-11-050 should be revised.

Ruling item 3 ensures that AT&T and other interested parties will receive notice of the proposed change:

In addition to service to the "Verizon UNE Phase" service list, this ruling shall be served on the "OANAD" phase service list used for D.99-11-050 in R.93-04-003/I.93-04-002 and the service list for Application 01-02-024.

Therefore, we determine that the Commission has met the requirements under § 1708 to amend the reexamination process adopted for AT&T in D.99-11-050. Also, we conclude that it makes sense to have the same reexamination process apply to both AT&T and Verizon. Thus, the reexamination process adopted in this proceeding will apply to both Verizon and AT&T.

By this order, we will terminate the UNE reexamination process adopted for Pacific Bell (now AT&T) in D.99-11-050, and replace it with the process adopted in this order.

#### **4. UNE Rate Reexamination Proposals**

We will examine each of the three proposals in turn, beginning with the proposal to use the process previously adopted for AT&T.

##### **4.1. Use the Process Adopted for AT&T in D.99-11-050**

In D.99-11-050 the Commission set prices for UNEs offered by Pacific Bell (now AT&T) based on the Total Element Long Run Incremental Cost (TELRIC) methodology. The Commission also established a process that invited carriers to annually nominate up to two UNEs for consideration of their costs by the Commission. The decision required that Pacific Bell itself, or another party nominating a UNE for review, must include a summary of evidence demonstrating a cost change of at least 20% (up or down) from the costs previously approved for the UNE to be eligible for nomination.

D.04-09-063 resulted from the 2001 and 2002 nominations by various parties to reexamine specific rates that AT&T charged. Because of the enormous effort expended by the parties and the Commission on the 2001 and 2002 reexamination, in D.04-09-063 the Commission suspended further nominations until February 2007. The Commission concluded:

It is not reasonable to conduct reviews in 2005 and 2006 because of the need for wholesale pricing stability and regulatory certainty in competitive local exchange markets. Annual re-examination proceedings lead to constantly shifting rates, true-ups, and regulatory delays. The benefit of pricing and market stability

outweighs the benefit of an annual wholesale pricing review and continual refinement of UNE rates.<sup>2</sup>

In its comments, AT&T defends the reexamination process used for setting AT&T's UNE rates, saying that no party has shown it failed to be able to set TELRIC-compliant rates.

Verizon disagrees, saying the approach adopted for AT&T in D.99-11-050 violates TELRIC rules. Verizon asserts it is contrary to TELRIC to focus on only two elements and to set a change-threshold of 20%, rather than review the underlying cost model. According to Verizon, there is the obvious potential that the Incumbent Local Exchange Carrier (ILEC) will not recover all of its costs for all of its network elements. That is, an element whose cost rises by less than 20% – or even which rises by more than 20% but whose volume does not bring it to the top of the list – would never be repriced under the nominations process. Verizon concludes that such a scheme violates 47 C.F.R. § 51.507(b)-(d), which mandates that the ILEC's costs “shall be recovered.”

Verizon sees that as markedly different from the “built-in lags in price adjustments,” recognized by the U.S. Supreme Court when it upheld the TELRIC methodology in *Verizon Communications Inc. v. FCC*, 535 U.S. 467, 505 (2002), in which the Court operated with the understanding that TELRIC rates “are set by state commissions, usually by arbitrated agreements with 3- or 4-year terms.” While a rate may age three or four years before review and potential resetting by a state commission, the nomination process suggests that some rates may change every year, and some may never change, notwithstanding the potential for

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<sup>2</sup> D.04-09-063 at 239.

dramatic changes in the underlying costs. According to Verizon, the TELRIC rules admit no such fundamental modification.

Prior experience shows us that the annual reexamination costing process is not the best method to update UNE rates. The AT&T reexamination proceedings from 2001 and 2002 were combined and several key UNEs were reviewed and recosted. That proceeding took 3 ½ years to complete and resulted in a decision almost 300 pages long. Needless to say, significant party and Commission resources went into that annual reexamination process. As CALTEL mentioned, The Utility Reform Network (TURN), which acts as an advocate on behalf of residential ratepayers, spent 1,200 hours participating in that proceeding.

The telecommunications landscape has changed radically since the first UNE costing proceedings, when CLECs AT&T and MCI sponsored the HM 5.3 model and participated vigorously in the proceeding. Those two companies have since been absorbed into Pacific Bell and Verizon, and are no longer available to sponsor the HM 5.3 model, as they have in previous UNE cost proceedings. CALTEL indicates that it does not have the resources to take a leading role in any UNE costing proceeding.

Therefore, any such resource-intensive process does not make sense for annual updating of the UNE rates adopted for AT&T and Verizon. However, we reject Verizon's contention that the rates adopted using the reexamination process adopted in D.99-11-050 do not comply with TELRIC. AT&T itself agrees that no party has shown that the process failed to set TELRIC-compliant rates, and no court has found that the rates adopted in D.04-09-063 do not comply with TELRIC. Regardless, the proposal to use the process adopted in D.99-11-050 is rejected because the process is too resource-intensive for annual updates in UNE rates.

#### **4.2. CALTEL's Price Cap Proposal**

CALTEL proposes implementation of a price cap mechanism to be used to adjust the rates for UNE services offered by AT&T and Verizon pursuant to § 251 of the Telecommunications Act of 1996. CALTEL's proposal is designed to operate as the sole method of adjusting rates for wholesale services and replaces the "re-examination process" adopted for AT&T in D.99-11-050. The price cap proposal that CALTEL recommends is similar to those commonly used in federal and state regulatory proceedings.

