BEFORE THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

CONSUMER ADVOCATE DIVISION	)	
v.	)	
UNITED TELEPHONE SOUTHEAST,	)	DOCKET NO. 98-00626
INC. (IN RE: UNITED TELEPHONE-	)	
SOUTHEAST, INC. TARIFFS TO	)	
REFLECT PROPOSED CHANGES	)	
UNDER PRICE REGULATION PLAN)		

CONSUMER ADVOCATE DIVISION'S POST-HEARING BRIEF AND MOTION TO CONTINUE THE HEARING TO PERMIT THE TAKING OF ADDITIONAL DISCOVERY

Comes the Consumer Advocate Division, or CAD, pursuant to the request of the Directors of the Tennessee Regulatory Authority ("TRA"), and hereby files a Post-Hearing Brief and Motion to Continue and to Permit Additional Discovery.

The continuance is needed in order to establish proof on the issue of the payphone subsidy and other matters in this case. At the hearing, a figure of $143,000 was referred to as the amount of the payphone subsidy. Transcript, May 13, 1999, No 98-00626, at 25. The Consumer Advocate Division, however, was not offered any opportunity to determine the validity of that statement. Accordingly, the hearing should be continued to develop proof on this issue.

I. THE STATUTE ESTABLISHING THE PRICE REGULATION PLAN, NOT A STIPULATION DRAFTED BY THE PARTIES, CONTROLS THE AMOUNT OF ANY RATE INCREASE

Tenn. Code Ann. § 65-5-209(e) provides a limit, or cap, on increases in telephone rates for companies operating under a price regulation plan. This cap is based on the rate of inflation for the year preceding the date of the proposed price increase; in essence, the amount of the increase is capped at a figure of one-half (1/2) the rate of inflation, or the rate of inflation minus 2%, whichever is less. The increases proposed by United Telephone exceed the cap set forth in Tenn. Code Ann. § 65-5-209(e). Accordingly, the proposed price increase should be denied.

The statute at issue in this case, Tenn. Code Ann. § 65-5-209(e), provides as follows:

> A price regulation plan shall maintain affordable basic and non-basic rates by permitting a maximum annual adjustment that is capped at the lesser of one half (1/2) the percentage change in inflation for the United States using the gross domestic product-price index (GDP-PI) from the preceding year as the measure of inflation, or the GDP-PI from the preceding year minus two (2) percentage points. An incumbent local exchange telephone company may adjust its rates for basic local exchange telephone services or non-basic services only so long as its aggregate revenues for such basic local exchange telephone services or non-basic services generated by such changes do not exceed the aggregate revenues generated by the maximum rates permitted by the price regulation plan.

United Telephone maintains that its proposed increases are permissible because they were calculated using the "methodology" contained in a stipulation entered into by United Telephone and the Consumer Advocate Division. A copy of the stipulation is in the record of the hearing Transcript, May 13, 1999, No. 98-00626, at 93-21. The Consumer Advocate Division acknowledges that it entered into a stipulation used in calculating the "caps" when a company proposes a rate increase under the price regulation plan. The Consumer Advocate Division maintains, however, that the stipulation must be interpreted in accordance with the statute and that in no event can the stipulation override state law. Accordingly, if there is a conflict between the stipulation, as interpreted by United Telephone, and state law, the conflict must be resolved in favor of state law.

The TRA recently recognized the principle that it "is not bound by a stipulation that includes an erroneous interpretation of law." Brief of Appellee Tennessee Regulatory Authority, Tennessee Court of Appeals, Middle Section, No. 01A01-9901-BC-00057, TRA Docket No 97-01438, at 21. The TRA recognized this principle in a case involving the issue of whether a service known as ISDN is a basic service. Id. In that case, the stipulation at issue required the TRA to find that ISDN is not a basic service. The TRA, however, held that ISDN is a basic service and any stipulation to the contrary would be an "erroneous interpretation of law." Similarly, in the present case, the TRA should find that any interpretation of the stipulation which allows an increase in an amount greater than that provided by state law is erroneous.

At the hearing, it was clear that United Telephone believes that the stipulation, not the statute, controls rate increases:

> Q [Mr. Williams, Consumer Advocate Division]. Now, is it your contention that the methodology or stipulation language allows for rate increases in any one year to be greater than the lesser of one half the percentage change in inflation for the United States, using the Gross Domestic Product Index for the preceding year as the measure of inflation or the GDP-PI from the preceding year minus 2 percent?
>
> A [Mr. Parrott, United Telephone]. It's my testimony that we are not allowed to effect an annual adjustment greater than the inflationary cap that's calculated in accordance with the stipulated methodology that's been found by this Authority to be compliant with 65-5-209(e). That's my testimony.

Transcript, May 13, 1999, No. 98-00626, at 114. At the time the stipulation was "found" to be compliant with § 65-5-209(e), however, there was no agreement of what to do in the event that the proposed increase, as calculated under the stipulation, was greater than that allowed by the clear language of the statute. Furthermore, the stipulation itself contains language agreeing to compliance with state law that United Telephone seeks to subvert (I. Purpose: ". . . . the agreement below reflects the stipulated aspects of Price Cap methodology to be used by United in calculating indexes and any price adjustments to ensure compliance with the Act.") Thus, at no time has the TRA approved a proposed rate increase that exceeded the inflation-based cap.

United Telephone also argued that the TRA had "approve[d] the methodology and formula for use in calculating the amount of the annual price cap adjustment pursuant to T.C.A. 65-5-209(e) as stipulated to by the parties to this docket." Transcript, Exhibit No. 1 to Testimony of Steve Parrott, May 13, 1999, No. 98-00626. It is one thing, however, for the TRA to approve a stipulation or methodology, and quite another for the TRA to say that the stipulation or methodology is superior to state law. The TRA has not done this and should not do so now.

The Consumer Advocate Division does not contest the mathematics used by United Telephone in computing its proposed price increase under the stipulation (although, as stated at the hearing, the Consumer Advocate Division does question Yellow Pages revenue and payphone subsidies). The Consumer Advocate Division simply contends that no matter what figure is yielded by the stipulation, the price increase cannot exceed the amount allowed by law.

In his pre-filed testimony, Mr. Terry Buckner, of the Consumer Advocate Division, established that United Telephone's proposed increase exceeds the amount allowed under state law. In Exhibit B to his pre-filed testimony, Mr. Buckner took the "Aggregate Non-Basic Revenues at Current Rates"($43,991, 817.48) and the "Aggregate Non-Basic Revenues [at] Proposed Rates ($46,067,289.72)." Transcript, May 13, No. 98-00626, at 203-11. He then determined the amount of the proposed increase by subtracting the current revenues from the proposed revenues ($46, 067,289.72 - $43,991,817.48 = $2,427,406.78). He then found the amount of the proposed in terms of percentage was 4.72%.

Mr. Buckner then followed the directions of Tenn. Code Ann. § 65-5-209(e) and computed the inflation-based cap ("A price regulation plan shall maintain affordable basic and non-basic rates by permitting a maximum annual adjustment that is capped at the lesser of one half (1/2) the percentage change in inflation for the United States using the gross domestic product-price index (GDP-PI) from the preceding year as the measure of inflation, or the GDP-PI from the preceding year minus two (2) percentage points."). The "cap" was determined to be 0.8%. Accordingly, it is obvious that United Telephone is not entitled to any increase; its proposed increase exceeds state law.

In his testimony, Mr. Parrott of United Telephone attempted to deride the Consumer Advocate Division's insistence on applying the inflation-based cap contained in § 65-5-209(e) to the proposed increase, calling it a "two-step" calculation. Transcript, May 13, 1999, No. 98-00626, at 239-7. Apparently, according to United Telephone, there is no need to do anything so mundane as follow the statute laid down by the Legislature. All that is needed, United Telephone would have us believe, is to do a "one-step" and look no further than the stipulation drafted by the parties. Such ignoring of the law, however, cannot be countenanced by this agency.

At various times, this dispute as to whether the statute or the stipulation controls has been described as a dispute as to whether rate increases should be figured on an "annual" or a "cumulative" basis. United Telephone maintained that the stipulation allowed it to compute its rate increases on a "cumulative" basis. In fact, United Telephone was so obsessed with the belief that it was entitled to "cumulative" increases that Mr. Wright, the attorney for United Telephone at the hearing, claimed that the word "cumulative" was expressly used in the stipulation at issue in regard to the calculation of both the inflation index and the aggregate revenues:

> And, again, the purpose [of referring to certain revisions to the stipulation as it was being drafted] was primarily to show that the stipulation, which includes the methodology -- and the methodology expressly includes the words

> cumulative when telling how to calculate the inflation index and the cumulative aggregate revenues, they both use the term cumulative.

Transcript, May 13, 1999, No. 98-00626, at 12. A reader, however, will look in vain for the term "cumulative" in relation to the inflation index in the stipulation.

Thus, according to United Telephone and its reading of the stipulation, if the inflation-based cap in § 65-5-209(e) allowed for a 2% increase in year 1, but no increase were taken, and a 2% increase in year 2, United Telephone should still be allowed have the 2% increase for year 1, for a total 4% adjustment. The Consumer Advocate Division, on the other hand, contends that the agency must follow § 65-5-209(e) and look to inflation in the year preceding the increase to determine what is allowed. This position was succinctly set forth by Consumer Advocate Division witness Buckner in Exhibit B to his pre-filed testimony. Transcript, May 13, 1999, No. 98-00626, at 203-11.

Mr. Buckner also testified that the conflict between cumulative and annual increases would be unnecessary if the allowable increases were taken <u>annually</u>. Transcript, May 13, 1999, No. 98-00626, at 203-5:

> The stipulation establishes the method of determining the cumulative percentage increases and the maximum cumulative increase allowed over a period of years <u>assuming that rates are increased the maximum allowed each year in accordance with Tenn. Code Ann. § 65-5-209</u>.

<u>Id</u>. (emphasis in original).

Significantly, the stipulation itself calls for an annual filing; it is even entitled "Price Cap Annual Filing Methodology."

Mr. Parrott acknowledged that the decision of whether or not to make an annual filing was United Telephone's. Transcript, May 13, 1999, No. 98-00626, at 131. United Telephone, therefore, is solely responsible for any results arising from its decision not to make an annual filing.

Finally, the statute itself, Tenn. Code Ann. § 65-5-209(e), clearly looks to annual, not cumulative, increases. First, the statute refers to a "maximum annual adjustment." The statute does not use the word cumulative anywhere. Furthermore, in describing the inflation-based cap, the statute refers to the increase in "the gross domestic product-price index (GDP-PI) from the preceding year," not years. Under United Telephone's theory of the case, however, it is necessary to use the GDP-PI from the preceding years. Thus, Mr. Parrott testified that his calculations under the methodology of the stipulation were based on the cumulative change in inflation since 1995, not the preceding year:

> We then multiply that by the 1997 PRI, which was 101.1028, to arrive at a cumulative change in inflation since we got into price regulation in October of '95, and that cumulative is 100.294.

Transcript, May 13, 1999, No. 98-00626, at 80.

In maintaining that the stipulation is controlled by the statute, the Consumer Advocate Division is not arguing that the stipulation has no function. On the contrary, the Consumer Advocate Division recognizes that the stipulation is absolutely critical for determining the "aggregate revenues" referred to in § 65-5-209(e). In particular, the stipulation sets forth the date at which revenues are calculated and the volumes of the services. Mr. Parrott acknowledged this fact in his testimony when he discussed how the stipulation dealt with the fact that the volume of usage of services changes constantly (or to use the term of art, the services were "stimulated" and "destimulated"; accordingly, it is necessary to decide which volumes are to be used in the calculations:

> United, in the course of the negotiations with the parties, understood that by

> using, in the stipulated methodology, current units of demand, there would be no need to try to guess what stimulation or destimulation might occur. The beauty of the calculation is, by using updated units of demand, it automatically tells you whether or not you had stimulation, destimulation. <u>And that's the very reason that United signed onto the stipulation with the other parties</u>.

Transcript, May 13, 1999, No. 98-00626, at 110-111 (emphasis added).

The Consumer Advocate Division agrees that the stipulation serves to establish a limit on rate increase because it utilizes a maximum cap or limit. However, when the limit as computed by the formula in the stipulation exceeds the limit established by statue, the stipulation must give way.

II. YELLOW PAGE AND DIRECTORY ADVERTISING REVENUE SHOULD BE IMPUTED TO UNITED TELEPHONE

United Telephone's allowed increase in its aggregate revenue is further altered by the amount of directory, or yellow page, advertising revenue. As previously discussed, the upper limit in the amount of the annual rate increase is prescribed in Tenn. Code Ann. § 65-5-209 (e). Although in previous filings, United Telephone included directory revenue in both the base period aggregate revenue and the aggregate revenues under proposed rates, the company excluded the yellow page revenue in this filing[1]. The Consumer Advocate Division contends that directory advertising revenue should be included in this filing to be consistent with the procedure followed by the Tennessee Public Service Commission when United Telephone's initial rates were approved.

United's witness, Mr. Parrott, agreed that the Yellow Page revenues were considered by the Public Service Commission when the initial rates were determined. In previous filings, United included a portion of its advertising revenue in the aggregate revenue. Mr. Parrott explained that,

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[1] United Telephone provides billing and collecting service for its affiliate, Sprint Publishing. United's witness, Parrott, testified that the total directory billing and collecting revenues for all companies (affiliates and non-affiliates combined) is $4,120 per month.[$4,120 X 12=$49,440 annual revenue.](TR page 86).

in the current filing, the directory revenues were excluded because the company had changed its contract with its affiliated directory company:

> A. There was a change, and if I could, I'd like to describe the change. The change was that in the September 1998 filing, there had been a contract change made effective July 1, '97, between our company and our directory publishing affiliate as it related to the base publishing fee that was contained in the original agreement, which dates back to like 1990. So there was a contract change.
>
> We incorporated that in the September 15th filing, which we would assert to the Authority even the September 15th filing was in accordance with the stipulated methodology. The only reason that we amended the filing was, in looking at that one particular item, which was **exclusively** between **us and an affiliate directory publishing company**, did not affect and would never affect any other publishing company. What we decided was that it was improper to extract from our customers the fact **that revenue that we were receiving from the affiliate under the old agreement now we were no longer receiving**. We did not believe it was appropriate or in the public interest to extract that from our customers, since it related solely to a contract and services rendered between us and that affiliate. And that's the reason for the change.(TR page 134) (Emphasis added.)

Mr. Parrott also explained that:

> But what we would tell you is that if we reverted back to the September 15th filing that our latitude **calculated <u>strictly by the stipulation</u>**, our latitude would be an additional 3.8 million dollars. And we chose to forgo that because of the uniqueness of that agreement and the change that was made related to that one item, the base publishing fee. We chose to take that out and, in the sake of public interest, not extract that from our customers.(TR page 135) (Emphasis added.)

United Telephone contends, if its filing was "calculated strictly by the stipulation," the decline in directory revenue results in an additional $3.8 million in allowed revenue increases. This change, however, was caused by United Telephone diverting its yellow pages advertising revenue to a wholly-owned affiliate.[2]

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[2]In a previous proceeding before the Tennessee Public Service Commission, including the proceeding that established Sprint United Telephone Company-Southeast, Inc. Telephone

Because this revenue has been given to its affiliate, United Telephone elected, instead of calculating the allowed change in aggregate revenue "strictly by the stipulation," to recognize none of the directory revenues that were included when its initial price regulation rates were determined, as illustrated below:

> Q. So the revenue that United was previously receiving from that affiliate is being retained by that affiliate now?
>
> A. The revenues that we were receiving are being retained by the affiliate?
>
> Q. Yes. You were receiving 3,845,187 before and now you're only receiving 194,000, so the affiliate retains the balance, doesn't it?
>
> A. Well, Mr. Williams, first of all --
>
> Q. Is that yes or no?
>
> A. Yes. But let me explain. There were reasons for making the contractual change, as I presented in my testimony, and that is, if you go back to the 1990 contract with Sprint Publishing and Advertising, they were paying us the publishing fee because they were publishing an exclusive directory for United Telephone-Southeast, Incorporated. Because the advent of competitors coming into the marketplace and the fact that Sprint Publishing and Advertising is no longer publishing an exclusive book for United Telephone-Southeast, Inc., they're now publishing a directory, and that directory will have our listings in it, competitive local exchange company listings in it, so it's simply a directory. It's not an official United Telephone-Southeast, Incorporated, directory any longer. It includes all listings for that market, including competitors. So that doesn't give Sprint Publishing and Advertising the value that they had at one time for publishing the directory when it was simply an exclusive directory, and that was the reason for the contracted change. (TR 159)

Company-Southeast, Inc.'s initial rates under price regulation, the advertising revenues actually collected from the affiliates and recorded on United's books were included along with imputed earnings that were not actually recorded on the utility's books. The process used resulted in the revenue requirement impact being recognized for ratemaking purposes to be the same as having the total directory advertising operation for Tennessee included in the revenues, expenses and investment used to set rates for United.

Mr. Parrott contends that the reason United Telephone is not compensated by Sprint Publishing and Advertising is because the directory may include United Telephone's competitors listings.[3] While there may be additional telephone companies offering service in the area, United Telephone continues to have a right to publish its own Yellow Page Directory. There is no basis to conclude that United's right to publish it own Yellow Page directory has no value; it should be compensated for transferring that right to an affiliate. The Tennessee Public Service Commission has addressed this issue and included directory compensation from the publishing companies recorded on the telephone companies' books. The Commission also imputed an additional amount to recognize the full revenue requirement impact of directory operations as if the telephone company published the directory directly instead of through a separate affiliate.

