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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks.	Rulemaking 93-04-003 (Filed April 7, 1993)
Investigation on the Commission's Own Motion Into Open Access and Network Architecture Development of Dominant Carrier Networks.	Investigation 93-04-002 (Filed April 7, 1993) **Verizon Permanent UNE Phase**

DECISION MODIFYING DECISION (D.) 06-03-025 AND DENYING REHEARING, AS MODIFIED

I. SUMMARY

In Decision (D.) 06-03-025 (or "Decision"), the Commission established permanent unbundled network element ("UNE") rates and price floors for Verizon. In today's decision we deny the application for rehearing of D.06-03-025, filed by Verizon California, Inc. ("Verizon"). Although we deny rehearing, we do modify D.06-03-025 to clarify the capital structure we adopted in the Decision, and to correct a clerical error, as discussed below. Accordingly, rehearing of D.06-03-025, as modified, is denied.

II. FACTS/BACKGROUND

On March 20, 2006, the Commission issued D.06-03-025, which established permanent unbundled network element ("UNE") rates for Verizon California, Inc.

("Verizon") and price floors for Verizon.[1] The rates adopted in the Decision replace interim rates adopted in D.03-03-033, and revised in D.05-01-057.

In the Decision, we established final UNE rates for Verizon, one of California's two largest incumbent local phone companies.[2] The Decision set prices that Verizon charges competitors who lease specified portions of their network. The rates in D.06-03-025 replace Verizon's interim rates for loops and switching established earlier in D.03-03-033, and later modified in D.05-01-057.[3] Those interim rates were subject to true-up[4] once the permanent rates have been established. The Decision also replaced the rates for other UNEs originally adopted when the Commission approved an interconnection agreement between AT&T Communications of California, Inc. ("AT&T") and GTE California in D.97-01-022.[5] (D.06-03-025, p. 3.)

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[1] FCC rules require state public utilities commissions to establish rates based on a cost methodology called Total Element Long Run Incremental Cost ("TELRIC"). (See *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order ("*Local Competition Order*") (FCC rel. Aug. 8, 1996) 11 F.C.C.R. 15,499 pp. 674-90.) Under TELRIC, UNE rates are not set based on an incumbent local exchange carrier's ("ILEC's") actual costs in building and maintaining its network. Rather, UNE rates are calculated according to what it would cost today to build and operate an efficient network that can provide the same services as the ILEC's existing network. This way, competitive local exchange carriers ("CLECs") can determine whether to invest in their own facilities or lease the ILEC's facilities. The TELRIC cost of an element "should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's [("local exchange carrier's")] wire centers." 47 C.F.R. section 51.505(b)(1). TELRIC rates must also be based on the forward looking cost of capital and on economic depreciation rates. (47 C.F.R. section 51.505(b)(2)-(3).)

[2] The "Verizon UNE Phase" of Open Access Network Architecture Development ("OANAD").

[3] In D.05-01-057, the CPUC revised the interim rates for certain elements based on new information available. D.05-01-057 retained the true-up provision in D.03-03-033. (See *Opinion Modifying Decision 03-03-033 to Adjust Interim Unbundled Network Elements Rates* [D.05-01-057] (2005) ___ Cal.P.U.C.3d ___; *Interim Opinion Establishing Interim Rates for Network Elements of Verizon California, Modifying Interim Price Floor Formula Adopted in Decision 99-12-018, and Adopting Nonrecurring Prices* [D.03-03-033] (2003) ___ Cal.P.U.C. ___.)

[4] A "true-up" is a determination by the Commission which adjusts the interim rates, either up or down, as of the earlier effective date of the interim rate order, so that the adjusted interim rates equal the permanent rates as set later in the permanent rate proceeding.

[5] *Re AT&T Communications of California, Inc.* [D.97-01-022] (1997) 70 Cal.P.U.C.2d 609.)