The methodology to be used under the CALTEL price cap proposal includes the following three elements:

- 1) Confirm the initial rates for AT&T and Verizon's § 251 network elements, based on prior proceedings;
- 2) Establish two annual price adjustment factors to apply to the § 251 network prices; and
- 3) Require AT&T and Verizon to file annual compliance reports identifying the revised price caps for each network element, with an opportunity for interested parties and the Commission to ensure the factors are applied properly.

CALTEL points out that, unlike the other two alternatives the Commission identified for consideration, the price cap plan does not require the Commission to go through a complex ratemaking process to update existing rates. The initial rates would be the rates set in proceedings that have already been completed for both AT&T and Verizon, and those rates would be updated by a simple formula.

According to CALTEL, the basic parameters that govern future prices are the applicable inflation rate (which permits gradually increasing price levels to compensate for inflation) and the productivity factor (that reduces prices based on expected productivity improvements, including increases in economies of

scale that result from spreading fixed costs over increasing demand). Together, these factors would link changes in UNE prices to expected changes in forward-looking costs, and thereby preserve the nexus between prices and costs that is required with respect to the TELRIC rates for UNEs.

CALTEL recommends that the Commission use the national Gross Domestic Product Price Index (GDP-PI) as its measure of inflation. The GDP is defined as the market value of all final goods and services produced within a country in a given period of time. The GDP-PI properly measures the price changes that affect these goods and services, including services like those provided by AT&T and Verizon. CALTEL points out that the Federal Communications Commission (FCC), in federal price cap proceedings, has used the GDP-PI for a decade in measuring general price inflation facing ILECs. Therefore, CALTEL concludes that it is an appropriate inflation measure.

Next, the Commission needs to adopt a productivity factor. CALTEL suggests that the Commission could consider what has happened to cost-based rates for UNEs over a sustained period of time and determine from those rate changes (which should reflect cost changes) an imputed level of productivity gains.

Productivity is evaluated by examining costs changes and eliminating the effect of inflation. A comparison of cost-based UNE prices to the previous Commission-determined UNE prices provides a basis for assessing the implicit productivity gains over the intervening years. With respect to AT&T, for example, the rate for a Zone 1 loop declined by 2.3% from 1999 to 2004, from

\$9.87 to \$9.64.<sup>3</sup> This decline, which reflects the result of detailed cost studies performed in the UNE rate setting proceedings before the Commission, represents an average annual decrease of about 0.45%.

CALTEL asserts that the rate change for Zone 1 loops is a good measure to use in this inquiry, as it represents the bulk of the UNEs that will be purchased by wholesale customers. Moreover, the Zone 1 loop rate adjustment appears to track inflation and conservatively low levels of productivity improvements.

During the 1999-2004 period of declining loop rates, the average annual inflation rate, based upon GDP-PI growth, was 2.25%.<sup>4</sup> Given this inflation level and the rate adjustments based on costs, it is reasonable to presume that the level of ILEC productivity over the same time period was approximately 2.7%. Specifically, if the ILEC was experiencing a productivity level of 2.7% and the inflation rate was 2.25%, this would account for the measured decline of about 0.45% per year (since cost-based rate change = inflation minus productivity factor).

Therefore, CALTEL recommends the use of a productivity factor of 2.7% in its proposed price cap plan for AT&T and Verizon. CALTEL points out that this is significantly lower than the 5.3% rate used by the FCC<sup>5</sup> and previously

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<sup>3</sup> D.99-11-050 (\$9.87); D.04-09-063 (\$9.64).

<sup>4</sup> The federal data on the GDP-PI over the relevant time period is as follows:

	1999	2000	2001	2002	2003	2004
GDP-PI Index	97.868	100.000	102.402	104.193	106.310	109.102

<sup>5</sup> In the industry-negotiated plan sponsored by the CALLS Coalition, there was no productivity factor per se, but rather a negotiated schedule of reductions to move rates lower. The FCC, therefore, had used a productivity factor of 5.3%. (Federal-State Joint

*Footnote continued on next page*

recommended by CALTEL. CALTEL believes that given the recent upward trend in inflation rates, adoption of a 2.7% productivity factor will probably have an extremely conservative effect, most likely resulting in steady or slightly increased UNE rates over the near term.

CALTEL cites recent government data on productivity for the telecom sector which demonstrates just how conservative the CALTEL proposal is. The Bureau of Labor Statistics tracks labor productivity data for wired communications carriers. As shown by this data for 1993 through 2003,<sup>6</sup> every year except 2001 shows labor productivity in that sector higher than 2.7%:

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Board on Universal Service, CC Docket No. 96-45, *Eleventh Report and Order*, 15 FCC Rcd 12962).

<sup>6</sup> Source: Bureau of Labor Statistics, *Industry Productivity and Costs, Wired Telecommunications Carriers*, <http://www.bls.gov/data/home.htm>.

<b>Year</b>	<b>Prod. Factor</b>
1993	7.1
1994	6.8
1995	6.8
1996	10.6
1997	3.7
1998	4.8
1999	7.9
2000	5.3
2001	0.8
2002	7.4
2003	4.4

In fact, with the near-miss of 1997 and the 2001 anomaly, every year's productivity level is at or above 4%, often much higher. The average over the entire period is approximately 6%.