Similarly, the Authority has concluded that the directory revenue be included in the revenue benchmark to be used in determining the amount needed to support universal service.

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[3] Mr. Parrott's admitted that he was not involved in the negotiation of the contract had no direct knowledge but relied on information supplied by others.

Q. Now, did you negotiate the contract changes?

A. I did not.

Q. Who did?

A. I'm not certain for United Telephone-Southeast, Inc., who negotiated the contract change.

Q. Who told you that was the purpose of the negotiation?

A. It was stated to me in discussions with Mr. Wright, our attorney, who was involved at least with the contractual changes, the Appendix F change, and that's the representation I had.

I've also talked about the issue with some of the folks at Sprint Publishing and Advertising, who have represented to me the reasoning why they no longer pay publishing fees. And it's because, again, under the situation that we had before, they would be paying publishing fees to us, to competitors. There's no reason to do that, because these are not exclusive directories any longer.

Q. Who specifically told you that, other than Mr. Wright? And Mr. Wright is your counsel for this proceeding; is that correct?

A. That's correct.

Q. Who, other than Mr. Wright, told you that that was the purpose?

A. I can't recall the gentleman's name. That discussion took place -- again, this is a 1997 contract change, and I can't recall who I talked to at that time. (TR Page 161)

United's election to attempt to circumvent regulation by giving its rights to the directory operations to its sister company conflicts with the decision of the Authority and the Tennessee Public Service Commission. In order to shield the Yellow Page revenue from being considered by the Authority in this proceeding, United Telephone wrongly contends customers who advertise in the Yellow Pages are not their customers but are customers of Sprint Advertising and Publishing, as illustrated below:

> Q. Is it United's position that there should not be any offsetting reduction, whether in Universal Service or this proceeding or otherwise, in either basic or nonbasic rates when Yellow Page advertising rates charged to UTSE's customers are increased?
>
> A. Well, first of all, you're suggesting that these are UTSE customers. These would actually be customers of Sprint Publishing and Advertising.
>
> Q. I'm just asking -- okay. I'm sorry.
>
> A. The answer to your question is, yes, that is our position. But the reason for that is that these customers who are paying for Yellow Page advertising, that is a business relationship between a customer who desires advertising in the Yellow Pages and the provider of the Yellow Pages, which happens to be Sprint Publishing and Advertising.
>
> Now, what we provide, United Telephone-Southeast, Inc. provides, is we provide billing and collection service. We bill the charges to our customers, and we get paid for that through the billing and collection contract. But the charges that you're talking about are the charges that Sprint Publishing and Advertising would quote to their customer for the advertising. These aren't United Telephone-Southeast customers who are contracting for Yellow Page advertising. They're Sprint Publishing and Advertising customers. (TR page 170)

In discussing the Authority's Universal Service decision, United's witness, Parrott, explained the company's position relative to Yellow Page revenue:

> Q. The directory revenues are going to be considered, as the Authority has already made a decision that directory revenues are going to be considered in the Universal Service calculations, hasn't it?

A. Yes. It's my understanding that in the revenue benchmark determination, that whatever those contracted revenues are, contracted revenues are -- and, again, we've got to draw a distinction between contracted directory revenues and what is referred to as imputation of Yellow Page earnings. The decision has been made that those **contracted revenues** have to appear in the revenue benchmark, and what's interesting, they also appear in this filing. So there's nothing inconsistent in this filing and the decision they made in Universal Service. (Emphasis added.)

Q. Did the Regulatory Authority say contracted revenues only?

A. I'm not aware in the context of the revenue benchmark in the Universal Service proceeding that there was a mandate to impute, as we did in the rate base rate-of-return days, The Yellow Pages earnings from the affiliate. I'm not aware of that, if that's the decision that was made. I do know that there was reference made to including Yellow Page revenues, what I call **contracted revenues**, in the benchmark, and we certainly will do that, compliant with the TRA's decision. And those contracted revenues are also in the stipulated methodology calculations. (TR 151) (Emphasis added.)

Since United Telephone's contract with Sprint Advertising and Publishing has been modified to eliminate the revenues previously collected by the telephone company for publishing fees, according to Mr. Parrott's position, no publishing fees would be considered in the revenue benchmark in accordance with the Authority's findings. The company's position relative to treatment of Yellow Page revenue is incorrect in both this proceeding and the universal service proceeding. The Yellow Page revenue was properly considered by the Tennessee Public Service Commission when the United's initial rates under the price regulation plan were established.

Whether the revenues are collected from the consumers by United Telephone or collected by Sprint Advertising and Publishing, these revenues are collected from the ratepayers, which have historically been included in United Telephone's aggregate revenues under base rates and under proposed rates.[4] A unilateral decision by Sprint to transfer the ownership of the revenues from one of its subsidiaries to another of its subsidiaries does not change the nature of the charges or how the resulting revenues should be considered in evaluating the proposed rate increase in accordance with Tenn. Code Ann. 65-5-209.

United Telephone is making no concession when it states that it will not ask to recover from its customers the revenue that was paid to Sprint Advertising and Publishing in some future filing. In making this promise, the company has conceded nothing since the transfer of revenues to the affiliate does not reflect a decline revenues as the result of a reduction in the rates charged to ratepayers.

United Telephone also attempts to confuse the issue by attempting to draw a distinction between the recognition of Yellow Page revenue recorded on its books and imputed earnings from the Yellow Page operations that historically have been recognized by the Tennessee Public Service Commission and are required to be reported monthly. It is correct that the imputed amount reflected on the monthly reports was shown as an increase in the rate base to reflect the Sprint Publishing and Advertising Investment allocated to Tennessee and an increase to the Net Operating Income (NOI) to reflect the net effect of both the revenues and expenses resulting from the Yellow Page operations in Tennessee. The effect of simply reporting the Yellow Page net income adjustment has the same effect of reporting the adjustment to the Yellow Page Revenue and the adjustment to reflect the Yellow Page expenses. The end result is the same increase in Net Operating Income. United should be directed to revise its filing to reflect both base period and aggregate revenues to include the

[4]CAD contends that directory revenues are included in the base amounts and there is a negative inflation adjustment there would be a greater reduction in consumer rates in this proceeding.

Yellow Pages income.

III. PAY PHONE REVENUE MUST BE STRIPPED FROM UNITED TELEPHONES'S REVENUES UNDER PRICE REGULATION

This agency has adopted the practice of refusing to consider payphone regulation as part of price regulation plan proceedings. In docket 95-02614, this agency specifically and summarily rejected CAD's argument that the federal preemption issues regarding payphones were relevant in price regulation plan proceedings solely because the agency had established a payphone docket. The hearing officer in this case, who also happens to be counsel for the agency in docket No. 95-02614, followed this expression of policy when he denied CAD's request to take discovery of UTSE regarding payphones. CAD took the position that it was futile to appeal the decision of the hearing officer when he is simply following agency policy. After the denial, CAD sought to simply preserve the issues in its testimony. Despite CAD's denial of due process discovery on the matter, the agency has permitted UTSE to testify to unverified amounts of payphone costs. Because of the lack of discovery which CAD specifically requested, CAD is unfairly prejudiced and the agency should continue the case, permit additional discovery and additional evidence.

United admits that payphones were subsidized by joint and common costs on all services above cost on June 6 in 1995. As a result, any state regulation which mandates use of June 6, 1995 rates also mandates the portion of the rates attributable to the payphone subsidy. If the state regulation mandates an increase in rates which is predicated in part upon the subsidy it perpetuates the subsidy through the increase . Mandatory decrease, by a percentage, decreases but does not eliminate the subsidy. Moreover, a test of rates predicated upon June 6, 1995 rates also perpetuates the subsidy directly or indirectly.

When the agency's "generic" payphone proceeding began United represented that it had no payphone subsidies. Subsequently it stated that it had $143,000 in payphone subsidies. It has not produced service element by service element discovery of the embedded subsidy amounts in 1994, 1995 or in succeeding years. In addition, the company has not produced service element by service element costs attributable to ratemaking adjustments under Tenn. Code Ann. § 65-5-209.

Traditionally the provision of payphone service was considered part of regulated operations. Any subsidy flowing from other regulated services to payphones was not considered a problem. As the market was opened, payphone service began to be considered as competitive. The Telecommunications Act of 1996 required the FCC to remove the payphone operation from the regulated classification and to remove any subsidy that was flowing to the payphone operations from those services that continue to be reclassified as regulated. In the case of United Telephone Southeast, the company has determined that there has been a subsidy flowing from regulated operations to payphones and has proposed to reduce access charges in order to eliminate the subsidy.

Tenn. Code Ann. § 65-5-209 provides in pertinent part:

> 65-5-209. Price regulation plan.
> (a) Rates for telecommunications services *are just and reasonable when they are determined to be affordable as set forth in this section.*[5] Using the procedures established in this section[6], *the authority shall ensure* that rates for

[5]This language clearly limits the agency's flexibility. If the matter is not contained in Tenn. Code Ann. § 65-5-209 or is not referred to in the section, the agency is forbidden from using it as a factor.

[6]Again reinforcing the section as a limitation on the power of the Authority and the Company.

all basic local exchange telephone services and non-basic services are *affordable* on the effective date of price regulation for each incumbent local exchange telephone company.

(b) An incumbent local exchange telephone company shall, upon approval of its application under subsection (c), be empowered to, and *shall charge and collect* only such rates that are less than or *equal to the maximum* permitted by this section and subject to the safeguards in § 65-5-208(c) and (d) and the non-discrimination provisions of this title.

(c) The authority shall enter an order within ninety (90) days of the application of an incumbent local exchange telephone company implementing a price regulation plan for such company. With the implementation of a price regulation plan, the rates existing on June 6, 1995, for all basic local exchange telephone services and non-basic services, as defined in § 65-5-208, *are deemed affordable*[7] if the incumbent local exchange telephone company's earned rate of return on its most recent Tennessee Regulatory Authority 3.01 report as audited by the authority staff pursuant to subsection (j) is equal to or less than the company's current authorized fair rate of return existing at the time of the company's application.[8] If the incumbent local exchange telephone company's earned rate of return on its most recent Tennessee Regulatory Authority 3.01 report as audited by the authority staff pursuant to subsection (j) is greater than the company's current authorized fair rate of return, the authority shall initiate a contested, evidentiary proceeding to establish the initial rates on which the price regulation plan is based.[9] The authority shall initiate such a rate-setting proceeding to determine a fair rate of return on the company's rate base using the actual intrastate operating revenues, expenses, rate base and capital structure from the company's most recent Tennessee Regulatory Authority 3.01 report as audited by the authority staff pursuant to subsection (j). If the incumbent local exchange telephone company's earned rate of return is less than its current authorized fair rate of return, the company may request the authority to initiate a contested, evidentiary proceeding to establish the initial rates upon which the price regulation plan is based. Upon request by the incumbent local exchange

[7]Deemed affordable as a matter of law.

[8]In UTSE's case one of the problems is this section. First, there was no true subsection (j) GAAP audit. If there were it could have been very useful. Second, even if there was a GAAP audit in 1995 it would not have excluded payphone subsidies "embedded" in the rates. Third, section (c), directly or indirectly, restores payphone subsidies by re-establishing the rate predicated upon the payphone subsidy. As a result, payphone competitors can not compete on a "level playing field" the incumbent local exchange company will continue receiving the financial benefit as if there was never a separation of payphone operations.

[9]After 1997, a contested case proceeding with a Tenn. Code Ann. § 65-5-209 (j) GAAP and part 32 audit which excluded payphones could save part of the statute, but that is not the case here.

telephone company, the authority shall initiate such a contested, evidentiary proceeding using the same rate-setting procedures described above. Rates established pursuant to the above process shall be the initial rates on which a price regulation plan is based, subject to such further adjustment as may be made by the authority pursuant to § 65-5-207.[10]

(d) A price regulation plan shall maintain affordable basic and non-basic rates by permitting a maximum annual adjustment[11] that is capped at the lesser of one half (1/2) the percentage change in inflation for the United States using the gross domestic product-price index (GDP-PI) from the preceding year as the measure of inflation, or the GDP-PI from the preceding year minus two (2) percentage points. An incumbent local exchange telephone company may adjust its rates for basic local exchange telephone services or non-basic services only so long as its aggregate revenues for basic local exchange telephone services or non-basic services generated by such changes do not exceed the aggregate revenues generated by the maximum rates permitted by the price regulation plan. [12]

(e) Notwithstanding the annual adjustments permitted in subsection (e), the initial basic local exchange telephone service rates of an incumbent local exchange telephone company subject to price regulation shall not increase for a period of four (4) years from the date the incumbent local exchange telephone company becomes subject to such regulation. At the expiration of the four-year period, an incumbent local exchange telephone company is permitted to adjust annually its rates for basic local exchange telephone services in accordance with the method set forth in subsection (e)[13] provided that in no event shall the rate for residential basic local exchange telephone service be increased in any one (1) year by more than the percentage change in inflation for the United States using the gross domestic product-price index (GDP-PI) from the preceding year as the measure of inflation.

(f) Incumbent local exchange telephone companies subject to price regulation may set rates for non-basic services as the company deems appropriate, subject

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[10] Again note the limitation of authority.

[11] Which in UTSE's case directly or indirectly includes payphone subsidies arising from the initial rates on June 6, 1995.

[12] The maximum rates permitted by the plan include the perpetuation of payphone subsidies and percentage increase on the payphone subsidies.

[13] The section perpetuates the embedded subsidy. Moreover, the "stipulation" between CAD and UTSE would perpetuate the subsidy because it is based on embedded 1995 rates which include the payphone subsidies.

to the limitations set forth in subsections (e) and (g), the non-discrimination provisions of this title, any rules or orders issued by the authority pursuant to § 65-5-208(c)[14] and upon prior notice to affected customers. Rates for call waiting service provided by an incumbent local exchange telephone company subject to price regulation shall not exceed, for a period of four (4) years from the date the company becomes subject to such regulation, the maximum rate in effect in the state for such service on June 6, 1995. [15]

(g) Incumbent local exchange telephone companies subject to price regulation are not required to seek regulatory approval of their depreciation rates or schedules.[16]

(h) For any incumbent local exchange telephone company electing price regulation under subsection (c), the authority shall conduct an audit to assure that the Tennessee Regulatory Authority 3.01 report accurately reflects, in all material respects, the incumbent local exchange telephone company's achieved results in accordance with generally accepted accounting principles as adopted in Part 32 of the uniform system of accounts, and the ratemaking adjustments to operating revenues, expenses and rate base used in the authority's most recent order applicable to the incumbent local exchange telephone company. Nothing herein is to be construed to diminish the audit powers of the authority.[17]

(i) Incumbent local exchange telephone companies subject to price regulation shall maintain their commitment to the FYI Tennessee master plan to the completion of the funded requirements with any alterations to the plan to be approved by the authority.

CAD has reviewed a number of the 40 or so FCC orders in the FCC's CC Docket No. 96-128. It is virtually certain that Tenn. Code Ann. § 65-5-209 is preempted in part. As the Authority

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[14]This subsection appears to apply only to non-basic service A subsidy perpetuated in a basic service is not covered. Even if it extended to consumers the agency has not issued a final order identifying United's embedded payphone subsidies. Moreover, the agency has no retroactive or contingent ratemaking authority as a result the consumers who are actually harmed prior to the entry of the rule or order could not receive any relief or reimbursement.

[15]This section applies to rates for individual services. No new rate should directly or indirectly perpetuate a portion attributable to a subsidy. Moreover this agency has not issued any Tenn. Code Ann. § 65-5-208(c) orders.

[16]There has not been a proceeding which determined how much of UTSE's depreciation is directly or indirectly attributable to payphones.

[17]This subsection does not provide a non-contested case assurance before 1997. In addition, it would not provide contested case restoration of the direct or indirect subsidy if the rate of return is equal to or less than the current authorized rate of return because the 1995 rate is restored.

is aware, the Court of Appeals held:

> Since Tenn. Code Ann. § 65-5-209(a) directs the Commission to set an incumbent local telephone company's initial rates "[u]sing the procedures established in this section," the statute has ministerial aspects and is the sole source of the Commission's authority to adopt a price regulation plan. BellSouth v. Greer, 972 S.W.2d at 674-675.

Therefore, the TRA has no discretion but to follow the procedures of Tenn. Code Ann. § 65-5-209. BellSouth v. Greer, 972 S.W.2d 663 (Tn. App. 1997), perm. to app. denied.

The Court of Appeals also stated in response to federal preemption arguments by AT&T that:

> We have determined that these proceedings were not preempted by the federal Telecommunications Act of 1996.

However, a more detailed examination explains the Court's position better. The Court stated:

> As a threshold matter, we take up AT & T's assertion that this appeal should be remanded. [Id. at. 670] to enable the Authority to determine whether the federal Telecommunications Act of 1996 preempts state law authorizing BellSouth to begin operating under a price regulation plan. [FN19] AT & T claims that the preemption issue should be addressed before the approval of BellSouth's price regulation plan because the interconnection provisions in state law differ from those in the Telecommunications Act of 1996 and because state law contains no provision for modifying a price regulation plan once it has been approved. We have determined that the possibility of preemption is not so pressing that it requires a remand to the Authority for further proceedings. Id. at 671.
>
> * * *
>
> [1] The Supremacy Clause provides Congress with the power to preempt state law. [FN20] FN20. Preemption may result from action by Congress itself or by action of a federal agency acting within the scope of its authority. ... Federal agencies must declare their intent to preempt state law with some specificity. [2] Preemption occurs when there is an outright or actual conflict between federal and state law. Freightliner Corp. v. Myrick, 514 U.S. 280, 287, 115 S.Ct. 1483, 1487, 131 L.Ed.2d 385 (1995); Louisiana Pub. Serv. Comm'n v. F.C.C., 476 U.S. at 368, 106 S.Ct. at 1898. It can also occur by implication when compliance with both federal and state law is impossible or when state

law obstructs the accomplishment of Congress's objectives. Preemption may also arise when Congress's legislation is so pervasive that it leaves no room for state legislative action. Cipollone v. Liggett Group, Inc., 505 U.S. 504, 516, 112 S.Ct. 2608, 2617, 120 L.Ed.2d 407 (1992); Louisiana Pub. Serv. Comm'n v. F.C.C., 476 U.S. at 368, 106 S.Ct. at 1898.

BellSouth v. Greer, 972 S.W.2d at 670.

The best evidence of preemptive intent is an express preemption clause. CSX Transp., Inc. v. Easterwood, 507 U.S. at 664, 113 S.Ct. at 1737. However, in the absence of explicit preemption language, the courts must also examine the structure and purpose of the federal statute for implicit preemptory intent.

BellSouth v. Greer, 972 S.W.2d at 671

* * *

AT & T asserts that the case should be remanded to the Authority to consider whether the Telecommunications Act of 1996 preempts state law because the federal Act's interconnection provisions differ from their state law counterparts. However, the mere existence of a federal regulatory program does not imply preemption of similar state laws. English v. General Electric Co., 496 U.S. 72, 87, 110 S.Ct. 2270, 2279, 110 L.Ed.2d 65 (1990). Thus, AT & T must demonstrate something more if its preemption argument is to succeed.

BellSouth v. Greer, 972 S.W.2d at 671

* * *

With specific reference to the interconnection issue, the Act also states that it should not be construed to prohibit state commissions from enforcing or promulgating regulations or from imposing additional requirements ***672** that "are necessary to further competition in the provision of telephone exchange service or exchange access" as long as they are "not inconsistent" with the Act.

* * *

The Telecommunications Act of 1996 contains no explicit preemption language and does not contain provisions that are in outright or actual conflict with state law. Accordingly, AT & T's preemption argument can succeed only if it can demonstrate that Congress's regulatory statutes have completely occupied the field, that it is impossible to comply with the requirements of both the federal and state law, or that the state law somehow obstructs the accomplishment of the objectives of the Telecommunications Act of 1996. AT & T has failed on

> all counts. Nothing in the text or structure of the Act supports its unfocused preemption claims.
>
> * * *
>
> As far as this record shows, this proceeding remains before the Authority. This type of proceeding, and others like it, provide the parties with an appropriate forum to air out and resolve more clearly defined issues concerning the possible preemptive effect of specific provisions of the Telecommunications Act of 1996 or of the Federal Communications Commission's regulations.
>
> BellSouth v. Greer, 972 S.W.2d at 672.

Although the TRA refused to provide CAD with a forum to air out and resolve more clearly issues concerning the possible preemptive effect of the Telecommunications Act or Federal Communications Commission regulations, the Telecommunications Act of 1996 and FCC regulations are sufficiently clear. The Telecommunications Act of 1996 provides in relevant part:

> §276. Provision of payphone service
>
> (a) Nondiscrimination safeguards
> After the effective date of the rules prescribed pursuant to subsection (b) of this section, any Bell operating company that provides payphone service--
>
> (1) shall not subsidize its payphone service directly or indirectly from its telephone exchange service operations or its exchange access operations;
>
> * * *
>
> (b) Regulations
>
> (1) Contents of regulations
>
> In order to promote competition among payphone service providers and promote the widespread deployment of payphone services to the benefit of the general public, within 9 months after February 8, 1996, the Commission shall take all actions necessary (including any reconsideration) to prescribe regulations that--
>
> * * *

> (B) <u>discontinue</u> the intrastate and interstate carrier access charge payphone service elements and payments *in effect on such date of enactment*, <u>and</u> *<u>all</u> intrastate* and interstate *payphone subsidies from basic exchange and exchange access revenues*, in favor of a compensation plan as specified in subparagraph (A);

* * *

> (c) State preemption
> To the extent that any State requirements are inconsistent with the Commission's regulations, the Commission's regulations on such matters shall preempt such State requirements.
>
> (d) Definition
>
> As used in this section, the term "payphone service" means the provision of public or semi-public pay telephones, the provision of inmate telephone service in correctional institutions, and any ancillary services.

47 U.S.C. § 276.

The Telecommunication Act of 1996 requires the elimination of **all intrastate and interstate payphone subsidies from basic exchange and exchange access revenues.** In its September 20, 1996 Order in Dockets 96-128 and 91-35, the FCC stated at paragraph 186:

> 186. **We require**, pursuant to the mandate of Section 276(b)(1)(B), incumbent LECs to remove from their **intrastate rates any charges that recover the costs of payphones. Revised intrastate rates must be effective no later than April 15, 1997.** Parties did not submit state-specific information regarding the intrastate rate elements that recover payphone costs. States must determine the intrastate rates elements that must be removed to eliminate any intrastate subsidies within this time frame.

The FCC directed that payphone operations be treated as nonregulated and separated in accordance with 47 CFR Part 64 or transferred to a separate affiliate:

> **142** We conclude that to best effectuate the 1996 Act's mandate that access charge payphone service elements and payphone subsidies from basic exchange and

exchange access revenues be discontinued, **incumbent LEC payphones should be treated as deregulated and detariffed CPE**. The Commission determined in Computer II that CPE should be deregulated and detariffed to ensure that the costs associated with regulated services are separated from the competitive provision of the equipment used in conjunction with those services. The Commission concluded that CPE should be unbundled from its underlying transmission service in order to prevent improper cross-subsidization. Consistent with this prior finding, we conclude that **LEC payphones must be treated as unregulated, detariffed CPE** in order to ensure that no subsidies are provided from basic exchange and exchange access revenues or access charge payphone service elements as required by the Act.

145 We decline to require the BOCs or other incumbent LECs to provide their payphone CPE through a structurally separated affiliate. We discuss below the nonstructural safeguards we require for BOCs to provide payphone CPE on an integrated basis and decline to require, as proposed by some commenters, that other incumbent LECs be required to provide CPE through structurally separate affiliates. Section 276 does not require LEC or BOC provision of payphone service through a separate subsidiary. Although the 1996 Act does not specifically prohibit the Commission from imposing a separation requirement, it requires the establishment of nonstructural safeguards for the BOCs, a clear statement that nonstructural safeguards, rather than structural separation, are mandated. Moreover, Section 276 does not require even nonstructural safeguards for other LECs. Other sections of the 1996 Act, including Section 272, BOC provision of interLATA services, and Section 274, BOC provision of electronic publishing, specifically require structural separation. In addition, in the BOC CPE Relief Order we removed the structural separation requirements established in Computer II for BOC provision of CPE because we concluded that nonstructural safeguards were sufficient to deter cross-subsidization and discrimination and the high costs of mandatory structural separation were not in the public interest. This conclusion is also applicable in the context of BOC provision of payphone CPE. We also note that the Computer II structural separation requirements were not applied to the provision of CPE by other LECs. Finally, we note that nonstructural accounting safeguards applicable to the BOCs' provision of payphone service are being established in a separate proceeding. Accordingly, we do not impose structural separation requirements for the provision of payphones by the BOCs or other LECs. As we did in the BOC CPE Relief Order, we preempt states' ability to impose structural separation requirements on the payphone operations of the BOCs or other LECs. We do not, however, preempt the states from imposing on nonBOC LECs nonstructural safeguards that are no more stringent than those we impose on the BOCs.

Reclassification or Transfer of Payphone Equipment to Nonregulated Status

157 As an initial matter, we have already determined that neither Section 276 nor our past experience requires the BOCs' competitive provision of payphone services to take place on a prospective basis through the use of structurally separate affiliates. Instead, in this Report and Order, we require that, if a BOC does not provide payphone services through a separate affiliate, it must provide these payphone services using nonstructural safeguards as described in our Computer III Orders and ONA proceedings and consistent with Section 276, because we conclude that, in the absence of structural separation, our nonstructural safeguards provide sufficient protection against the possibility of cross-subsidization of nonregulated activities. **Those nonstructural safeguards include the cost allocation rules and affiliate transactions rules adopted in the Joint Cost Order. Under those rules, the BOCs and other incumbent LECs must classify each of their activities as regulated or nonregulated in accordance with our requirements. We now require that the BOCs and other incumbent LECs, subject to our joint cost rules, classify their payphone operations as nonregulated for our Part 32 accounting purposes. We note, however, that the BOCs or other incumbent LECs are free to provide these services using structurally separate affiliates if they choose to do so. Therefore, our discussion below will address two possible approaches a carrier may take in reclassifying its payphone activities as nonregulated: (1) a carrier may maintain its payphone assets on the carrier's books but treat the assets as nonregulated, or (2) a carrier may transfer its payphone assets to a separate affiliate engaged in nonregulated activities.**

163 Carriers that do not transfer the payphone assets to a separate affiliate make no reclassification accounting entries to their Part 32 regulated accounts. **The reclassification of these assets to nonregulated status is accomplished instead through the operation of our Part 64 cost allocation rules**. Accordingly, we conclude that payphone investment in Account 32.2351, Public telephone terminal equipment, and any other assets used in the provision of payphone service, along with the associated accumulated depreciation and deferred income tax liabilities should be directly assigned or allocated to nonregulated activities pursuant to our cost allocation rules. **LECs should establish whatever Part 64 cost pools are needed and should file revisions to their cost allocations manuals within sixty (60) days prior to the effective date of the change. This will ensure that the provision of payphone service is separate and distinct from the provision of common carrier services in accordance with our rules.**

164 **On the other hand, carriers that transfer their payphone assets to either a separate affiliate or an operating division that has no joint and common use of assets or resources with the LEC and maintains a separate set of books in accordance with Section 32.23(b) of our rules must account for the transfer**

according to the affiliate transactions rules of Section 32.27(c) which require that the transfer be recorded at the higher of fair market value or cost less all applicable valuation reserves (net book cost). Fair market value has been defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." We conclude, that in instances when the transfer of payphone assets is governed by Section 32.27(c), it is appropriate, as argued by CPA, that the going concern value associated with the payphone business be taken into consideration in determining fair market value. Such going concern value should, as asserted by GPCA and Peoples, include intangible assets such as location contracts that add value to the payphone business. These intangible assets would be considered in the theoretical purchase price negotiated by a willing buyer and seller. We do not believe, however, that the intangible asset value of BOC or LEC brand names should be included in the determination of going concern or fair market value because a BOC or a LEC would not transfer the right to use its brand name to a third party willing buyer.

165 The operation of our cost allocation rules and our affiliate transactions rules serve to protect ratepayers from different concerns. The cost allocation rules are used to provide guidance to carriers as to how joint and common costs are to be allocated among regulated and nonregulated activities that impact upon regulated activities. These rules are premised on the assumption that ratepayers benefit from the economies of scope associated with integrated operations of regulated and nonregulated activities. Since costs are recorded in regulated accounts, the Commission retains the ability to scrutinize costs associated with nonregulated activities. For example, carriers must file cost allocation manuals. These manuals are subject to public comment and must be audited annually by an independent auditor. The report of the independent auditor must also be submitted to the Commission. These procedures promote fair cost allocation and protect regulated ratepayers from absorbing the costs of nonregulated activities. In addition, as assets are retained on the books of the carrier, any resulting gains from a sale of those nonregulated assets accrue to the carrier and to the benefit of ratepayers and shareholders.

166 Our affiliate transactions rules also afford a level of protection to ratepayers. These rules first protect ratepayers by requiring that when an affiliate transfers to or performs a service for the carrier, those assets or services are not charged to regulated ratepayers at an inflated price. In addition, when the carrier transfers assets to an affiliate, the operation of our affiliate transactions rules effectively captures on the carrier's books any appreciation in value of those assets, thus ensuring that any eventual gains would accrue to the benefit of the ratepayers and shareholders.

167 The difference in accounting treatment for payphone assets either reclassified as nonregulated pursuant to our Part 64 cost allocation rules or transferred to a separate affiliate and accounted for in accordance with our Part 32 affiliate transactions rules stems primarily from the fact that in one instance there is no transfer, only a reallocation of assets to nonregulated status, and in the other instance, there has been an actual transfer. In addition, in the first instance our rules are designed to promote fair cost allocation between regulated and nonregulated activities; in the second instance, our rules are designed to protect against cross-subsidies between separate companies by capturing any appreciated value of assets transferred on the books of the carrier.

169 **One of the primary goals of Section 276 is that a BOC shall not be allowed to subsidize its payphone operations directly or indirectly from its telephone exchange operations or its exchange access operations. In order to achieve this goal, Congress required that we adopt at a minimum the nonstructural safeguards of <u>Computer III</u>. In <u>Computer III</u>, the Commission reexamined its regulatory regime for the provision of enhanced services and established nonstructural safeguards for the provision of enhanced services on an integrated basis. These safeguards included the cost allocation rules and the affiliate transactions rules the Commission developed in the <u>Joint Cost Order</u>. These nonstructural safeguards include our Part 64 cost allocation rules and our Part 32 affiliate transactions rules. We also note that the <u>Conference Report</u> states:**

> **"[t]he BOC payphone operations will be transferred, at an appropriate valuation, from the regulated accounts associated with local exchange services to the BOC's unregulated books. The Commission's implementing safeguards must be at least equal to those adopted in the Commission's <u>Computer III</u> proceedings."**

We believe that, consistent with <u>Computer III</u>, our cost allocation rules and affiliate transactions rules, as discussed above, provide rules for the appropriate valuation of the reclassification or transfer of payphone assets and we see no compelling argument to deviate from those well-settled rules at this time.

171 **We also agree with the RBOCs that our cost allocation rules only require a reassignment of payphone assets from regulated to nonregulated status. In reality, carriers maintain these assets in regulated Part 32 accounts and do not establish "unregulated books." These accounts are considered "regulated" accounts even though a carrier may assign** the entire amount in an account to nonregulated activities. Using regulated accounts serves the public interest by allowing Commission scrutiny of nonregulated activities as they potentially impact

regulated activities, maintaining a minimal amount of regulatory burden while protecting regulated ratepayers from cross-subsidies and cost misallocations, and preserving economies of scope that accrue to ratepayers from integrated operations. We believe regulated ratepayers are better served by the requirement that carriers account for payphone operations in regulated accounts than if we required them to account for payphone operations in "nonregulated" accounts or "unregulated books."

Other Matters

172 **We require the LECs to reclassify any pay telephone investments recorded in Account 32.2351, Public telephone terminal equipment, and other assets used in the provision of payphone service, along with the associated accumulated depreciation and deferred income tax liabilities, from regulated to nonregulated status pursuant to our Part 64 and Part 32 rules by April 15, 1997 when the associated revised tariffs are effective. We thus agree with Ameritech that we should adopt our tentative conclusion that a phase-in period is unnecessary.**

If a telephone company continues to provide payphone service as part of integrated operations, the payphone investment and operating expense continues to be recorded on the regulated books in accordance with Part 32. For reporting purposes the investment and cost are separated along with other nonregulated operations investment and cost in accordance with allocation procedures required in Part 64.

The problem arises from the use of the rates in effect on June 6, 1995 as the base rates for price regulation. Since the rates in effect at that time were set assuming payphones were part of regulated operations, the payphone subsidy would be included in the rates for other regulated rates. Under the adjustment formula in the statue that allows rates to change on an annual basis by the lesser of 1/2(GDP-PI or GDP-PI-2% any payphone subsidy continues to be included in the rates for other regulated services.

The Telecommunications Act section regarding payphones specifically provides for preemption of state regulation including preemption by FCC orders. FCC orders, from the

September 20, 1996 order which mandated a one year implementation schedule, through the October 9, 1997 order, mandate stripping of the costs and revenues associated with payphones from intrastate rates. (See, attached orders) (A list of additional paragraphs in the order is attached for convenience). On June 6, 1995 all rates of incumbent local exchange companies included rate components associated with direct or indirect subsidies for payphones. As a result, rates on June 6, 1995 perpetuated or increased through any means are inconsistent with the commissions regulations and are preempted.

Tenn. Code Ann. § 65-5-209 (c) mandates in certain instances (if the audit associated with Tenn. Code Ann. § 65-5-209 (j) finds a current authorized rate of return equal to or less than the current authorized rate of return) that the rates existing on June 6, 1995 shall be the initial rates for price regulation. Since the intrastate rates existing on June 6, 1995 by their very nature include revenues associated with the direct or indirect subsidy of payphones, those portions of Tenn. Code Ann. § 65-5-209 (c) are federally preempted. 47 U.S.C § 276 (c).

CONCLUSION

For the foregoing reasons, the Authority should deny United Telephone's request for a rate increase. Instead, Authority should order a rate decrease as set forth in Mr. Buckner's testimony.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing Post-Hearing Brief has been faxed and or mailed postage prepaid to the parties listed below this 28th day of June, 1999.