CALTEL supports its price cap mechanism as the best solution saying that the resources necessary to conduct cost proceedings for UNEs have overwhelmed the Commission and the parties. CALTEL points to the recent decision in the Verizon UNE phase of this proceeding that was five years in the making; the AT&T proceeding that ended in 2005 took a similar amount of time. A price cap plan eliminates the need for future cost proceedings, other than periodically to evaluate the productivity factor. It would allow for automatic adjustments to UNE rates based on predetermined calculations. CALTEL says that the resources needed for viable participation in such cases are rapidly disappearing. The two largest UNE-based CLECs (the pre-merger AT&T and MCI), which clearly were the non-ILEC parties that invested the most resources in the prior UNE cases, have been acquired by the ILECs. Other interested parties like CALTEL simply do not have the wherewithal to engage in multi-year

proceedings regarding UNE costs and UNE rates, despite the enormous significance that such proceedings would have on its members.

Verizon opposes CALTEL's price cap proposal, saying it is contrary to the TELRIC methodology. It attempts to graft onto the TELRIC rules additional rate-base-related costing principles that are expressly proscribed by the Telecommunications Act. Verizon cites the Ninth Circuit decision reversing the interim rates earlier set in this proceeding in support of its position:

The Telecommunications Act of 1996 provides a single methodology for the setting of rates: TELRIC. 'Federal law requires that any rate for unbundled network elements, adopted by a state commission, comply with TELRIC when adopted.' No provision is made by this law for any rate to be established in a different way.<sup>7</sup>

According to Verizon the seminal Seventh Circuit decision in *AT&T Communications Inc. v. Illinois Bell Telephone*, 349 F.3d 402 (7<sup>th</sup> Cir. 2003) is especially instructive. There, a state law directed that the state commission consider only two TELRIC inputs – fill factors and asset lives – to the exclusion of any others in re-setting the ILEC UNE rates. The court found:

The ICC took as set in stone all ingredients of ratemaking from 1997, and it adjusted the rate only by changing fill factors and asset lives. That approach conflicts with the 1996 Act and is therefore preempted....A rate for unbundled network elements generated by combining some factors that are six years out of date with two other factors that are not forward-looking cannot possibly satisfy the requirements of federal law. *Id.* at 411.

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<sup>7</sup> *Verizon California Inc. v. Peevey*, 413 F.3d 1069, 1073 (9<sup>th</sup> Cir. 2005) (citing *AT&T v. Illinois Bell*, 349 F.3d 402, 411 (7<sup>th</sup> Cir. 2003)).

According to Verizon, if the Illinois statute, which required focus on only two legitimate TELRIC factors was unlawful, then the CALTEL approach which requires focus on two factors that are not even part of the TELRIC process is manifestly so.

AT&T concurs with Verizon's assertion that CALTEL's price cap mechanism is unlawful. Under CALTEL's proposal, UNE rates would be set initially at the rates the Commission has previously approved and that are in place today, and then changed automatically, annually, to account for productivity improvements that CALTEL asserts AT&T might realize accordingly, rather than being "based...on cost" as the 1996 requires. AT&T's UNE rates would be "based...on cost[s]" determined by the Commission, minus a percentage applied each and every year to account for cost savings CALTEL simply asserts that AT&T will realize. According to AT&T, nothing in the 1996 or FCC rules countenances that approach.

AT&T asserts that although CALTEL's proposal also includes an upward adjustment to reflect inflation, which does not salvage its proposal; whether or not the combined effect of inflation and productivity drive rates up or down, the change is not based on a showing of a cost change. Consequently, AT&T concludes the rates would not be compliant with the FCC's requirement that states set TELRIC rates.

According to AT&T, CALTEL confuses the issue by interchanging the distinct *actual* cost principles behind price caps and the *hypothetical* cost principles underlying TELRIC pricing. Under price caps, a regulator makes a real world calculation of actual, current costs and then puts in place a formula for calculating the productivity improvements, with an offset for inflation, that are expected to occur over time. Under TELRIC, by contrast, state commissions are

charged with making a hypothetical – not actual – determination of costs. What is the forward-looking cost of a given element, using the most efficient technology available? TELRIC studies thus already account for all foreseeable productivity as they assume placement of only new technology, essentially replacing AT&T's existing network with a forward-looking, more productive network. CALTEL's proposal to reduce TELRIC costs by the very same productivity gains already incorporated in TELRIC would be double-counting.

Also, AT&T rebuts CALTEL's reliance on the FCC's *TELRIC NPRM*,<sup>8</sup> in support of its price cap proposal, saying that it is clear that the FCC's rules do not presently permit states to use a price cap regime to set UNE rates. In the NPRM, the FCC explained that, under its existing rules, "state commissions [need] to conduct a full UNE pricing proceeding every few years."<sup>9</sup> It was in connection with that statement that the FCC invited comment on whether it should change its rules to permit UNE rates to be adjusted automatically over time "similar to many price cap regimes." AT&T concludes that it is clear that the FCC's rules do not presently permit state to use a price cap regime to set UNE rates.

In our analysis of CALTEL's price cap proposal, we must first look at the FCC's TELRIC NPRM. The parties all cite the FCC's TELRIC NPRM to prove

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<sup>8</sup> *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*, 18 FCC Rcd. 18,945 FCC 03-224, ¶140 (rel. Sept. 15, 2003), (*TELRIC NPRM*).