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Vance L. Broemel

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of the	)	CC Docket No. 96-128
Pay Telephone Reclassification	)	
and Compensation Provisions of the	)	
Telecommunications Act of 1996	)	
	)	
Policies and Rules Concerning	)	CC Docket. No. 91-35
Operator Service Access and	)	
Pay Telephone Compensation	)	
	)	
Petition of the Public Telephone	)	
Council to Treat Bell Operating Company	)	
Payphones as Customer Premises	)	
Equipment	)	
	)	
Petition of Oncor Communications	)	
Requesting Compensation for	)	
Competitive Payphone Premises	)	
Owners and Presubscribed Operator	)	
Services Providers	)	
	)	
Petition of the California Payphone	)	
Association to Amend and Clarify	)	
Section 68.2(a)of the	)	
Commission's Rules	)	
	)	
Amendment of Section 69.2(m)	)	
and (ee) of the Commission's Rules	)	
to Include Independent Public	)	
Payphones Within the "Public	)	
Telephone" Exemption from End User	)	
Common Line Access Charges	)	

ORDER ON RECONSIDERATION

Adopted: November 8, 1996 **Released: November 8, 1996**

By the Commission:

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I. INTRODUCTION

II. ISSUES

A. COMPENSATION FOR EACH AND EVERY COMPLETED INTRASTATE AND INTERSTATE CALL ORIGINATED BY PAYPHONES

1. Payphone Calls Subject to this Rulemaking and Compensation Amount

a. Report and Order

4. Defining Fair Compensation. The Commission concluded that, once competitive market conditions exist, the most appropriate way to ensure that payphone service providers ("PSPs") receive fair compensation for each call is to let the market set the price for individual calls originated on payphones.[12] We concluded that it is only in cases where the market does not or cannot function properly that the Commission needs to take affirmative steps to ensure fair compensation.[13]

5. The Commission concluded that the transition to market-based rates should occur in two phases. Because LECs will terminate, pursuant to Section 276(b)(1)(b), subsidies for their payphones within one year of the effective date of the rules adopted in this proceeding, LECs will not be eligible to receive compensation under Section 276(b)(1)(a) until that termination date.[14] The period before per-call compensation becomes effective will be the first phase of implementing the rules adopted in this proceeding. During this first phase, states may continue to set the local coin rate in the same manner as they currently do. States may, however, move to market-based local coin rates anytime during this period. In addition, the states must conduct their examination of payphone regulations during this period to review and remove, if necessary, those regulations that affect competition, such as entry and exit restrictions.[15] Interexchange carriers ("IXCs") will pay compensation for access code calls and subscriber 800 calls on a flat-rate basis.[16] In addition, under the Report and Order, all payphones must provide free access to dialtone, emergency calls, and telecommunications relay service ("TRS") calls for the hearing disabled.[17]

6. The Commission stated in the Report and Order that, in the second phase,

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12 Report and Order at para. 49.

13 Id.

14 Id. at para. 50.

15 Id.

16 Id.

17 Id.

which will begin on October 7, 1997, LECs will have already terminated the subsidies prohibited by Section 276(b)(1)(B), and per-call tracking capabilities will be in place.[18] The carriers to whom payphone calls are routed will be responsible for tracking each compensable call and remitting per-call compensation to the PSP. During this second year, which is the first year of per-call compensation (as opposed to flat-rate compensation), the market will be allowed to set the rate for local coin calls, unless the state can show that there are market failures that would not allow market-based rates. In addition, during the second phase, to allow us to ascertain the status of competition in the payphone marketplace, we concluded that IXCs must pay PSPs a default rate of $.35 for each compensable call, which may be changed by mutual agreement.[19] PSPs will be required to post the local coin rate they choose to charge at each payphone.[20] During the second phase, the Commission may review, at our option, the deregulation of local coin rates nationwide and determine whether marketplace disfunctions exist, such as locational monopolies caused by the size of the location with an exclusive PSP contract or the caller's lack of time to identify potential substitute payphones, and should be addressed by the Commission.[21]

7. Ensuring Fair Compensation. To ensure fair compensation, we concluded in the Report and Order that we must provide for compensation for access code calls and subscriber 800 and other toll-free number calls, whether they are intrastate or interstate in destination.[22] We concluded that we must ensure fair compensation for 0+ calls that use BOC payphones.[23] We concluded further that once the BOCs reclassify their payphones and terminate all subsidies, pursuant to Section 276(b)(1)(B), they may receive the compensation established by the Report and Order, so long as they do not otherwise receive compensation for use of their payphones in originating 0+ calls.[24] We also concluded that, in the absence of a contract providing compensation to the PSP for intraLATA 0+ calls, the PSP shall be eligible to collect per-call compensation from the carrier to whom the call is routed.[25] In addition, the Commission concluded that PSPs should receive compensation for international calls. We found that we have authority under Sections 4(i) and 201(b) of the Communications Act of 1934, as amended, to ensure that PSPs are fairly compensated for international as well as interstate and intrastate calls using their payphones in the

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18 Id. at para. 51.

19 Id.

20 Id.

21 Id.

22 Id. at para. 52.

23 Id. at para. 53.

24 Id.

25 Id.

would not generally be transferred by a willing seller under the definition of fair market value. We thus conclude that such intangible assets should not be included in the determination of fair market value. This determination is consistent with existing Commission rules and the Ameritech CAM Order.

186. We disagree with those petitioners who assert that intangible assets such as the going concern value stemming from location contracts and other like assets should not be included in the determination of fair market value. Going concern value is the additional element of value that attaches to property by reason of its existence as an integral part of a going concern.[547] As such, this intangible asset is directly related to the payphone assets being transferred and enhances the value of the assets. The fact that this intangible asset is directly related to the asset distinguishes this intangible asset from the carrier brand name that is not directly related. In addition, the petitioners have asserted that the cost of this intangible asset has never been recorded on the carriers' regulated books and thus should not be considered in determining fair market value. Most, if not all, of the going concern value associated with the payphone assets is generated by the existence of the location contracts. While the cost of these location contracts are not capitalized to the payphone asset accounts, the commissions paid to location providers as required by the location contracts are recorded as period expenses on the carrier's books. This further distinguishes these intangible assets from the carrier's brand name.

187. We also see no conflict with the Joint Cost Reconsideration Order or Ameritech CAM Order as those orders addressed the intangible benefits accruing from previous employee training. Like the carrier brand name, that type of intangible benefit is not directly associated with any particular asset. In addition, it is doubtful whether such an intangible benefit is even subject to valuation under reasonable appraisal techniques. As a result, we conclude that these types of intangible benefits are distinguishable from the going concern value generated by the location contracts of the payphone assets. We thus conclude that we did nothing in the Report and Order that conflicted with existing Commission rules and that we did not deviate from either the Joint Cost Reconsideration Order or the Ameritech CAM Order.

3. Termination of Access Charge Compensation and Other Subsidies

a. Report and Order

188. In the Report and Order we noted that in the telephone network, payphones, as well as all other telephones, are connected to the local switch by means of a subscriber line. The costs of the subscriber line that are allocated to the interstate jurisdiction are recovered through two separate charges: a flat-rate subscriber line charge (SLC) assessed upon the end-user customer who subscribes to local service; and a per-minute CCL charge assessed upon IXCs that recovers the balance of the interstate subscriber line costs not recovered through the SLC. LEC payphone costs

[547] VGS v. Comm. of Internal Revenue, 68 T.C. 563, 591 (1977).

are also included in the CCL charge. The CCL charge, however, applies to interstate switched access service that is unrelated to payphone service costs. While independent payphone providers are required to pay the SLC for the loop used by each of their payphones, LECs have not been required to pay this charge because the subscriber lines connected to LEC payphones have been recovered entirely through the CCL charge.

189. In the Report and Order, we concluded that to implement Section 276 (b)(1)(B) of the 1996 Act, incumbent LECs must reduce their interstate CCL charges by an amount equal to the interstate allocation of payphone costs currently recovered through those charges. LECs subject to the price cap rules would treat this as an exogenous cost change to the Common Line basket pursuant to Section 61.45(d) of the Commission's rules. The incumbent LECs' residential SLC is limited to $3.50 per month and their multi-line business SLC is currently subject to a $6.00 per month cap.

190. The 1996 Act mandates that the Commission "discontinue the intrastate and interstate carrier access charge payphone service elements and payments ... and all intrastate and interstate subsidies from basic exchange and exchange access revenues[.]" Accordingly, we adopted rules that provide for the removal from regulated intrastate and interstate rate structures of all charges that recover the costs of payphones (i.e., the costs of payphone sets, not including the costs of the lines connecting those sets to the public switched network, which, like the lines connecting competitive payphones to the network, will continue to be treated as regulated). Therefore, we concluded that incumbent LECs must file revised CCL tariffs with the Common Carrier Bureau no later than January 15, 1997 to reduce their interstate CCL charges by an amount equal to the interstate allocation of payphone costs currently recovered through those charges, scheduled to take effect April 15, 1997. The Report and Order required that LECs subject to the price cap rules must treat this as an exogenous cost change to the Common Line basket pursuant to Section 61.45(d)(1)(v) of our rules.[548] Incumbent LECs must identify and report accounts that contain costs attributable to their payphone operations. Incumbent LECs must identify specific cost pools and allocators that are required to capture the nonregulated investment and expenses associated with their payphone operations. LECs must file this information with the Common Carrier Bureau by January 15, 1997.

191. The Report and Order required LECs that file tariffs pursuant to Section 61.38 or Section 61.39, rate-of-return regulation, or Section 61.50, optional incentive regulation, to file tariffs to revise interstate CCL rates to remove the payphone investment and any other assets used in the provision of payphone service along with the accumulated depreciation and deferred income tax liabilities from the common line costs recovered through those rates. As stated previously, these LECs must reclassify payphone assets from regulated to nonregulated activity pursuant to Part 64 rules. Expenses incurred after payphones are deregulated should be classified as nonregulated expenses. The CCL rate reduction must account for overhead costs assigned to common line costs as a result of payphone investment and expenses. We required these LECs to recalculate their CCL

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[548] 47 C.F.R. § 61.45(d)(1)(v).

rates, using the same data and methods they used to develop their current CCL rates, except those calculations should exclude payphone costs.

192. In the Report and Order we required that price cap LECs must also revise their CCL rates, using the following method to remove payphone costs from their CCL rates. First, price cap LECs should develop a common line revenue requirement using ARMIS costs for calendar year 1995. Second, price cap LECs are required to develop a payphone cost allocator equal to the payphone costs in Section 69.501(d) divided by total common line costs, based on 1995 ARMIS data. Each LEC is required to reduce its PCI in the common line basket by this payphone cost allocator minus one.

193. We required in the Report and Order that, pursuant to the mandate of Section 276(b)(1)(B), incumbent LECs must remove from their intrastate rates any charges that recover the costs of payphones. Revised intrastate rates must be effective no later than April 15, 1997. Because parties did not submit state-specific information regarding the intrastate rate elements that recover payphone costs, the Report and Order required that states must determine the intrastate rates elements that must be removed to eliminate any intrastate subsidies within this time frame.

194. Finally, we concluded that, to avoid discrimination among payphone providers, the multiline business SLC must apply to subscriber lines that terminate at both LEC and competitive payphones. We conclude that the removal of payphone costs from the CCL and the payment or imputation of a SLC to the subscriber line that terminates at a LEC nonregulated payphone will result in the recovery of LEC payphone costs on a more cost-causative basis consistent with the requirements of the 1996 Act.[549]

b. Petitions

195. Sprint requests clarification that not just the payphone equipment costs that are transferred from the regulated books are removed from the CCL costs. Sprint argues that costs for the local network used for payphone services and local business office expenses should be removed.[550] USTA requests clarification of the instructions for the removal of payphone costs from the CCL charges, because the multiline SLC was applied to all payphones.[551] WPTA requests that the Commission reconsider its decision not to discontinue the application of the SLC to payphones but to instead apply them to all payphones including those provided by LECs. WPTA argues that application of the end-user common line is not consistent with the Act because it appears to require discontinuation of the carrier access charges relative to payphone service like the end user common

[549] See Ameritech/SW Bell Waiver at para. 25.

[550] Sprint Petition at 19.

[551] USTA Petition at 1-4.

line charge.[552] AT&T requests that the Commission clarify that LECs must reduce their CCL rates by an amount of the additional SLC that will be received from the LEC operations.[553]

c. Comments

196. AT&T opposes several suggestions for clarification presented by USTA. AT&T argues that LEC payphone line costs included in 69.501(d) should remain as part of the LECs' regulated operations.[554] AT&T argues that to avoid double counting we should clarify that the payphone allocator and PCI established in the Report and Order are the same as those that existed before the inmate payphone order.[555] With regard to the SLC, AT&T contends that the Commission should require LECs to hold the base period constant and have the change in SLC revenue as a change to the base period revenue.[556] Finally, AT&T argues that the Report and Order correctly found that Part 61.45(d)(1)(v) applies to reclassification of payphone costs.[557] Sprint contends that the CCL charge should not reflect any payphone transmission costs, and should reflect the increase in SLC revenues received by the LECs from their own payphone operations.[558] BellSouth argues that WPTA is incorrect when it says that SLC must be discontinued for payphone service because the act requires removal of regulated charges that subsidize unregulated payphone operations, not regulated charges for regulated services.[559] BellSouth opposes Sprint's claim that the costs of payphone lines connecting payphone sets to the network should be removed from the CCL charge. The RBOC Coalition agrees with USTA's methodology for removing payphone costs.[560]

d. Discussion

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552 WTPA Petition at 14-15 .

553 AT&T Petition at 24.

554 AT&T Comments at 16.

555 Alternatively, AT&T asserts that LECs could obtain the same result by adjusting their current price cap index (PCI) and rate caps by adding a positive exogenous cost to the current PCI that is equal to the negative exogenous cost amount used in the inmate filing. Id. at 16, note 38.

556 Id. at 17.

557 Id.

558 Sprint Comments at 15.

559 BellSouth Comments at 3.

560 RBOC Coalition Comments at 22.

197. The Report and Order requires LECs to remove interstate payphone costs being recovered through CCL charges by doing the following: (1) transferring payphone set costs to nonregulated accounts; and (2) transferring the recovery of payphone line costs from CCL charges to subscriber line charges.[561] The following addresses petitions seeking clarification of the method of revising CCL charges under price cap rules.

198. As a threshold matter, the Report and Order requires price cap LECs to reflect the removal of deregulated costs by making an exogenous cost adjustment to the PCI in the Common Line Basket, pursuant to Section 61.45(d)(1)(v) of the rules.[562] USTA has petitioned the Commission to clarify that the removal of deregulated payphone cost qualifies instead as an exogenous cost adjustment under Section 61.45(d)(1)(vi).[563] According to USTA, Section 61.45(d)(1)(v) is limited to investment reallocations from regulated to nonregulated accounts caused by usage forecast revisions pursuant to Section 64.901(b)(4). AT&T contends that USTA offers no justification for treating payphone-related costs pursuant to Section 61.45(d)(1)(vi), a rule relating to tax and other extraordinary cost changes, and supports the finding in the Report and Order that the reclassification falls under Section 61.45(d)(1)(v).[564]

199. We deny USTA's request regarding Section 61.45(d)(1)(vi). We state clearly in the Report and Order that LECs are required to transfer payphone set costs from regulated to nonregulated accounts pursuant to Section 64.901 and other applicable rules.[565] Section 61.45(d)(1)(v) governs exogenous cost changes resulting from "the reallocation of investment from regulated to nonregulated activities pursuant to § 64.901." USTA has not provided any reasonable basis for construing Section 61.45(d)(1)(v) to be inapplicable here.

200. USTA seeks clarification of the procedure for LECs to use in removing from the CCL charges the deregulated payphone costs described in Section 69.501(d) of the rules.[566] The Report and Order requires LECs to determine the percent ratio of payphone cost to all costs in the common line category in 1995, the payphone cost allocator, and to reduce the Common Line Basket PCI by that percentage.[567] USTA maintains that cost associated with payphone lines identified by

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561 Report and Order at paras. 182-87.

562 Id. at para. 183.

563 USTA Comments at 3.

564 AT&T Comments at 17.

565 Report and Order at paras. 161-71.

566 USTA Comments at 2.

567 Report and Order at para. 185.

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561 Report and Order at paras. 182-87.

562 Id. at para. 183.

563 USTA Comments at 3.

564 AT&T Comments at 17.

565 Report and Order at paras. 161-71.

566 USTA Comments at 2.

567 Report and Order at para. 185.

Section 69.501(d) should be subtracted before developing the payphone cost allocator, because payphone lines will remain under regulation. AT&T maintains that the intent of the Report and Order clearly states that payphone line costs allocated pursuant to Section 69.501(d) should remain as part of the LEC's regulated operations, and thus supports USTA's position.[568]

201. USTA also seeks acknowledgment that the exogenous cost adjustment to the PCI should be reduced by the amount of PCI adjustment that has already occurred as a result of prior deregulation of inmate payphones.[569] According to USTA, this credit can be obtained by multiplying the PCI in effect prior to the inmate payphone filing by the payphone cost allocator. AT&T maintains that USTA's suggested approach will not achieve the correct result, which can be achieved by clarifying that the PCI and payphone cost allocator described in paragraph 185 of the Report and Order refer to the PCI and allocator that existed prior to implementation of the inmate payphone order.[570]

202. We agree that LECs should subtract the payphone costs described in Section 69.501(d) associated with payphone lines, prior to developing the payphone cost allocator. We therefore clarify and revise the exogenous cost adjustment mechanism we adopted in paragraph 185 of the Report and Order, and require LECs to subtract the costs of lines associated with payphones from the costs described in Section 69.501(d), prior to calculating their payphone cost allocator. We further agree that a credit should be applied to the PCI adjustment equal to any prior PCI adjustment associated with inmate payphone deregulation, and that AT&T has proposed a method that achieves the correct result. LECs proposing to subtract payphone line costs or inmate payphone costs from Section 69.501(d) for the purpose of their PCI adjustment should provide complete details, including references to Parts 32, 36, and 69 of the rules and associated ARMIS line items, to demonstrate that their line cost calculations are reasonable.[571]

203. Sprint seeks clarification by the Commission that CCL charges must be reduced by more than the amount of payphone equipment cost transferred from regulated to nonregulated accounts. Sprint further espouses that payphone cost includes non-equipment cost such as the cost of the local network used for payphone service and local business office expense.[572] BellSouth maintains that local network and local business associated with the payphone lines should

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568 AT&T Comments at 16.

569 USTA Comments at 2.

570 AT&T Comments at 16.

571 See AT&T Comments at 16.

572 Sprint Comments at 19.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996	)	CC Docket No. 96-128
	)	
Policies and Rules Concerning Operator Service Access and Pay Telephone Compensation	)	CC Docket. No. 91-35
	)	
Petition of the Public Telephone Council to Treat Bell Operating Company Payphones as Customer Premises Equipment	)	
	)	
Petition of Oncor Communications Requesting Compensation for Competitive Payphone Premises Owners and Presubscribed Operator Services Providers	)	
	)	
Petition of the California Payphone Association to Amend and Clarify Section 68.2(a)of the Commission's Rules	)	
	)	
Amendment of Section 69.2(m) and (ee) of the Commission's Rules to Include Independent Public Payphones Within the "Public Telephone" Exemption from End User Common Line Access Charges	)	

REPORT AND ORDER

Adopted: September 20, 1996 **Released: September 20, 1996**

I. INTRODUCTION

1. On June 4, 1996, the Commission adopted a Notice of Proposed Rulemaking ("Notice") to implement Section 276 of the Communications Act of 1934, as amended by the Telecommunications Act of 1996 ("1996 Act").[1] In this Report and Order, the Commission adopts new rules and policies governing the payphone industry that: (1) establish a plan to ensure fair compensation for "each and every completed intrastate and interstate call using [a] payphone[;]"[2] (2) discontinue intrastate and interstate carrier access charge payphone service elements and payments and intrastate and interstate payphone subsidies from basic exchange services;[3] (3) prescribe nonstructural safeguards for Bell Operating Company ("BOC") payphones;[4] (4) permit the BOCs to negotiate with payphone location providers on the interLATA carrier presubscribed to their payphones;[5] (5) permit all payphone service providers to negotiate with location providers on the intraLATA carrier presubscribed to their payphones;[6] and (6) adopt guidelines for use by the states in establishing public interest payphones to be located "where there would otherwise not be a payphone[.]"[7]

2. The Telecommunications Act of 1996 fundamentally changes telecommunications regulation. The 1996 Act erects a "pro-competitive deregulatory national framework designed to accelerate rapid private sector deployment of advanced telecommunications

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1 Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, CC Docket No. 96-128, Notice of Proposed Rulemaking, 11 FCC Rcd 6716 (1996) ("Notice"). The complete text of Section 276 is attached as Appendix A.

2 47 U.S.C. § 276(b)(1)(A).

3 47 U.S.C. § 276(b)(1)(B).

4 47 U.S.C. § 276(b)(1)(C).

5 47 U.S.C. § 276(b)(1)(D).

6 47 U.S.C. § 276(b)(1)(E).

7 47 U.S.C. § 276(b)(2).

and information technologies and services to all Americans by opening all telecommunications markets to competition."[8] In this proceeding we advance the twin goals of Section 276 the Act of "promot[ing] competition among payphone service providers and promot[ing] the widespread deployment of payphone services to the benefit of the general public..."[9] To this end, we seek to eliminate those regulatory constraints that inhibit the ability both to enter and exit the payphone marketplace, and to compete for the right to provide services to customers through payphones. At the same time, we recognize that a transition period is necessary to eliminate the effects of some long-standing barriers to full competition in the payphone market. For this reason, we will continue for a limited time to regulate certain aspects of the payphone market, but only until such time as the market evolves to erase these sources of market distortions.

3. Congress has directed us to take certain actions to effectuate its goals in the payphone area including the removal of subsidy schemes, providing for nondiscriminatory access to bottleneck facilities, ensuring fair compensation for all calls from payphones, and allowing all competitors equal opportunity to compete for essential aspects of the payphone business. In general, we believe that vigorous and unfettered competition is the best way of achieving Congress' dual objectives. Unfortunately, various barriers -- regulatory, structural, economic, and technological -- stand in the way of having a fully competitive market providing payphone services. For example, the lack of an effective per-call tracking mechanism is a technological barrier that prevents market forces from readily achieving Congress' goal of ensuring fair compensation to payphone services providers ("PSPs"). Regulatory restrictions on the placement of payphones, and existing subsidies from other telecommunication services available to certain competitors but not others are also examples of regulatory inefficiencies affecting competition and the widespread deployment of payphones.

4. In this Report and Order, we take the critical steps necessary to remove these barriers. Some barriers are removed right away. For example, we establish an immediate plan to ensure that PSPs receive fair compensation, especially for those calls for which PSPs have not been compensated in the past. We also order that subsidies from basic telecommunications services paid to some carriers for providing payphone services be terminated as soon as it is practicable. We condition the competitive entry of these carriers into the nonregulated activity of providing payphone services on their termination of these subsidies. Similarly, we allow the BOCs to negotiate with the payphone location providers in selecting and contracting with the telecommunications carriers that provide interLATA service from their payphones, but only after they have put in place nonstructural safeguards necessary to protect against a BOC from unlawfully subsidizing its payphone operations from its local exchange services or otherwise engaging in anti-competitive behavior.

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8 S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess. 1 (1996).

9 47 U.S.C. § 276(b)(1).

5. Removing other types of barriers to full competition will take more time. For example, the ability to track toll-free calls has not been developed fully. Until that functionality is available, as we have specified in this Report and Order, our plan for ensuring fair compensation will be a proxy that closely resembles the behavior of the marketplace as demonstrated by the record of this proceeding. To the extent that they exist, removing entry and exit restrictions placed upon the provisioning of payphone services will also take time because it requires action by the states. During the interim period before subsidies for LEC payphones are terminated and per-call compensation becomes effective, the states should examine and remove those regulations that affect the ability of PSPs to freely enter and exit this business.

6. Although we embark in this Report and Order on a new deregulatory structure for the payphone industry, we take a number of steps to facilitate use of payphones by consumers. First, we require that each payphone clearly indicate the local coin rate within the informational placard on each payphone. Pursuant to existing requirements,[10] this placard must provide information on the operator service provider presubscribed to the payphone and the address of the Commission, to which the consumer may direct complaints regarding operator services. Second, we require that each payphone provide access, free of charge to the caller, to emergency calling, telecommunications relay service calls for the hearing disabled, and dialtone generally.

7. In addition, payphones unquestionably serve critical public interests in health, safety and welfare. It is possible, however, that reliance on the market may fail to provide adequately for payphones in locations serving important public needs, because some payphones providing these benefits may not be economically self-supporting. For example, payphones in neighborhoods with low residential phone penetration, or along deserted stretches of highway, can be essential for public safety but fail to be revenue-generating for various reasons, including lack of sufficient traffic, damage from extreme weather conditions, or high maintenance costs. For these reasons, we establish criteria by which the states may maintain and fund public interest payphones in locations serving health, safety, and welfare goals, where they would not otherwise exist as a result of the operation of the market. Public interest payphones will also further our policies on emergency access[11] and telecommunications relay service calls for the hearing disabled.[12] But while we grant the states broad discretion in administering and funding public interest payphone programs, we also require that they do so in a manner which does not upset the competitive balance of the payphone market (i.e., competitively neutral), and that fairly and equitably compensates those entities providing public interest payphones.

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10 47 CFR § 64.703.

11 Revision of the Commission's Rules to Ensure Compatibility with Enhanced 911 Emergency Calling Systems, CC Docket No. 94-102, Notice of Proposed Rulemaking, 9 Fcc Rcd 6170 (1994) ("911 Notice").

12 Telecommunications Relay Services and the Americans with Disabilities Act, CC Docket No. 90-571, Memorandum Opinion and Order, 10 FCC Rcd 10927 (Com. Car. Bur. 1995).

14. Even after such regulatory barriers are removed, there are three structural reasons why, at least initially, the full benefits of competition may not be realized by all segments of the payphone market. First, independent PSPs currently rely on LECs for basic payphone services. LEC participation both in providing payphones to the public and also providing the underlying tariffed payphone services to independent PSPs may give LECs the incentive and the potential ability to unfairly act to the detriment of their PSP competitors and to act in other anti-competitive ways against PSPs. However, by implementing safeguards, we intend to ensure that LECs cooperate fully in the provision of any necessary payphone services and do not otherwise restrain competition, as long as LECs remain the monopoly providers of these services.[30]

15. Second, there are certain locations where, because of the size of the location or the caller's lack of time to identify potential substitute payphones, no "off premises" payphone serves as an adequate substitute for an "on premises" payphone. In such locations, the location provider can contract exclusively with one PSP to establish that PSP as the monopoly provider of payphone service. Absent any regulation, this could allow the PSP to charge supra-competitive prices. The location provider would share in the resulting "locational rents" through commissions paid by the PSPs. To the extent that market forces cannot ensure competitive prices at such locations, continued regulation may be necessary.[31] Payphones in many locations are likely to face a sufficient level of competition from payphones at nearby locations to ensure that prices are at the competitive level. As a result, we believe that payphones at such locations are unlikely to need additional scrutiny.

16. Third, for competitive markets to work properly, it is essential that consumers have full information concerning the choices available to them. Information on prices for payphone service is of primary importance.[32] The instant Report and Order concerns two different types of consumers who need to be informed of the charges they will face: (1) consumers who choose to use a payphone for local, 0+,[33] or access code calls,[34] and (2) consumers who contract with an IXC for

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30 See generally Section C, below.

31 See para. 51, below.

32 See e.g., Billed Party Preference for InterLATA 0+ Calls, CC Docket No. 92-77, Second Further Notice of Proposed Rulemaking, 11 FCC Rcd 7274 (1996) ("OSP Reform"). In the OSP Reform proceeding, we have proposed rules to ensure that operator service providers ("OSPs") inform consumers of their price, or if their price will be higher than that charged by the largest OSPs. While OSP Reform is separate from the instant proceeding, the OSP rules we ultimately adopt will benefit those who make calls from payphones.

33 A 0+ call occurs when the caller dials "0" plus the called telephone number. 0+ calls include credit card, collect, and third number billing calls. Second Report and Order, 7 FCC Rcd at 3251, n.4. 0- call transfer service is a service offered by LECs to OSPs under which LECs transfer a 0- call (when a caller dials only the digit "0" and then waits for operator intervention) to the OSP requested by the calling party. Id. at 3255, n.44.

34 The Second Report and Order defines an "access code" as a "sequence of numbers that, when dialed, connects the caller to the OSP associated with that sequence, as opposed to the OSP presubscribed to the originating line. Access codes include 10XXX in equal access areas and "950" Feature Group B dialing (950-0XXX or 950-1XXX) anywhere, where the three-digit XXX denotes a particular IXC. Some OSPs use an 800 number as an access code." Id. at 3251,

fairly compensate PSPs for the use of their payphones.[79] They argue that the guidelines must recognize that costs associated with local calls vary and have individual market characteristics, and that the states must be directed to eliminate all subsidies from other local exchange operations and from interexchange carriers.[80] US West argues that the Commission should not require the states to reexamine their respective local coin rates unless the per-call rate is below the nationwide predominant rate of $.25.[81]

29. Many states argue that the Commission must defer to the states in setting the local coin rates.[82] They argue that the states must maintain their wide discretion in setting the specific local coin rates.[83] Florida PSC, Indiana URC, and Tennessee contend that the Commission should prescribe a nationwide local coin rate or price cap and allow the states to petition for a variance.[84] APCC states that it would support a variance approach.[85] Ohio PUC asserts that it is within its authority to keep local coin rates low by requiring LECs to reduce the costs of various payphone services to PSPs.[86] California PUC argues that the Commission should adopt an approach to local coin rates that is a hybrid of setting federal guidelines and deferring to the states.[87] It argues that federal guidelines should allow states maximum participation in setting rates for payphones generally, and should recognize the interest of states in setting end-user rates for local calls and directory assistance calls.[88]

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79 See, e.g., Ameritech Comments at 7; Brill Comments at 1-2; GTE Comments at 4; GVNW Comments at 2-3; New Jersey DRA Comments at 2; USTA Comments at 4.

80 Id.

81 US West Comments at 4.

82 See, e.g., Indiana URC Comments at 3-4; Iowa Comments at 2; Maine Comments at 2; Missouri PSC Reply at 3; Montana PSC Reply at 2; New York DPS Comments at 4; New York City Comments at 9; Ohio PUC Comments at 5; Oklahoma CC Comments at 3; Texas PUC Comments at 2; Virginia SCC Comments at 2. See also Cable & Wireless Comments at 5; MCI Comments at 4; MPTA Comments at 12-13.

83 Id.

84 Florida PSC Comments at 3; Indiana URC Reply at 3 (only when states do not directly regulate payphone rates); Tennessee Reply at 1.

85 APCC Reply at 10.

86 Ohio PUC Reply at 2-4.

87 California PUC Comments at 12-13.

88 Id. California PUC also argues that the Commission's proposed petition process for review of state- determined local rates might raise state constitutional issues, because any review process must depend on state constitutions and the procedural safeguards developed by those constitutions. Id. at 10.

49. We conclude that, once competitive market conditions exist, the most appropriate way to ensure that PSPs receive fair compensation for each call is to let the market set the price for individual calls originated on payphones. It is only in cases where the market does not or cannot function properly that the Commission needs to take affirmative steps to ensure fair compensation, such as in the following situations. First, because TOCSIA requires all payphones to unblock access to alternative OSPs through the use of access codes (including 800 access numbers), PSPs cannot block access to toll free numbers generally. However, TOCSIA does not prohibit an IXC from blocking subscriber 800 numbers from payphones, particularly if the IXC wants to avoid paying the per-call compensation charge on these calls. This uneven bargaining between parties necessitates the Commission's involvement. Second, as discussed more fully below,[182] we conclude that each state should, in light of the instant proceeding, examine and modify its regulations applicable to payphones and PSPs, particularly those rules that impose market entry or exit requirements, and others that are not competitively neutral and consistent with the requirements of Section 276 of the Act. We conclude that, for purposes of ensuring fair compensation through a competitive marketplace, states need only remove those regulations that restrict competition, and they need not address those regulations that, on a competitively neutral basis, provide consumers with information and price disclosure. Third, we conclude that callers should have information in every instance about the price of the calls they make from payphones. To this end, we require that each payphone clearly indicate the local coin rate within the informational placard on each payphone.

50. While the most appropriate way to ensure fair compensation is to let the market set the price for individual payphone calls, we conclude that this transition to market-based rates should occur in two phases. Because LECs will terminate, pursuant to Section 276(b)(1)(b), subsidies for their payphones within one year of the effective date of the rules adopted in this proceeding,[183] LECs will not be eligible to receive compensation under Section 276(b)(1)(a) until that termination date. This one-year period before per-call compensation is effective, as discussed below, will be the first phase of implementing the rules adopted in this proceeding. During this first phase, states may continue to set the local coin rate in the same manner as they currently do. States may, however, move to market-based local coin rates anytime during this one-year period. In addition, the states must conduct its examination of payphone regulations during this one-year period to review and remove, if necessary, those regulations that affect competition, such as entry and exit restrictions. IXCs will pay compensation for access code calls and subscriber 800 calls on a flat-rate basis. In addition, all payphones must provide free access to dialtone, emergency calls, and telecommunications relay service calls for the hearing disabled.

51. In the second phase, which will begin one year after the effective date of rules adopted in this proceeding, LECs will be eligible to receive compensation, and per-call tracking

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[182] See para. 60, below.

[183] See paras. 181-183, below.

55. Local Coin Calls. As outlined above,[195] we believe that full and unfettered competition is the best way of achieving Congress' dual objectives to promote "competition among payphone service providers and promote the widespread deployment of payphone services to the benefit of the general public."[196] Competition over time will lead to the more efficient placement of payphones, improved payphone service, and lower prices for consumers. To encourage competition in the payphone marketplace, we ensure in this Report and Order that PSPs are fairly compensated for "each and every completed intrastate and interstate call[;]" terminate certain LEC subsidies for payphones; and permit all PSPs, including BOCs, to negotiate with the location provider regarding the selection of the presubscribed interLATA and intraLATA carriers.