<sup>9</sup> *TELRIC NPRM* ¶139.

their position. One point is clear, namely the FCC shows that it is well aware of the tremendous resources involved in conducting a TELRIC UNE proceeding.

One issue on which all parties likely agree is that UNE pricing proceedings under the Commission's current rules require a substantial commitment of resources from everyone involved. A typical UNE pricing proceeding may take two or three years to complete, which results in rates that may be outdated at the time they are adopted.<sup>10</sup>

Because of the resources necessary to conduct a TELRIC cost proceeding, the FCC asks parties to comment on whether a price cap regime might be used to reduce the need for state commissions to conduct a full UNE pricing proceeding every few years. The FCC asks whether a periodic adjustment to rates in lieu of a full UNE pricing proceeding would be sufficient to satisfy a state's legal obligations under § 252. The FCC asks those questions, but we do not yet have an answer to them. According to CALTEL, there is no federal law that prohibits this Commission from adopting a price cap mechanism now, even in advance of any action by the FCC. We disagree. The FCC leaves open the question of whether a periodic price cap adjustment would constitute compliance with § 252. Until that question is answered, we are required by § 252 to conduct periodic UNE cost proceedings.

The bulk of the FCC's NPRM includes a comprehensive review of the TELRIC methodology. The FCC indicates that it proposes to simplify TELRIC pricing while improving the accuracy of the process. The question on price caps is tacked on to the end.

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<sup>10</sup> *TELRIC NPRM* ¶138.

The FCC issued its *TELRIC NPRM* almost five years ago, in 2003. Comments were collected, but the FCC has not yet rendered a decision. The FCC's proposal that a price cap regime be adopted as a means to update UNE pricing is just that – merely a proposal, not a rule. However, while we believe the price cap mechanism would provide a good way to make annual updates to our TELRIC costs, we believe that it would not fulfill the stated requirements under § 252, and therefore could not replace cost proceedings.

However, CALTEL is correct that the federal rules are silent on how changes in TELRIC-based rates should be reviewed. There are no rules concerning how frequently such rates should be adjusted. To the contrary, the timing of full UNE-cost proceedings is within a state's discretion. We find nothing in the FCC's rules that would preclude adopting a price cap methodology to adjust UNE rates annually, in lieu of holding frequent reexamination costing proceedings. However, the FCC has not concluded that a price cap adjustment to rates in lieu of a full UNE pricing proceeding would satisfy a state's legal obligations under § 252. That issue is still open, pending decision by the FCC.

We do not agree with AT&T's contention that price caps, which rely on an inflation rate and a productivity factor, cannot set rates that are TELRIC-compliant. We also disagree with AT&T's contention TELRIC studies already account for all foreseeable productivity, and its conclusion that CALTEL's proposal to reduce TELRIC costs by productivity gains would be double-counting. These arguments rely on some sort of hypothetical theory of absolute perfection in determining compliance with TELRIC. Federal law does not require such preciseness. Although AT&T uses the word "hypothetical" to describe these costs, its argument is instead based on such costs being

absolutely precise. Such is not the case. TELRIC rates are modeled based on a hypothetical network, and as such there is a lack of precision in the rates which result from the model. The TELRIC rates are hypothetical at one point in time, and we assume that inflation and productivity will continue into the future.

However, we need to adopt a method for periodic updates of our UNEs, and CALTEL's price cap methodology provides a more ministerial approach, requiring far fewer resources than the reexamination process adopted for AT&T in D.99-11-050. Therefore, we will adopt CALTEL's price cap proposal to make annual updates in our UNE rates, between costing proceedings. We anticipate that this will allow us to hold costing proceedings less frequently, and the update process will be accomplished more quickly, using fewer resources. If the FCC determines that a price cap process would completely fulfill a state's legal obligations under § 252, we will tailor our process to meet the FCC's requirements.

We note that the starting points for this price cap process are the TELRIC UNE rates adopted for AT&T and Verizon by this Commission. While not all parties agree with the rates adopted, no court has found that the rates currently in place are not in compliance with TELRIC principles.

The ILECs' reliance on the Ninth Circuit Court of Appeals is misplaced. The Ninth Circuit requires that UNE rates adopted by a state commission comply with TELRIC when adopted. We met that requirement by adopting TELRIC rates for both AT&T and Verizon. Those TELRIC-compliant rates will be the starting point for this process. Using those rates as a starting point, the price cap plan makes an adjustment to reflect reasonable changes in costs that have occurred over time, as determined by inflation and productivity changes.

As CALTEL states, nothing about the price cap plan assumes that these price cap adjustments constitute the actual, direct cost changes in providing the services.

We find that the Seventh Circuit case cited by Verizon is not on point. The circumstances in *AT&T Communications inc. v. Illinois Bell Telephone* were not the same. In that case, a state law ordered the state commission to consider only two TELRIC inputs – fill factors and asset lives – in re-setting its UNE rates. It is a stretch to apply those results to what CALTEL is proposing.

CALTEL's proposal uses a floating inflation rate and a fixed productivity factor. The floating inflation rate is based on the annual GDP-PI data compiled by the U.S. Bureau of Labor Statistics.

The FCC has used GDP-PI as its measure of inflation in federal price cap proceedings, and it is appropriate to use that measure of inflation in our UNE price cap process as well. We will utilize the data for the prior year in our calculations.<sup>11</sup>

CALTEL proposes a fixed productivity factor of 2.7%. The productivity factor was based on historical evidence and then leaves that factor fixed over a period of time. Also, the CALTEL proposal does not assume that costs will decrease over time. If inflation increases to any level over the productivity factor of 2.7%, the price cap mechanism sees increasing costs and thus allows for increases of AT&T's and Verizon's UNE rates. As CALTEL states, this is a modest productivity factor, especially when compared with the 5.3% rate adopted as part of the CALLS proposal. Neither AT&T nor Verizon commented

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<sup>11</sup> The source for the GDP-PI data is the Bureau of Economic Analysis, U.S. Department of Commerce, [http://www.bea.gov/industry/gpotables/gpo\\_action.cfm?anon=71875&table\\_id=22091&format\\_type=0](http://www.bea.gov/industry/gpotables/gpo_action.cfm?anon=71875&table_id=22091&format_type=0).

on the fact that CALTEL reduced the productivity factor from the 5.3% rate that it recommended last year to the 2.7% recommended here.

AT&T argues that there is no evidence that productivity gains will continue over time. CALTEL responds that it has not argued that the productivity factor should be established now and never looked at again. CALTEL suggests that the Commission set the factor now at a recommended level of 2.7% and then establish regular reviews to update the factor. We concur with CALTEL, that this plan should alleviate AT&T's concerns.

AT&T asserts that CALTEL attempted to skew the productivity factor by looking only at Zone 1 UNE loop rates, rather than the average across the state. CALTEL responds that it chose the Zone 1 UNE loop rate because that represents the vast majority of loops purchased by wholesale customers. According to CALTEL, it is not reasonable to include the statewide average on UNE loop rates because it would bring into the analysis, with equal weighting, UNE loops that are purchased far more infrequently.

We find it significant that AT&T's assertion that CALTEL used the wrong rates (from D.04-09-063 instead of D.05-03-026) results in a higher productivity factor for Zone 1 UNE loop rates. Based on AT&T's calculation, the productivity factor recommended by CALTEL should be set at 3.04% rather than 2.7%.<sup>12</sup> According to AT&T, CALTEL used the wrong rates; the 2004 rates CALTEL used were reduced in D.05-03-026 to reflect a change to the shared and common cost factor. In its Rebuttal Comments, CALTEL does not rebut AT&T's assertion that it used the wrong rates, but CALTEL notes that, based on AT&T's calculation,

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<sup>12</sup> AT&T reply brief at 2.

the productivity factor would be higher, 3.04% rather than the 2.7% calculated by CALTEL. We agree with AT&T that the productivity factor should be set using the latest data available, and therefore, will adopt 3.04%, which is based on historical evidence, as the productivity factor for future price cap adjustments.

AT&T notes that productivity or inflation is not the only factors that affect TELRIC; other factors indisputably include such items as fill factors, cost of capital, etc. We agree that other factors affect TELRIC, but what we are looking for is a simple way to update the TELRIC rates on an annual basis, without embarking on a lengthy, time-consuming proceeding. There is no easy way to review the inputs to the TELRIC rates. The price cap mechanism allows us to adjust those rates without resorting to a full-blown cost proceeding every year.

We will model our price cap process on that adopted in our New Regulatory Framework D.89-10-031. The adopted UNE rates will be adjusted annually by an Advice Letter filed by the two major ILECs with the Communications Division.

However, while the price cap mechanism allows us to update UNEs between cost proceedings, we need to address how such costing proceedings will occur in the future.

#### **4.3. Revise UNE Rates by Adjusting Inputs to the HM 5.3 Model**

The HM 5.3 model was used to set UNE rates for both AT&T and Verizon in their latest UNE ratesetting proceedings. The May 15, 2006 ALJ Ruling proposes adjusting inputs to the HM 5.3 model to set future UNE rates. All parties are opposed to use of the HM 5.3 model, but for widely different reasons.

Verizon objects saying that pre-ordaining use of HM 5.3 violates Verizon's due process rights. Also, Verizon says it is impractical because there is no party presently willing to sponsor the HM 5.3 model. Sponsorship of a model in a

UNE proceeding is critical because of the complexity of the modeling process itself.

Verizon asserts the proposed option is unlawful because it strips Verizon of the right to introduce evidence on its behalf for consideration in the ratemaking process. It is undisputed that the incumbent bears the burden of proof in TELRIC rate proceedings. A Commission directive that prevents Verizon from introducing what it then determines is the best evidence of its case in chief, using a methodology mandated by federal law, is inconsistent with this burden assignment.<sup>13</sup>

Verizon finds it especially inappropriate for the Commission to pre-determine which model will be used in an area of the law where the limitations on state jurisdiction have been expressly articulated by numerous federal courts. Verizon relies on language of the Ninth Circuit, previously cited in support of its position.

According to Verizon, there is no requirement in the TELRIC rules that permits a state to choose a “permanent” model, nor is the absence of a restriction against it a basis for the Commission doing so. Because Verizon does not presently intend to sponsor the HM 5.3 model, and, as the party bearing the burden of proof, has the right to provide its case as it deems best, the Commission should not pre-ordain which model may be used. According to

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<sup>13</sup> Verizon cites *E.g., Sargent Fletcher, Inc. v. Able Corp.*, 110 Cal. App. 4<sup>th</sup> 1658, 1667 (2d Dist. 2003) (“Except as otherwise provided by law, a party has the burden of proof as to each fact the existence or nonexistence of which is essential to the claim for relief or defense that he is asserting...If that party fails to produce sufficient evidence to make a prima facie case, it risks nonsuit or other unfavorable determination.”).