56. Once competitive conditions exist, we believe that the market should set the compensation amount for all payphone calls, including local coin calls. Because we have an obligation under Section 276 to ensure that the compensation for all local coin calls is fair, we conclude that the market should be allowed to set the price for all compensable calls, including a local coin call. We believe this approach is appropriate because, once PSPs are free to enter the market, and once callers are free to choose payphones for their calls, the market will ultimately determine whether a particular payphone is economically viable. According to the record in this proceeding, five states have already deregulated local coin rates.[197] In four of those states, Iowa, Nebraska, North Dakota, and Wyoming, the market-based rate is $.35 per call.[198] In the other deregulated state, South Dakota, the market-based rate is $.25 per call.[199]

57. Historically, however, the rate for the most common type of call -- the local coin call -- has not been set by the market, but has instead been determined by state commissions.[200] In the Notice, we stated that Section 276 of the Act requires the Commission to ensure that the PSP receives fair compensation for each interstate and intrastate call, including local coin sent-paid calls.[201] Section 276 also states that "to the extent that any State requirements are inconsistent with the Commission's regulations, the Commission's regulations on such matters shall preempt such State requirements."[202] We sought comment in the Notice on how we should exercise our

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195 See paras. 11-19, above.

196 47 U.S.C. § 276(b)(1).

197 See Ex Parte Letter of Michael Kellogg, Counsel, RBOCs, to William Caton, Acting Secretary, FCC (August 30, 1996).

198 Id.

199 Id.

200 Notice at para. 19.

201 Id.

202 47 U.S.C. § 276(c).

jurisdiction under Section 276, and noted that we have a range of options for ensuring fair compensation for local coin calls, including setting a nationwide local coin rate for all calls originated by payphones, establishing specific national guidelines that states would use to establish a local rate that would ensure that all PSPs are fairly compensated and permitting the states to continue setting the coin rates for local payphone calls according to factors within their discretion.[203]

58. As we stated in the Notice, the Commission recognizes that the states have long had a traditional and primary role in regulating payphones, including setting local call rates paid by end users.[204] This role, however, has been in the context of LECs providing local payphone service as part of their regulated service. Section 276, however, significantly alters the regulatory landscape by requiring that LEC provision of payphone service be on par with independent PSP provision of service.[205] In addition, by mandating that LEC payphones can no longer receive subsidies from basic exchange services, Section 276 greatly changes the way in which states set local coin rates. Further, Section 276(b)(1)(A) gives the Commission both the jurisdiction to ensure fair compensation for local coin calls and the mandate to establish a plan to compensate PSPs on a per-call basis. We also stated our concern in the Notice that "current local rates may not always 'fairly' compensate the PSP for use of its payphone[,]" because the caller may use the payphone at "a subsidized local coin rate[.]"[206] Based on the record in this proceeding, we conclude that a deregulatory, market-based approach to setting local coin rates is appropriate, because existing local coin rates are not necessarily fairly compensatory.

59. We recognize, however, that the competitive conditions, which are a prerequisite to a deregulatory, market-based approach, do not currently exist and cannot be achieved immediately. Many states impose regulations on PSPs, including certain requirements that must be fulfilled before a PSP can enter or exit the payphone marketplace. We conclude that these state regulations are barriers to a fully competitive payphone market, and, therefore, "to the extent that any State requirements are inconsistent with the Commission's regulations, the Commission's regulations on such matters shall preempt such State requirements."[207] In addition, in some locations, because of the size of the location with an exclusive PSP contract or the caller's lack of time to identify potential substitute payphones, the PSP may be able to charge an inflated rate for local calls based on its monopoly, pursuant to an exclusive contract with the location provider, on

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203 Notice at para. 20-22.

204 Id.

205 See also Jt. Statement of Managers, S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess. (1996) at 43 ("Conference Report"): "In crafting implementing rules, the Commission is not bound to adhere to existing mechanisms or procedures established for general regulatory purposes in other provisions of the Communications Act."

206 Notice at para. 22, n.64.

207 47 U.S.C. § 276(c).

originate, on average, 52 access code calls and 80 subscriber 800 calls per payphone per month (total of 132 compensable calls).[426]

125. The data on the record from the five PSP sources noted in the preceding paragraph yield similar average monthly compensable call volumes. Based on the call volume data provided by the PSPs, we conclude that, for purposes of calculating flat-rate compensation, that the average payphone originates a combined total of 131 access code calls and subscriber 800 calls per month.[427] When 131 calls per month is multiplied by the $.35 compensation amount, the monthly flat-rate compensation amount is $45.85. We conclude that this $45.85 flat-rate amount must be paid by carriers, proportionally to their annual toll revenues, to PSPs. This flat-rate obligation applies to access code calls and subscriber 800 calls originated on or after the effective date of the rules adopted in this proceeding.[428] PSPs that are affiliated with LECs will not be eligible for this interim compensation until the first day of the month following their reclassification and transfer of payment equipment along with the termination of subsidies, as discussed below.[429]

126. We decline to require that per-call compensation be paid retroactive to the date of release of the Notice.[430] We conclude that the rules adopted in this Report and Order, including the requirement that interim flat-rate compensation be paid until per-call tracking capabilities are in place, provides compensation to PSPs as soon as practicable. For the same reasons discussed elsewhere in this Report and Order,[431] we also reject Intellicall's argument that interim compensation be mandated through a "caller pays" coin-deposit approach.

B. RECLASSIFICATION OF INCUMBENT LEC-OWNED PAYPHONES

127. In the foregoing Part, we establish rules and guidelines to ensure that PSPs are fairly compensated for calls originating at their payphones. For certain PSPs -- those who are

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426 See Ex Parte Letter of Michael Kellogg, Counsel, RBOCs, to William Caton, Acting Secretary, FCC (August 23, 1996).

427 The PSP data tend to show that one third of the total amount of compensable calls are access code calls, while two thirds are subscriber 800 calls.

428 We conclude that on the effective date of the interim compensation set forth in this Order, the $6 per payphone per month compensation for access code calls, as set forth in CC Docket No. 91-35, is terminated. See para. 119, above.

429 See generally, Part B of this Report and Order.

430 The independent payphone providers refer to this retroactive compensation as "interim relief." See para. 117, above. The interim flat-rate compensation that we mandate in this Report and Order, pursuant to Section 276(b)(1)(A), is for the first year after the effective date of the rules adopted in this proceeding. The term "interim" refers to the one-year period before compensation is to be paid on a per-call basis.

431 See para. 85, above.

LECs -- the new compensation arrangement can be implemented only upon the discontinuance of the regulatory system under which they now recover their costs of providing payphone service. In this Part, we describe the necessary steps for the LECs' transition to the new compensation framework, and set a schedule for the LECs' implementing actions.

128. Section 276(b)(1)(B) directs the Commission to "discontinue the intrastate and interstate carrier access charge payphone service elements and payments in effect on such date of enactment, and all intrastate and interstate payphone subsidies from basic exchange and exchange access revenues, in favor of a [per-call] compensation plan[.]"[432] Currently, incumbent LEC payphones, classified as part of the network, recover their costs from Carrier Common Line (CCL) charges assessed on those carriers that connect with the incumbent LEC. In order to comply with Section 276(b)(1)(B) by removing payphone costs from the CCL charge and all intrastate and interstate payphone subsidies from basic exchange and exchange access revenues, the Notice sought comment on: (1) the prospective classification of incumbent LEC payphones as Customer Premises Equipment (CPE); (2) the transfer of incumbent LEC payphone equipment assets from regulated to nonregulated status; (3) the termination of access charge compensation and all other subsidies for incumbent LEC payphones; and (4) the classification of AT&T payphones.

1. Classification of LEC Payphones as CPE

a. The Notice

129. In the Notice, we tentatively concluded that incumbent LEC payphones should be treated as nonregulated, detariffed CPE.[433] We also proposed that incumbent LECs, whether or not they provide payphone service, must offer individual central office coin transmission services to PSPs under a nondiscriminatory, public, tariffed offering.[434] To this end, we sought comment on both the central office coin services that must be made available by incumbent LECs to the PSPs to achieve this goal, and the type of services and the technological requirements necessary to allow independent payphone providers to use payphones that are equivalent to those payphones currently used by LECs. In addition, we sought comment on any industry standards that may need to be developed with respect to potential claims regarding any demonstrable network reliability concerns that may result from PSPs connecting their payphones that make use of central office coin transmission services.[435]

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432 47 U.S.C. § 276(b)(1)(B).

433 Notice at para. 42.

434 Id. at para. 45.

435 Id.

b. Comments

i. CPE Deregulation

132. Most of the parties support reclassifying payphone equipment as CPE and generally assert that deregulating payphone equipment is important in establishing a competitive payphone market.[442] Ohio PUC, on the other hand, argues that payphones should be detariffed but not deregulated and a charge should be imputed for LEC payphones.[443] Florida PSC supports deregulating payphones because needed functionalities are available either from the set or the network and because deregulation will ensure that payphone service is not subsidized. Florida PSC argues, however, that smaller LECs should be given a choice whether to deregulate CPE, because separating costs is burdensome.[444] Ameritech contends that payphone deregulation should apply to all LECs, not just incumbent LECs, because Section 276 (b)(1)(B) is not limited in applicability.[445]

133. The RBOCs argue that there should be a twelve-month transition period to nonregulated status for payphone CPE.[446] Others argue there should be no transition period, or a shorter period than twelve months, for example, 90 days after release of an order.[447] BellSouth argues that it should be able to conduct deregulated operations immediately on the release of this Report and Order.[448]

134. GPCA argues that a separate subsidiary should be required for BOCs that merge.[449] Ohio PUC argues that Tier 1 LECs should provide payphones through a separate

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442 AT&T Comments at 18; USTA Comments at 5; Ameritech Comments at 13; NJPA Comments at 10; SCPCA Comments at 2; Sprint Comments at 25; CPA Comments at 10-11; MCI Comments at 15; RBOC Comments at 23; GPCA Comments at 5 [Note: with regard to payphone reclassification and nonstructural safeguards, APCC relies on and agrees with GPCA comments. See APCC Comments at 41; APCC Reply at 35]; California PUC Comments at 14; USTA Comments at 5; GTE Reply Comments at 8-10.

443 Ohio PUC Comments at 9-10 .

444 Florida PSC Comments at 4-5. Florida recommends that LECs with less than 100,000 access lines be allowed to choose whether to deregulate CPE. Id.

445 Ameritech Comments at 3-4 .

446 RBOC Comments at 30.

447 International Telecard Comments at 26-27; GPCA Reply at 15.

448 BellSouth Reply at 8.

449 GPCA Comments at 4.

to include specifications for central-office-implemented payphones.[479] Anchorage Telephone suggests that a technical committee should be established to develop interconnection standards.[480]

141. AT&T, MCI, and Sprint contend that the demarcation point for LEC payphones should be the same as it is today for independent payphone providers.[481] GPCA argues that the demarcation point should be applied in a nondiscriminatory manner to all payphones and that LECs should be required to set demarcation points for different types of sites if the points will vary. GPCA also asserts that embedded inside wire should be available to all providers on an equal basis and that the demarcation point for embedded and new inside wire should be the same.[482] The RBOCs argue that the demarcation point should be treated flexibly.[483] In contrast, CPA argues that the demarcation point should not be flexible and should be at the minimum point of entry.[484]

c. Discussion

i. CPE Deregulation

142. We conclude that to best effectuate the 1996 Act's mandate that access charge payphone service elements and payphone subsidies from basic exchange and exchange access revenues be discontinued, incumbent LEC payphones should be treated as deregulated and detariffed CPE. The Commission determined in Computer II that CPE should be deregulated and detariffed to ensure that the costs associated with regulated services are separated from the competitive provision of the equipment used in conjunction with those services.[485] The Commission concluded that CPE should be unbundled from its underlying transmission service in order to prevent improper cross-subsidization.[486] Consistent with this prior finding, we conclude that LEC payphones must be treated as unregulated, detariffed CPE in order to ensure that no subsidies are provided from basic

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479 RBOC Comments at 26, n.28.

480 Anchorage Telephone Comments at 1.

481 AT&T Comments at 18 n.34; MCI Comments at 16; Sprint Comments at 25-26.

482 GPCA Comments at 7, 10-11.

483 RBOC Comments at 27.

484 CPA Comments at 10-11.

485 Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), 77 FCC 2d 384, 445 (1980) (Computer II), modified on recon., 84 FCC 2d 50 (1981), modified on further recon., 88 FCC 2d 512 (1981), aff'd sub nom. Computer and Communications Industry Ass'n v. FCC, 693 F.2d 198 (D.C. Cir. 1982), cert denied, 462 U.S. 938 (1983).

486 Computer II, 77 FCC 2d at 466-7, 474.

exchange and exchange access revenues or access charge payphone service elements as required by the Act.

143. In Computer II, the Commission specifically excluded coin-operated payphones from the definition of CPE.[487] The Commission found that, unlike other CPE, which could be unbundled from basic exchange service, coin-operated payphones were still integrated with the LECs' network facilities and concluded that payphones owned by LECs and AT&T should remain part of regulated basic communications service.[488] The Commission later extended this determination to LEC coinless payphones.[489] Thereafter, the Commission, in the Coin Registration Order, recognized the right of nonLEC payphone providers to interconnect smart payphones to the interstate public switched network.[490] Following this order allowing the interconnection of smart payphones, independent payphone providers began to compete with the LECs. Currently, there are approximately 1.5 million LEC payphones and approximately 350,000 competitively provided payphones.[491] We conclude that the market for payphone CPE is competitive and that it is no longer necessary to treat payphone CPE differently by integrating LEC payphones with the underlying service. Moreover, we conclude that the transient public that uses payphones will best be served by the wide availability of competitive payphones services. We also conclude that it is not in the public interest to continue to treat LEC payphones as regulated equipment, while treating independent payphones as CPE, and that deregulation of payphones is consistent with the procompetitive approach set forth in Section 276.[492] We have recently deregulated inmate payphones[493]and most of the parties in this proceeding agree that incumbent LEC payphones should also be deregulated and detariffed.[494] Accordingly, we conclude that incumbent LEC payphones must be deregulated, detariffed and classified as CPE for regulatory purposes.[495]

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487 Id. at 447, n. 57.

488 Id.

489 Petition for Declaratory Ruling of Tonka Tools, Inc. and Southern Merchandise Corp. Regarding American Telephone and Telegraph Company Provision of Coinless Pay Telephones, 58 RR2d 903, 910 (1985) (Tonka Tools).

490 See Registration of Coin Operated Telephones, Memorandum Opinion and Order, 49 Fed. Reg. 27763 (1984) (Coin Registration Order).

491 See para. 9, above.

492 47 U.S.C. § 276(b)(1)

493 Petition for Declaratory Ruling by the Inmate Calling Services Providers Task Force, Declaratory Ruling, 11 FCC Rcd 7362 (1996) (Inmate Services Order); Petitions for Waiver and Partial Reconsideration or Stay of Inmate-Only Payphones Declaratory Ruling, Order, 11 FCC Rcd 8013 (Com. Car. Bur. 1996)(Inmate Services Waiver Order).

494 We discuss at paras. 159, below, the equipment to be deregulated and detariffed and the method of valuation.

495 See also para. 190, below, regarding AT&T payphones. Section 255 of the 1996 Act requires manufacturers of telecommunications equipment and CPE, and telecommunications service providers, to ensure that their equipment and services are accessible to persons with disabilities, if readily achievable. 47 U.S.C. § 255(b)-(c). If such access is

144. We decline to limit the deregulation of payphones to those owned by larger LECs, as suggested by the Florida PSC, because Section 276 is not limited in application to larger LECs. Moreover, we conclude that the benefits we have observed in CPE deregulation apply to payphones and that these benefits apply regardless of the size of the LEC.

145. We decline to require the BOCs or other incumbent LECs to provide their payphone CPE through a structurally separated affiliate.[496] We discuss below the nonstructural safeguards we require for BOCs to provide payphone CPE on an integrated basis and decline to require, as proposed by some commenters, that other incumbent LECs be required to provide CPE through structurally separate affiliates. Section 276 does not require LEC or BOC provision of payphone service through a separate subsidiary. Although the 1996 Act does not specifically prohibit the Commission from imposing a separation requirement, it requires the establishment of nonstructural safeguards for the BOCs, a clear statement that nonstructural safeguards, rather than structural separation, are mandated.[497] Moreover, Section 276 does not require even nonstructural safeguards for other LECs. Other sections of the 1996 Act, including Section 272, BOC provision of interLATA services, and Section 274, BOC provision of electronic publishing, specifically require structural separation. In addition, in the BOC CPE Relief Order we removed the structural separation requirements established in Computer II for BOC provision of CPE because we concluded that nonstructural safeguards were sufficient to deter cross-subsidization and discrimination and the high costs of mandatory structural separation were not in the public interest.[498] This conclusion is also applicable in the context of BOC provision of payphone CPE. We also note that the Computer II structural separation requirements were not applied to the provision of CPE by other LECs.[499] Finally, we note that nonstructural accounting safeguards applicable to the BOCs' provision of payphone service are being established in a separate proceeding.[500] Accordingly, we do not impose structural separation requirements for the provision of payphones by the BOCs or other LECs. As we did in the BOC CPE Relief Order, we preempt states' ability to impose structural separation

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not readily achievable, the manufacturer or service provider must ensure that the equipment or service is compatible with existing peripheral devices or specialized CPE commonly used by persons with disabilities, if readily achievable. 47 U.S.C. § 255(d). The implementation of Section 255 will be addressed in a separate proceeding.

496 See paras. 192-207, below, for a discussion of the statutory mandate that we "prescribe a set of nonstructural safeguards for [BOC] payphone service ... which safeguards shall, at a minimum, include the nonstructural safeguards equal to those adopted in the Computer Inquiry-III ... proceeding." 47 U.S.C. § 276(b)(1)(C).