Verizon, the TELRIC rules do not permit the Commission to make such a determination prior to the initiation of a proceeding.

AT&T agrees that using HM 5.3 for future reexaminations is not a viable option. First, AT&T states that HM 5.3 is a fundamentally flawed model that does not accurately identify AT&T's TELRICs. The starting point of HM 5.3 is a clustering process that in essence builds the network that HM 5.3 costs. The clustering process and HM 5.3 fundamentally change the way telephone plant is or would be installed. Real world attributes are ignored, and the result is that costs are intentionally driven well below accurate measures of TELRIC. According to AT&T, those structural errors cannot be corrected by changing inputs.

Second, the primary input to HM 5.3 is actually the output from the clustering process that was performed for HM 5.3's sponsors by TNS.<sup>14</sup> This clustering process was an enormous modeling exercise that took service volumes and service locations and built a network with design characteristics dictated by the HM 5.3 developers. Once the clustering process is done, the results are input into HM 5.3 and costs are generated. According to AT&T, no revisions to TELRIC rates based on HM 5.3 would be possible without also updating the clusters to reflect current demand. HM 5.3 is not a viable model to revise UNE rates because no party can create new clusters themselves or is likely to incur the very large expense of revising the clusters to create the required forward-looking network.

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<sup>14</sup> D.04-09-063, *mimeo.* at 79.

Third, the inputs used in HM 5.3 cannot be easily updated, so any reexamination procedure would not be swift and without contention.

Thousands of potential inputs could be changed.

Fourth, the Ruling generally references HM 5.3 but HM 5.3's proponents filed numerous revisions to HM 5.3 in both AT&T's reexamination proceeding and Verizon's UNE cost proceeding. AT&T is unaware of the existence of an HM 5.3 model that conforms to the changes made by the Commission to arrive at the rates for AT&T or Verizon. Without the versions of HM 5.3 that were used to set the rates, any reexamination based on input changes would have the wrong starting point and lead to erroneous results.

Fifth, because the previous model proponents will no longer be putting forward and financially supporting HM 5.3, necessary changes and explanation will not likely be available.

CALTEL opposes use of the HM 5.3 model because of the resources necessary to conduct a UNE cost proceeding. CALTEL points out that the decision in the Verizon UNE phase was five years in the making, and the AT&T proceeding that ended in 2005 took a similar amount of time. To put this in perspective, CALTEL points to the intervener compensation applications filed by TURN in the AT&T and Verizon UNE rate cases. TURN acts as an advocate on behalf of residential ratepayers. In D.05-04-044, TURN was awarded more than \$270,000 for its work on the AT&T UNE proceeding that resulted in D.04-09-063. Turn's award identified more than 1,200 hours over the four years of the proceeding. TURN's filing in the Verizon UNE proceeding, shows a total of more than 2,600 hours of work, spread over a five-year period. And this is just one party to the proceeding. It does not take into account the time expenditures

of the Commission staff, the CLEC interveners, and Verizon itself for their participation in the case.

CALTEL points out that the resources needed for viable participation in such cases are rapidly disappearing. The two largest UNE-based CLECs (the pre-merger AT&T and MCI), which were clearly the non-ILEC parties that invested the most resources in the prior UNE cases, have been acquired by the ILECs. Other interested parties like CALTEL, simply do not have the resources to engage in multi-year proceedings regarding UNE costs.

We do not agree with Verizon's contention that TELRIC rules do not permit the Commission to select a model prior to the initiation of a proceeding. We find nothing in the TELRIC rules that would preclude our selecting the model to be used. In the past our TELRIC costing proceedings have been lengthy. Part of the dispute has centered around which model to use, the HM 5.3 model or the models presented by the ILECs. We have rejected the models proffered by AT&T and Verizon, as not being consistent with TELRIC rules. We recognized that the HM 5.3 model was not perfect but felt that it produced the best approximation of TELRIC costs. Therefore, we have no intention of going over the same territory again. We will use HM 5.3 as a starting point, and parties will have an opportunity to present evidence as to which assumptions and inputs should be changed.

In its Reply comments, TURN asserts that it would be appropriate to use HM 5.3 to update UNE costs. According to TURN, AT&T attempts to re-litigate an argument that the Commission has already rejected, namely that the clustering process in HM 5.3 does not accurately identify AT&T's costs. AT&T conveniently forgets that the Commission found significant flaws in AT&T's and Verizon's own cost models to the extent that these were deemed incapable of

calculating lawful costs. HM 5.3, including its utilization of the clustering process, has been thoroughly examined by the Commission and found to produce lawful UNE rates.

AT&T argues that the model is not viable because of the expense required to update the clustering data, claiming that because the original sponsoring parties are no more, no party will want to incur that expense. According to TURN, AT&T ignores an important fact. AT&T's own analysis demonstrates that changes to the clustering database had very little impact on the costs generated by the HM 5.3 model. CLECs AT&T and MCI (co-sponsors of HM 5.3) presented testimony demonstrating that the difference in costs calculated by Pacific Bell's cost models and costs calculated with the HM model were due to changes in a relatively small number of inputs, rather than the "thousands of potential inputs" claimed by AT&T, or clustering inputs.<sup>15</sup> This rebuts AT&T's arguments against use of the HM 5.3.

Verizon objects that the option of using HM 5.3 to update UNE costs is unlawful because it strips Verizon of the right to introduce evidence on its behalf for consideration in the ratemaking proceeding. According to TURN, nothing could be further from the truth. The sensitivity analysis conducted by the Joint Applicants [CLECs AT&T and MCI] identified the key inputs that drive the calculation of costs. All parties – including the ILECs – will have an opportunity to present evidence as to what inputs should be used to calculate costs. Further,

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<sup>15</sup> Those inputs are copper cable investments, DLC investments, cost of capital, maintenance factors, switch investments, depreciation, the Network Interface Device and protection block, and the copper cable limit. Application 01-02-024, etc. Corrected Rebuttal Comments of Joint Applicants, March 12, 2003, p. 6-35.

the practice of picking a “preferred” model for future rate setting proceedings is common at the Commission.

AT&T makes equivocal statements about the HM 5.3 model. On one hand, it asserts that using HM 5.3 for future reexaminations is not a viable action. According to AT&T, HM 5.3 is a “fundamentally flawed model that does not accurately identify AT&T California’s TELRICs.”<sup>16</sup> However, in the same document, AT&T states: “The reexamination process used for setting AT&T California’s current UNE rates was set out in 1999, and *no party has shown it failed in being able to set TELRIC-compliant rates.*”<sup>17</sup> The UNE rates adopted in D.04-09-063, using the process set out in the 1999 decision, were based on HM 5.3. AT&T is endeavoring to have it both ways, but either its rates set using HM 5.3 are TELRIC-compliant or they are not. We previously found those rates to be TELRIC-compliant.

We are concerned about the dynamics of such future proceedings, since we no longer have CLECs AT&T and MCI to sponsor the HM 5.3 model. CALTEL says that it does not have the resources to take a lead role in a lengthy UNE proceeding, and while TURN suggests that Google might be willing to take on that role, we have no way of knowing if that will happen. In order to encourage participation of interveners and parties with fewer resources, we will require the ILECs to pay for a consultant to run the HM 5.3 model (and update the clustering database, if necessary) on behalf of the Commission and all the

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<sup>16</sup> AT&T California’s (U 1001 C) Comments on Proposals for Reexamination of UNE Rates, June 27, 2006 at 6.

<sup>17</sup> *Ibid.*, p. 8 (emphasis added).

parties. While the ILEC – either AT&T or Verizon – will pay for the cost of the consultant, the consultant will be selected by and be under the exclusive direction of the Commission’s Communications Division. If any party wants “what if” scenarios run, it will place a request with the Communications Division, which will transmit that request to the consultant. Clearly, AT&T and Verizon have the resources to pay for a consultant, and this will take some of the burden of participating in the proceeding off the shoulders of interveners and other parties.

In order for the process to move smoothly, we will require the ILEC that intends to file an application for changing UNE rates, to file a Notice of Intent (NOI) 12 months in advance of its filing. That will give the Communications Division time to complete the selection process for a consultant to administer the HM 5.3 model, and to work with the consultant in reconstructing the model from that ILEC’s last UNE costing proceeding. While the ILECs contend that that model would be impossible to re-create, we disagree. The model itself was submitted and is part of the record of each proceeding and any changes that occurred would be documented in the official record of the proceeding. The Commission’s decisions delineate any changes the Commission ordered to the model.

Also, if any party sees the need to update the clustering process, that party should file a motion in the new UNE cost proceeding docket. If necessary, we will have a consultant perform that function before the ILEC files its application.

However, there is another wrinkle on the horizon. In its TELRIC NPRM, the FCC proposes clarification or changes to the TELRIC model which would have significant impact on UNE costs developed by the states. The FCC has not yet acted on that NPRM, but once it does, we anticipate that those changes will

need to be incorporated into the HM 5.3 model. If necessary, we will open a proceeding, to determine how best to implement the FCC's revised UNE costing rules. That could cause delay in conducting full-blown UNE costing proceedings, but it does not make sense to conduct a cost proceeding – at great expense in Commission and party resources – and then find that the outcome was not in compliance with the FCC's revised rules.

Since we have implemented the price cap process described above, we will have a mechanism in place to adjust our UNE rates annually, without recourse to a full-blown UNE proceeding. We propose that we will allow<sup>18</sup> AT&T to file an NOI of its intent to file an application for a UNE costing proceeding no sooner than five years from the effective date of this order. The same will be true for Verizon, no sooner than eight years from the effective date of this order. We are staggering the proceedings so as to avoid overlap. In the interim, we will use the price cap methodology adopted here to update UNE prices. Once an ILEC files an NOI, the price cap process will be in abeyance. As part of the costing proceeding, we will review the adopted productivity factor.

## 5. Comments on Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed on \_\_\_\_\_, by \_\_\_\_\_, and reply comments on \_\_\_\_\_ by \_\_\_\_\_.

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<sup>18</sup> The ILECs would not be *required* to file applications to update their UNE rates, but would be *allowed* to do so, on the schedule adopted here.

## 6. Assignment of Proceeding

Michael R. Peevey is the assigned Commissioner and Dorothy Duda is the assigned ALJ in this proceeding.