497 See 47 U.S.C. § 276(b)(1)(C).

498 Furnishing of Customer Premises Equipment by the Bell Operating Telephone Companies and the Independent Telephone Companies, 2 FCC Rcd 143 (1987)(BOC CPE Relief Order).

499 See Computer II, 77 FCC 2d at 469-70. Structural separation requirements initially imposed on GTE were removed on reconsideration. See 84 FCC 2d at 72-75.

500 See Implementation of the Telecommunications Act of 1996: Accounting Safeguards under the Telecommunications Act of 1996, Notice of Proposed Rulemaking, 11 FCC Rcd 9054 (1996) ("Accounting Safeguards NPRM").

disclosure on the basic network payphone services must be made by the BOCs by January 15, 1997.

147. We conclude that tariffs for payphone services must be filed with the Commission as part of the LECs' access services to ensure that the services are reasonably priced and do not include subsidies.[507] This requirement is consistent with the Section 276 prescription that all subsidies be removed from payphone operations. We decline to require, as proposed by AT&T, that the pricing regime under Sections 251 and 252 apply to all Section 276 payphone services offered by incumbent LECs. Section 276 does not refer to or require the application of Sections 251 and 252 to LEC payphone services. In addition, the elements and services to be offered under Sections 251 and 252 are not available to entities that are not telecommunications carriers, and many PSPs are not telecommunications carriers.[508] In addition, Section 276 does not refer to or require the application of Sections 251 and 252 to LEC payphone services. Moreover, Section 276 specifically refers to the application of Computer III and ONA requirements, at a minimum for BOC provision of payphone services. Accordingly, we conclude that Computer III tariff procedures and pricing are more appropriate for basic payphone services provided by LECs to other payphone providers. Pursuant to Section 276(c), any inconsistent state requirements with regard to this matter are preempted.

148. Parties argue that several other network services and network elements should be unbundled and provided to payphone providers. We decline to impose this requirement on all LECs. We do not find that such unbundling is necessary to provide payphone services. In addition, some features require substantial costs to make switch changes.[509] Moreover, pursuant to Computer III and ONA requirements discussed below, BOCs must unbundle additional network elements when requested by payphone providers based on specific criteria established in the Computer III and ONA proceedings. In Computer III, we decided that it was not necessary to apply this requirement to other LECs, and we similarly conclude that it is not necessary to direct other LECs to unbundle additional services or unbundled elements in this proceeding because additional services are not necessary to provide payphone services and because other LECs do not represent the same control of payphone

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507 BOCs have filed payphone service tariffs with the Commission. See e.g., US West Communications, Tariff FCC No. 5, Pay Telephone Sent-Paid Services, August 5, 1994; BellSouth Communications Inc., Tariff F.C.C.No. 1, Access Service, Coin Services, January 31, 1992. See 47 U.S.C. § 276(c) and §§ 201-205 regarding authority to require tariffing of basic payphone services.

508 See Local Competition Order at para. 876 (holding that the services that incumbent LECs offer to PSPs are retail services provided to end users, and should be available at wholesale rates to telecommunications carriers and Section 251(c)(4), but need not be made available at wholesale rates to independent PSPs that are not telecommunications carriers).

509 See ex parte, Michael K. Kellogg to William F. Caton, Secretary, FCC, September 6, 1996 at 3; GVNW Comments at 5-7.

period.[546] MCI does not object to up to 12 months for transition, but argues that the Commission should set a specific date.[547] USTA contends that the deregulation should be flash cut in order tp eliminate subsidies.[548]

c. Discussion

157. As an initial matter, we have already determined that neither Section 276 nor our past experience requires the BOCs' competitive provision of payphone services to take place on a prospective basis through the use of structurally separate affiliates.[549] Instead, in this Report and Order, we require that, if a BOC does not provide payphone services through a separate affiliate, it must provide these payphone services using nonstructural safeguards as described in our Computer III Orders and ONA proceedings and consistent with Section 276, because we conclude that, in the absence of structural separation, our nonstructural safeguards provide sufficient protection against the possibility of cross-subsidization of nonregulated activities.[550] Those nonstructural safeguards include the cost allocation rules and affiliate transactions rules adopted in the Joint Cost Order.[551] Under those rules, the BOCs and other incumbent LECs must classify each of their activities as regulated or nonregulated in accordance with our requirements.[552] We now require that the BOCs and other incumbent LECs, subject to our joint cost rules, classify their payphone operations as nonregulated for our Part 32 accounting purposes. We note, however, that the BOCs or other incumbent LECs are free to provide these services using structurally separate affiliates if they choose to do so.[553] Therefore, our discussion below will address two possible approaches a carrier may take in reclassifying its payphone activities as nonregulated: (1) a carrier may maintain its payphone assets on the carrier's books but treat the assets as nonregulated, or (2) a carrier may transfer its payphone assets to a separate affiliate engaged in nonregulated activities.

546 Ameritech Comments at 14.

547 MCI Reply at 9.

548 USTA Comments at 8.

549 See para 145, above.

550 See paras. 199-207, below.

551 See Separation of Costs of Regulated Telephone Service From Costs of Nonregulated Activities, 2 FCC Rcd 1298 (1987) (Joint Cost Order), recon., 2 FCC Rcd 6283 (1987) (Joint Cost Reconsideration Order), further recon., 3 FCC Rcd 6701 (1988), aff'd sub nom., Southwestern Bell Corp. v. FCC, 896 F.2d 1378 (D.C.Cir. 1990).

552 47 C.F.R. § 32.23(a).

553 In the Accounting Safeguards NPRM, we sought comment on what rules should apply to transactions between a LEC and a separate payphone affiliate. Id. at para. 118.

158. In the Notice, we sought comment on three primary aspects of the reclassification of payphone assets from regulated to nonregulated status. We solicited comment on the proper accounting treatment for the reclassification or transfer of the payphone assets from a regulated activity to a nonregulated activity. We also sought comments on the specific assets to be reclassified or transferred.[554] We tentatively concluded that the assets to be transferred should be defined generally in terms of CPE deregulation and that this would include all facilities related to payphone service, including associated depreciation and deferred income taxes, but likely would not include the loops connecting the payphones to the network, the central office "coin-service," or operator service facilities supporting incumbent LEC payphones.[555] We next tentatively concluded that a phase-in period was not necessary for the reclassification or transfer of the payphone assets to nonregulated status and sought comment on this tentative conclusion.[556] We address these questions and tentative conclusions in the sections that follow.

i. Specific Assets Reclassified or Transferred

159. We adopt our tentative conclusion, supported by numerous commenters,[557] that the payphone assets to be reclassified or transferred include all facilities related to payphone service, including associated accumulated depreciation and deferred income tax liabilities. We do not agree with GVNW that related expenses, such as maintenance, should also be reclassified and transferred[558] because expenses are period costs that should be associated with the status of the service at the time they were incurred. That is, expenses incurred during the period payphones were regulated remain as regulated expenses and expenses incurred after payphone deregulation should be classified as nonregulated expenses. We, however, do not include as payphone assets to be reclassified or transferred the loops connecting the payphones to the network, the central office "coin-service," or operator service facilities supporting incumbent LEC payphones because these are part of network equipment necessary to support basic telephone services.

160. In adopting our tentative conclusion, we disagree with commenters such as GPCA, Peoples, SDPOA and others who assert that, in all instances, the value of intangible assets that have not been capitalized on the books of the carrier, such as location contracts and brand

554 Notice at para. 49.

555 Id.

556 Id.

557 See USTA Comments at 6; MCI Comments at 15-16; Florida PSC Comments at 6.

558 GVNW Comments at 8.

names, should be included in the payphone assets reclassified to nonregulated status.[559] We note that these assets are not recorded in the carriers' Part 32 accounts and, in fact, are not, without some triggering event such as a purchase or sale, required to be recorded by either generally accepted accounting principles or our Part 32 accounting rules. We do, however, discuss these intangible assets in more detail below as they relate to actual payphone asset transfers to separate affiliates or, in certain limited instances, to an operating division of the carrier.

ii. Accounting Treatment for Assets Reclassified or Transferred

161. Our tentative conclusion in the Notice called for the transfer of the LECs' payphone assets to nonregulated operations to take place at the undepreciated baseline costs plus interest charges at the authorized rate of return for interstate services. The parties have correctly pointed out that this standard only applies in those circumstances where there has been an underforecasting of demand for nonregulated usage requiring a transfer to compensate ratepayers for the additional risks they have borne due to the underforecasting.[560] Since the issue at hand does not involve an underallocation of payphone costs between regulated and nonregulated activities, we see no need to consider this approach any further.

162. The parties question whether the carriers should account for the transfer or reclassification of the payphone assets from regulated to nonregulated status at "fair market value" or the net book value of the assets.[561] While Section 276 provides us with discretion to change our accounting rules to provide safeguards in excess of those provided by Computer III, we believe that our existing rules are sufficient to meet the requirements of Section 276. We conclude that our existing rules require that this determination be based on whether a carrier maintains the assets in its regulated Part 32 accounts or instead transfers the payphone assets to a separate affiliate or an operating division within the carrier that is treated as an affiliate.

163. Carriers that do not transfer the payphone assets to a separate affiliate make no reclassification accounting entries to their Part 32 regulated accounts. The reclassification of these assets to nonregulated status is accomplished instead through the operation of our Part 64 cost allocation rules.[562] Accordingly, we conclude that payphone investment in Account 32.2351, Public telephone terminal equipment, and any other assets used in the provision of payphone service, along with the associated accumulated depreciation and deferred income tax liabilities should be directly

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559 See GPCA Comments at 15-16; GPCA Reply at 13-14; Peoples Reply at 20-21; SDPOA Reply at 3.

560 See Joint Cost Order, 2 FCC Rcd at 170-171.

561 See, e.g., RBOC Reply at 19-21.

562 47 C.F.R. §§ 64.901-904. See also Inmate Services Order, 11 FCC Rcd at 7374.

assigned or allocated to nonregulated activities pursuant to our cost allocation rules.[563] LECs should establish whatever Part 64 cost pools[564] are needed and should file revisions to their cost allocations manuals within sixty (60) days prior to the effective date of the change.[565] This will ensure that the provision of payphone service is separate and distinct from the provision of common carrier services in accordance with our rules.

164. On the other hand, carriers that transfer their payphone assets to either a separate affiliate or an operating division that has no joint and common use of assets or resources with the LEC and maintains a separate set of books in accordance with Section 32.23(b) of our rules must account for the transfer according to the affiliate transactions rules of Section 32.27(c) which require that the transfer be recorded at the higher of fair market value or cost less all applicable valuation reserves (net book cost).[566] Fair market value has been defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[567] We conclude, that in instances when the transfer of payphone assets is governed by Section 32.27(c), it is appropriate, as argued by CPA, that the going concern value associated with the payphone business be taken into consideration in determining fair market value.[568] Such going concern value should, as asserted by GPCA and Peoples, include intangible assets such as location contracts that add value to the payphone business.[569] These intangible assets would be considered in the theoretical purchase price negotiated by a willing buyer and seller. We do not believe, however, that the intangible asset value of BOC or LEC brand names should be included in the determination of going concern or fair

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[563] RBOC Comments at 28, citing Inmate Services Order. See also Letter from Michael K. Kellogg to William F. Caton, Secretary dated August 30, 1996 at 9 (RBOC Ex Parte 8/30/96).

[564] Inmate Services Order, 11 FCC Rcd at 7374. "Cost pools" are comprised of logical homogeneous groupings of costs that maximize the extent to which cost causative allocation factors can be used to divide costs between regulated and nonregulated activities. Implementation of Further Cost Allocation Uniformity, Memorandum Opinion and Order, 8 FCC Rcd 4664 (1993).

[565] 47 C.F.R. § 64.904(b).

[566] 47 C.F.R. §§ 32.23(b), 32.27(c). In applying the affiliate transactions rules to asset transfers to operating divisions that maintain a separate set of books and do not jointly use assets or resources with the carrier, we have provided a safeguard to protect against a carrier that attempts to avoid our affiliate transactions rules by "reincarnating a nonregulated affiliate as an operating division." Joint Cost Reconsideration Order, 2 FCC Rcd at 6296.

[567] 26 C.F.R. § 1.170-1. See also, Accounting Safeguards NPRM at para. 83.

[568] See CPA Reply at 12-15.

[569] See GPCA Comments at 15-16; GPCA Reply at 13-14; Peoples Reply at 20-21. This conclusion is also supported by the APCC and GPCA ex parte filing dated September 11, 1996 to the extent that the ex parte filing relates to transfers to separate affiliates. Letter from Albert H. Kramer, Attorney for APCC and GPCA, to William F. Caton, Secretary, dated September 11, 1996 (APCC & GPCA Ex Parte 9/11/1996).

market value because a BOC or a LEC would not transfer the right to use its brand name to a third party willing buyer.

165. The operation of our cost allocation rules and our affiliate transactions rules serve to protect ratepayers from different concerns. The cost allocation rules are used to provide guidance to carriers as to how joint and common costs are to be allocated among regulated and nonregulated activities that impact upon regulated activities. These rules are premised on the assumption that ratepayers benefit from the economies of scope associated with integrated operations of regulated and nonregulated activities. Since costs are recorded in regulated accounts, the Commission retains the ability to scrutinize costs associated with nonregulated activities. For example, carriers must file cost allocation manuals. These manuals are subject to public comment and must be audited annually by an independent auditor.[570] The report of the independent auditor must also be submitted to the Commission.[571] These procedures promote fair cost allocation and protect regulated ratepayers from absorbing the costs of nonregulated activities. In addition, as assets are retained on the books of the carrier, any resulting gains from a sale of those nonregulated assets accrue to the carrier and to the benefit of ratepayers and shareholders.

166. Our affiliate transactions rules also afford a level of protection to ratepayers. These rules first protect ratepayers by requiring that when an affiliate transfers to or performs a service for the carrier, those assets or services are not charged to regulated ratepayers at an inflated price. In addition, when the carrier transfers assets to an affiliate, the operation of our affiliate transactions rules effectively captures on the carrier's books any appreciation in value of those assets, thus ensuring that any eventual gains would accrue to the benefit of the ratepayers and shareholders.

167. The difference in accounting treatment for payphone assets either reclassified as nonregulated pursuant to our Part 64 cost allocation rules or transferred to a separate affiliate and accounted for in accordance with our Part 32 affiliate transactions rules stems primarily from the fact that in one instance there is no transfer, only a reallocation of assets to nonregulated status, and in the other instance, there has been an actual transfer. In addition, in the first instance our rules are designed to promote fair cost allocation between regulated and nonregulated activities; in the second instance, our rules are designed to protect against cross-subsidies between separate companies by capturing any appreciated value of assets transferred on the books of the carrier.

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[570] See 47 C.F.R. § 64.904(a).

[571] 47 C.F.R. § 64.904(b).

168. We note that some parties assert that, based on the holding of the Court of Appeals for the D.C. Circuit in Democratic Central Committee,[572] the proper measure of value for an asset reclassified from regulated to nonregulated status is the asset's economic value, which would ordinarily be its fair market value.[573] Democratic Central Committee involved the distribution of capital gains realized from the sale to a third party of property that had been transferred out of the rate base. Although Democratic Central Committee provided several general guiding principles on which the Commission fashioned its affiliate transactions rules, we note that the facts in that case did not involve affiliate transactions.[574] Accordingly, we do not think that case is directly applicable either to the situation where a carrier retains the payphone assets on its books or transfers the payphone assets to a separate affiliate. In both instances, ratepayers are protected by the application of our accounting safeguards.

169. One of the primary goals of Section 276 is that a BOC shall not be allowed to subsidize its payphone operations directly or indirectly from its telephone exchange operations or its exchange access operations. In order to achieve this goal, Congress required that we adopt at a minimum the nonstructural safeguards of Computer III. In Computer III, the Commission reexamined its regulatory regime for the provision of enhanced services and established nonstructural safeguards for the provision of enhanced services on an integrated basis. These safeguards included the cost allocation rules and the affiliate transactions rules the Commission developed in the Joint Cost Order. These nonstructural safeguards include our Part 64 cost allocation rules and our Part 32 affiliate transactions rules. We also note that the Conference Report states:

> "[t]he BOC payphone operations will be transferred, at an appropriate valuation, from the regulated accounts associated with local exchange services to the BOC's unregulated books. The Commission's implementing safeguards must be at least equal to those adopted in the Commission's Computer III proceedings."[575]

We believe that, consistent with Computer III, our cost allocation rules and affiliate transactions rules, as discussed above, provide rules for the appropriate valuation of the reclassification or

572 Democratic Central Committee v. Washington Metropolitan Area Transit Commission, 485 F.2d 786 (D.C.Cir. 1973), cert. denied, 415 U.S. 935 (1974) (Democratic Central Committee).