### Findings of Fact

1. The AT&T reexamination proceedings from 2001 and 2002 took 3 ½ years to complete and resulted in a decision almost 300 pages long.
2. Significant party and Commission resources went into the annual reexamination process for AT&T that resulted in D.04-09-063.
3. The telecommunications landscape has changed radically since the first UNE costing proceedings, when CLECs AT&T and MCI sponsored the HM 5.3 model and participated vigorously in the proceeding.
4. CLECs AT&T and MCI have been absorbed into Pacific Bell and Verizon and are no longer available to sponsor the HM 5.3 model.
5. CALTEL states that it does not have the resources to take a leading role in any UNE costing proceeding.
6. A resource-intensive process does not make sense for annual updating of the UNE rates adopted for AT&T and Verizon.
7. The FCC shows that it is well aware of the tremendous resources involved in conducting a TELRIC UNE proceeding.
8. Federal rules are silent on how annual changes in TELRIC-based rates should be reviewed.
9. There is nothing in the FCC's rules that would preclude adopting a price cap methodology to adjust UNE rates annually, between cost proceedings.
10. TELRIC rates are modeled based on a hypothetical network, and as such, there is a lack of precision in the rates which result from the model.

11. CALTEL's price cap methodology provides a simple way to update TELRIC rates on an annual basis.

12. The starting point for the price cap process is the TELRIC-compliant UNE rates adopted for AT&T and Verizon by the Commission.

13. The FCC has been using the GDP-PI in its federal price cap proceedings.

14. The 3.04% productivity factor, which is based on historical evidence, is reasonable, and well below that adopted by the FCC as part of the CALLS proposal.

15. The Commission has rejected the models presented by AT&T and Verizon as not being consistent with TELRIC rules.

16. The HM 5.3 model is not perfect but it produces the best approximation of TELRIC costs.

17. It does not make sense to spend party and Commission resources analyzing various models presented by AT&T and Verizon when HM 5.3 meets our needs for TELRIC-compliant rates.

18. AT&T and Verizon have the resources to pay for a consultant to set up and make changes to the HM 5.3 model.

19. The HM 5.3 model was submitted and is part of the record of the last cost proceedings conducted for AT&T and Verizon. Any changes that occurred would be documented in the official record of the proceeding. That information will be used by the outside consultant to re-create the version of HM 5-3 that will serve as a starting point for each proceeding.

### **Conclusions of Law**

1. The UNE rates adopted in D.04-09-063 for AT&T and D.06-03-025 for Verizon are compliant with TELRIC principles.

2. While the price cap mechanism provides a good way to make annual updates to adopted TELRIC costs, the FCC has not ruled on whether use of a price cap fulfills the stated requirements under § 252.

3. The FCC recognizes that the timing of full UNE-cost proceedings is within a state's discretion.

4. No court has found that the UNE rates currently in place for AT&T and Verizon are not in compliance with TELRIC principles.

5. The FCC has used the GDP-PI as a measure of inflation in federal price cap proceedings for many years; therefore, it is a reasonable measure to use in the adopted UNE price cap mechanism.

6. The 3.04% productivity factor adopted here is set low enough to be a reasonable target for the ILECs.

7. There is nothing in the TELRIC rules that would preclude the Commission from mandating the model to be used.

## **O R D E R**

### **IT IS ORDERED** that:

1. The Unbundled Network Element (UNE) reexamination process adopted for Pacific Bell Telephone Company (now AT&T California) in Decision (D.) 99-11-050 is hereby terminated, and replaced with the process adopted in this order.

2. The price cap mechanism proposed by the California Association of Competitive Telephone Companies (CALTEL) is adopted as a means to make annual updates in adopted UNE rates, between costing proceedings.

3. The inflation rate used in the price cap adjustment mechanism shall be based on the national Gross Domestic Product Price Index (GDP-PI).

4. The price cap mechanism shall use a productivity factor of 3.04 percent, subject to periodic review.

5. AT&T California and Verizon California Inc. shall make advice letter filings on October 1 of each year, beginning in 2008 to implement the annual UNE price cap process adopted here. The advice letters shall be filed under Tier 2, and Communications Division staff has the discretion to re-categorize the advice letter as Tier 3 if it is deemed necessary. The UNE rates filed shall reflect the previous year's inflation factor found in the GDP-PI and a productivity factor of 3.04 percent.

6. Interested parties shall have an opportunity to protest the UNE price cap filings, and the advice letters shall become effective upon approval by the Commission via the resolution process.

7. The revised UNE rates shall go into effect the month following approval of the advice letter by the Commission.

8. Until changed by order of the Commission, HM 5.3 is adopted as the model to use for future Total Element Long Run Incremental Cost (TELRIC) proceedings.

9. AT&T California is authorized to file a Notice of Intent (NOI) expressing its intention to file a TELRIC cost proceeding, no sooner than five years following the effective date of this order. Its application for a TELRIC cost proceeding shall be filed 12 months following the NOI.

10. Verizon California Inc. is authorized to file a Notice of Intent (NOI) expressing its intention to file a TELRIC cost proceeding, no sooner than eight years following the effective date of this order. Its application for a TELRIC cost proceeding shall be filed 12 months following the NOI.

11. The February 5, 2008 motion of the CALTEL is granted in part, as described in this order.

12. This decision shall also be served on the Open Access and Network Architecture Development (OANAD) service list used for D.99-11-050 in Rulemaking 93-04-003/Investigation 93-04-002 and the service list for Application 01-02-024.

This order is effective today.

Dated \_\_\_\_\_, at San Francisco, California.