573 See, e.g., GPCA Comments at 16-17.

574 Joint Cost Reconsideration Order, 2 FCC Rcd at 6295.

575 Conference Report at 43.

transfer of payphone assets and we see no compelling argument to deviate from those well-settled rules at this time.[576]

170. APCC and GPCA argue that the legislative history cited in the previous paragraph makes clear that Congress intended that the assets be "transferred."[577] We disagree. We have already stated that Section 276 does not require that a BOC establish a separate affiliate to hold the payphone assets.[578] In fact, the Senate version of Section 276 authorized the Commission to determine whether to require Bell operating companies "to provide payphone service...through a separate subsidiary..."[579] This authorization was deleted from the final version of Section 276. If Congress intended that there be a "transfer", we believe that Congress would have required the BOCs to establish separate affiliates for their payphone operations. Congress did not do so. Instead, Congress in the very next sentence of the legislative history states that the Commission's implementing safeguards must, at a minimum, be at least equal to those adopted in the Computer III proceedings. These safeguards include our cost allocation rules. Our cost allocation rules are applicable when a carrier maintains integrated regulated and nonregulated activities. To read congressional intent to require a "transfer" would effectively eliminate our cost allocation rules from application to payphone operations. This is contrary to Section 276 which states that the Commission shall prescribe regulations that prescribe a set of nonstructural safeguards for BOC payphone service which "at a minimum, include[s] the nonstructural safeguards equal to those adopted in the Computer Inquiry-III...proceeding."[580] Computer III included our cost allocation rules as a part of the nonstructural safeguards and thus they are applicable to BOC payphone operations. To exclude the cost allocation rules would be contrary to Section 276's intent that they be included.

171. We also agree with the RBOCs that our cost allocation rules only require a reassignment of payphone assets from regulated to nonregulated status.[581] In reality, carriers maintain these assets in regulated Part 32 accounts and do not establish "unregulated books." These accounts are considered "regulated" accounts even though a carrier may assign the entire amount in an account to nonregulated activities. Using regulated accounts serves the public interest by

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576 We note that in the Accounting Safeguards NPRM, we proposed changes to the affiliate transactions rules of Section 32.27 of our rules. See Accounting Safeguards NPRM at paras. 70-88.

577 Ex Parte Letter from Albert Kramer, Counsel, APCC to William Caton, Acting Secretary, FCC (September 11, 1996) at 3.

578 See para. 145, above.

579 S. 652, 104th Cong., 1st Sess., § 265(c) (1995). See also RBOC Comments at 40, n. 53.

580 47 U.S.C. § 276(b)(1)(C).

581 See RBOC Ex Parte 8/30/96 at 8.

allowing Commission scrutiny of nonregulated activities as they potentially impact regulated activities, maintaining a minimal amount of regulatory burden while protecting regulated ratepayers from cross-subsidies and cost misallocations, and preserving economies of scope that accrue to ratepayers from integrated operations. We believe regulated ratepayers are better served by the requirement that carriers account for payphone operations in regulated accounts than if we required them to account for payphone operations in "nonregulated" accounts or "unregulated books."

iii. Other Matters

172. We require the LECs to reclassify any pay telephone investments recorded in Account 32.2351, Public telephone terminal equipment, and other assets used in the provision of payphone service, along with the associated accumulated depreciation and deferred income tax liabilities, from regulated to nonregulated status pursuant to our Part 64 and Part 32 rules by April 15, 1997 when the associated revised tariffs are effective. We thus agree with Ameritech that we should adopt our tentative conclusion that a phase-in period is unnecessary.[582]

3. Termination of Access Charge Compensation and Other Subsidies

a. The Notice

173. In the Notice, we tentatively concluded that incumbent LECs must reduce their interstate CCL charges by an amount equal to the interstate allocation of payphone costs currently recovered through those charges.[583] LECs subject to the price cap rules would treat this as an exogenous cost change to the Common Line basket pursuant to Section 61.45(d) of the Commission's rules.[584] We requested incumbent LECs to identify in their comments all accounts that contain costs attributable to their payphone operations and sought comment on whether specific cost pools and allocators should be used to capture the nonregulated investment and expenses associated with their payphone operations.[585] We also sought comment on whether a transition period is necessary to move from subsidized compensation to per-call compensation for LEC payphones, and how that transition would proceed.[586] We also proposed, in accordance with the mandate of Section 276(b)(1)(B), to require incumbent LECs to remove from their intrastate rates

[582] Ameritech Comments at 14.

[583] Notice at para. 51.

[584] Id.

[585] Id.

[586] Id.

ii. Intrastate Rates

178. Florida PSC asserts that intrastate adjustments vary and that a national scheme is impractical. Instead, the Commission could set a date for removal of state subsidies.[605] California PUC is concerned that, if LECs cannot recover the interstate costs of subscriber lines because the CCL mechanisms are removed, the state's local phone charges and the state-mandated pay station service charge may not fully recover costs.[606] USTA argues that the payphone line is a common line and should be tariffed at the state level.[607] USTA also contends that states should be permitted to formulate mechanisms to remove intrastate costs.[608]

iii. Subscriber Line Charge

179. Florida PSC and the Ohio PUC argue that access lines terminating at LEC payphones should be subject to SLC imputation.[609] Ameritech and SW Bell argue that a SLC should be imputed to all payphones.[610] GPCA opposes application of the SLC to payphones but if the Commission imposes such a requirement, GPCA also opposes any additional charge in addition to what is required of other end users.[611] USTA also opposes imposition of an additional charge for the difference between the SLC cap and the full cost of subscriber lines. USTA argues that if there are any loop subsidies they will be uniform for all loops, not just payphone loops.[612] SW Bell argues that the SLC should apply to payphones because payphones use common lines and access the public switched network just like any other common line service.[613] Sprint supports the additional charge

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605 Florida PSC Comments at 7.

606 California PUC Comments at 15.

607 USTA Reply at 7.

608 USTA Comments at 9.

609 Florida PSC Comments at 8; Ohio PUC Comments at 12.

610 Ameritech Comments at 14; SW Bell Reply at 7-9.

611 GPCA Reply at 17-19.

612 USTA Comments at 10. See also RBOC Comments at 32.

613 SW Bell Reply at 7-8.

to all PSPs including LECs to the extent that the multi-line business SLC is less than the full interstate cost of subscriber lines.[614]

c. Discussion

180. In the telephone network, payphones, as well as all other telephones, are connected to the local switch by means of a subscriber line. The costs of the subscriber line that are allocated to the interstate jurisdiction are recovered through two separate charges: a flat-rate SLC assessed upon the end-user customer who subscribes to local service; and a per-minute CCL charge assessed upon IXCs that recovers the balance of the interstate subscriber line costs not recovered through the SLC. LEC payphone costs are also included in the CCL charge. The CCL charge, however, applies to interstate switched access service that is unrelated to payphone service costs. While independent payphone providers are required to pay the SLC for the loop used by each of their payphones, LECs have not been required to pay this charge because the subscriber lines connected to LEC payphones have been recovered entirely through the CCL charge.

181. We conclude that to implement Section 276 (b)(1)(B) of the 1996 Act, incumbent LECs must reduce their interstate CCL charges by an amount equal to the interstate allocation of payphone costs currently recovered through those charges. LECs subject to the price cap rules would treat this as an exogenous cost change to the Common Line basket pursuant to Section 61.45(d) of the Commission's rules. The incumbent LECs' residential SLC is limited to $3.50 per month and their multi-line business SLC is currently subject to a $6.00 per month cap.[615] Those LECs with interstate subscriber line costs that exceed this amount recover a portion of the interstate costs of subscriber lines through the CCL charge. The issue of the appropriate interstate SLC has been referred to a Federal-State Joint Board.[616]

182. Incumbent LECs today generally recover payphone costs allocated to the interstate jurisdiction through the per-minute carrier CCL charge they assess on IXCs and other interstate access customers for originating and terminating interstate calls. The incumbent LEC assesses the independent payphone provider a SLC (at the multi-line business rate) to recover the

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614 Sprint Comments at 28.

615 47 C.F.R. § 69.104.

616 See Federal-State Joint Board on Universal Service, NPRM and Order Establishing Joint Board, FCC 96-93 at para. 114 (rel. March 8, 1996) ("Joint Board Notice"). We note that pursuant to Section 254 of the Act, we have referred to the universal service joint board the matter of how to recover the interstate allocated portion of the subscriber loop costs. Federal-State Joint Board on Universal Service, Notice of Proposed Rulemaking and Order Establishing Joint Board, CC Docket No. 96-45, FCC 96-93 (adopted and released on Mar. 8, 1996). The decision to remove payphone costs from the CCL charge and the decision to impose a SLC to all subscriber lines that terminate at both LEC and competitive payphones was not referred to the universal service joint board.

payphone common line costs associated with that phone.[617] In the case of competitive payphones, an independent payphone provider recovers its payphone costs out of the revenue it receives from end users, premises owners, and OSPs to whom its payphones are presubscribed. The 1996 Act mandates that the Commission "discontinue the intrastate and interstate carrier access charge payphone service elements and payments ... and all intrastate and interstate subsidies from basic exchange and exchange access revenues[.]"[618]

183. Accordingly, we adopt rules that provide for the removal from regulated intrastate and interstate rate structures of all charges that recover the costs of payphones (i.e., the costs of payphone sets, not including the costs of the lines connecting those sets to the public switched network, which, like the lines connecting competitive payphones to the network, will continue to be treated as regulated). Therefore, we conclude that incumbent LECs must file revised CCL tariffs with the Common Carrier Bureau no later than January 15, 1997 to reduce their interstate CCL charges by an amount equal to the interstate allocation of payphone costs currently recovered through those charges, scheduled to take effect April 15, 1997. LECs subject to the price cap rules must treat this as an exogenous cost change to the Common Line basket pursuant to Section 61.45(d)(1)(v) of our rules.[619] Incumbent LECs must identify and report accounts that contain costs attributable to their payphone operations. Incumbent LECs must identify specific cost pools and allocators that are required to capture the nonregulated investment and expenses associated with their payphone operations. LECs must file this information with the Common Carrier Bureau by January 15, 1997.

184. LECs that file tariffs pursuant to Section 61.38 or Section 61.39, rate-of-return regulation, or Section 61.50, optional incentive regulation, must file tariffs to revise interstate CCL rates to remove the payphone investment and any other assets used in the provision of payphone service along with the accumulated depreciation and deferred income tax liabilities from the common line costs recovered through those rates. As stated previously, these LECs must reclassify payphone assets from regulated to nonregulated activity pursuant to Part 64 rules. Expenses incurred after payphones are deregulated should be classified as nonregulated expenses. The CCL rate reduction must account for overhead costs assigned to common line costs as a result of payphone investment and expenses. We require these LECs to recalculate their CCL rates, using the same data

[617] We recently reaffirmed a decision by the Common Carrier Bureau concluding that independent payphone providers should be classified as "end users" under our rules. C.F. Communications Corp. v. Century Telephone of Wisconsin, Inc., Memorandum Opinion and Order, 10 FCC Rcd 9775 (1995), petition for review filed, C.F. Communications Corp. v. FCC and United States, No. 95-1563 (D.C. Cir. filed Nov. 6, 1995). Thus, independent payphone providers are required to pay a SLC for their use of common lines connected to the payphones they serve, but are not assessed a per-minute CCL charge.

[618] 47 U.S.C. § 276(b)(1)(B).

[619] 47 C.F.R. § 61.45(d)(1)(v).

and methods they used to develop their current CCL rates, except those calculations should exclude payphone costs.

185. Price cap LECs are also required to revise their CCL rates, using the following method to remove payphone costs from their CCL rates. First, price cap LECs should develop a common line revenue requirement using ARMIS costs for calendar year 1995. Second, price cap LECs are required to develop a payphone cost allocator equal to the payphone costs in Section 69.501(d) divided by total common line costs, based on 1995 ARMIS data. Each LEC is required to reduce its PCI in the common line basket by this payphone cost allocator minus one.

186. We require, pursuant to the mandate of Section 276(b)(1)(B), incumbent LECs to remove from their intrastate rates any charges that recover the costs of payphones. Revised intrastate rates must be effective no later than April 15, 1997. Parties did not submit state-specific information regarding the intrastate rate elements that recover payphone costs. States must determine the intrastate rates elements that must be removed to eliminate any intrastate subsidies within this time frame.

187. Finally, we conclude that, to avoid discrimination among payphone providers, the multiline business SLC must apply to subscriber lines that terminate at both LEC and competitive payphones. We conclude that the removal of payphone costs from the CCL and the payment or imputation of a SLC to the subscriber line that terminates at a LEC nonregulated payphone will result in the recovery of LEC payphone costs on a more cost-causative basis consistent with the requirements of the 1996 Act.[620] No action we take today affects the authority of states to address the state ratemaking implications of reclassification or transfer of payphone assets.

4. Deregulation of AT&T Payphones

a. The Notice

188. In the Notice, we tentatively concluded that payphones provided by AT&T should be classified as CPE, finding that discontinuing possible subsidies for AT&T payphones would be congruent with the 1996 Act's requirement that the Commission discontinue subsidies for other payphones (i.e., those owned by incumbent LECs) and would provide for symmetrical regulation of the payphone industry.[621] We cited two other reasons why this proposed action is in

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620 See Ameritech/SW Bell Waiver at para. 25.

621 Notice at para. 56.

CEI plans have been an integral part of ensuring that BOCs do not discriminate in providing basic underlying services to enhanced services providers. We likewise require the filing of CEI plans for payphone services, even though we have traditionally only required such plans for the BOC provision of enhanced services, to ensure that the BOCs provide payphone services in a nondiscriminatory manner and consistent with other Computer III and ONA requirements. Finally, we conclude that this requirement is consistent with the requirement in Section 276 that we establish safeguards, at a minimum, "equal to those adopted in the Computer III Inquiry."[667]

203. In a CEI plan, a BOC must describe how it intends to comply with the CEI "equal access" parameters for the specific payphone service it intends to offer. The CEI equal access parameters include: interface functionality; unbundling of basic services; resale; technical characteristics; installation, maintenance, and repair; end user access; CEI availability; minimization of transport costs; and availability to all interested customers or enhanced service providers.[668]

204. In its CEI plan, a BOC must explain how it will unbundle basic payphone services. Thus, a BOC must indicate how it plans to unbundle, and associate with a specific rate element in a tariff, the basic services and basic service functions that underlie its provision of payphone service.[669] Nonproprietary information used by the BOC in providing the unbundled basic services will be made available as part of CEI.[670] In addition, any options available to the BOC in the provision of such basic services or functions would be included in the unbundled offerings.[671]

205. A BOC also must explain in its CEI plan how it will comply with the CPNI requirements. We have continued to require compliance with the Computer III and ONA CPNI requirements that are not inconsistent with Section 222 of the 1996 Act, which was immediately effective.[672] In the CPNI NPRM, we are currently examining a carrier's obligations under the CPNI

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[667] Id.

[668] Phase I Order, 104 FCC 2d at 1039-1043.

[669] Id. at 1040.

[670] Id.

[671] Id.

[672] 47 U.S.C. § 222. See Implementation of the Telecommunications Act of 1996, Telecommunications Carriers' Use of Customer Proprietary Network Information and Other Customer Information, Notice of Proposed Rulemaking, CC Docket No. 96-115 (rel. May 17, 1996) (CPNI NPRM).

take into account as many of these concerns as possible in promulgating the rules contained in this Order.

F. Report to Congress

362. The Commission shall send a copy of this FRFA, along with this Order, in a report to Congress pursuant to the Small Business Regulatory Enforcement Fairness Act of 1996, 5 U.S.C. § 801(a)(1)(A). A copy of this FRFA will also be published in the Federal Register.

V. CONCLUSION

363. In this Report and Order, we have established procedures that will ensure that all payphone service providers are fairly compensated for every completed intrastate, interstate and international call, except for those calls excepted by statute, and we adopt interim compensation until the new compensation procedures are effective. We have also established procedures that ensure that all subsidies from basic exchange and exchange access revenues are removed simultaneous with the LECs' receipt of compensation for calls from LEC payphones. We require the BOCs to comply with certain nonstructural safeguards for their provision of payphone service, and allow them to negotiate with location providers for selecting and contracting with the carriers that provide interLata service from their phones. We set forth herein guidelines for public interest payphones, and establish guidelines for states to use in their proceedings for funding of such payphones.

VI. ORDERING CLAUSES

364. Accordingly, pursuant to authority contained in Sections 1, 4, 201-205, 215, 218, 219, 220, 226, and 276 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151, 154, 201-205, 215, 218, 219, 220, 226, and 276, IT IS ORDERED that the policies, rules, and requirements set forth herein ARE ADOPTED.

365. IT IS FURTHER ORDERED, that 47 C.F.R. Part 64, Subpart G and Subpart M ARE AMENDED as set forth in Appendix D, effective (30) days after publication of the text thereof in the Federal Register.

366. IT IS FURTHER ORDERED, that 47 C.F.R. Part 64, Subpart M IS AMENDED as set forth in Appendix E, effective one year after publication of the text thereof in the Federal Register.

367. IT IS FURTHER ORDERED, that 47 C.F.R. Part 68, Subpart A IS AMENDED as set forth in Appendix E, effective April 15, 1997.

36 Peoples Telephone Company, Inc. ("Peoples")
37 Puerto Rico Telephone Company ("Puerto Rico Telephone")
38 RBOC Payphone Coalition ("RBOC")
39 San Diego Payphone Owners Association ("SDPOA")
40 Southwestern Bell Telephone Company ("SW Bell")
41 Sprint Corporation ("Sprint")
42 Telaleasing Enterprises, Inc. ("Telaleasing")
43 Telecommunications Resellers Association ("TRA")
44 Tennessee Regulatory Authority
45 United States Telephone Association ("USTA")
46 US WEST, Inc. ("US WEST")
47 Voice Telephone Company ("Voice")
48 Wisconsin Public Communications Association ("WPCA")