In adopting the permanent UNE rates, the Commission evaluated two cost models. The first model was proposed by Verizon (known as "VzCost"). The second model was jointly proposed by AT&T and MCI (formerly known as WorldCom) (collectively, "Joint Commenter's" or "JC") that included UNE rates based on the latest version of the HAI Model, known as "HM 5.3." The two proposals differed greatly from each other.

After careful review of the competing cost models, we found that although both models contain flaws, the Verizon model is not forward-looking because it attempts to replicate Verizon's embedded network configuration and fails to efficiently size and deploy current technology. With regard to the HM 5.3 model, we found that the method it uses to model Verizon's network is reasonable.[6]

The Commission ultimately used the HM 5.3 model to set Verizon's UNE rates. We chose the model it believed most accurately reflects an efficient, forward-looking network. We also found that most of the inputs and assumptions in HM 5.3 can be modified. Thus, the Decision modified many inputs and assumptions in HM 5.3 and then used the modified model run to set Verizon's UNE rates.[7]

On April 19, 2006, Verizon filed a timely application for rehearing of D.06-03-025. In its rehearing application, Verizon raises the following challenges: (1) the Decision's use of book value to determine Verizon's cost of capital is contrary to TELRIC standards and unsupported by the record; (2) the adopted DS-1 and DS-3 rates do not reflect Verizon's costs and are significantly lower than the rates adopted for SBC California; (3) the Commission's requirement that Verizon true-up the interim rates adopted in D.03-03-033 to the permanent rates adopted in the Decision constitutes retroactive ratemaking and is prohibited under both the Telecommunications Act of 1996 and Public Utilities Code section 728.

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[6] D.06-03-025, p. 4.

[7] See D.06-03-025, p. 4.

On May 4, 2006, a response to the rehearing application was filed by Cbeyond Communications, LLC, Covad Communications Company, the Division of Ratepayer Advocates, DMR Communications, Inc., MPower Communications Corp., Navigator Telecommunications, LLC, and XO Communications Services, Inc. (collectively, "Joint Respondents").

We have reviewed each and every allegation raised in the rehearing application. We are of the opinion that no legal error has been established, and thus, Verizon's application for rehearing of D.06-03-025 shall be denied. However, we will modify the Decision to expand on the evidence supporting the capital structure we adopted, and to correct a clerical error, as set forth below. Accordingly, rehearing of D.06-03-025, as modified, is denied.

III. DISCUSSION

In general, Verizon merely reargues evidence that was considered and rejected by the Commission. Although the rehearing application demonstrates there may be differences of opinion regarding the conclusions drawn from the evidence, they do not demonstrate legal error in the Commission's findings, nor do they demonstrate that the resulting UNE rates fall outside acceptable total element long run incremental cost ("TELRIC") guidelines established by the Federal Communications Commission ("FCC"). Each issue raised in the application for rehearing is discussed below.

With regard to Verizon's contention that the Commission engaged in retroactive ratemaking due to the true-up of the interim rates to the permanent rates established in D.06-03-025, this issue was rendered moot. On June 13, 2006, the U.S. District Court in *Verizon v. Peevey*, (N.D. Cal. 2006) Case No. C03-2838 the ("*June 13, 2006 Order*"), rejected Verizon's assertion that the entire 2003 rate order, D.03-03-033, as opposed to only the challenged interim rates, must be vacated. Therefore, the true-up provision in D.03-03-033 was still valid and gave notice that the interim UNE rates established in D.03-03-033 were under review and subject to true-up payments when the CPUC adopted permanent rates. Subsequently, on April 11, 2008, the Commission adopted Decision (D.) 08-04-040 which resolved outstanding issues in this proceeding relating to the adjustment or "true-up" of interim unbundled network element rates to permanent rate levels since permanent rates have been adopted for Verizon in D.06-03-025. A fuller discussion is set forth below.[8]

A. The arguments regarding cost of capital have no merit.

In its rehearing application, Verizon argues the Decision's use of book value to determine Verizon's cost of capital is contrary to TELRIC standards and unsupported by the record. Specifically, Verizon argues the capital structure, a component of the cost of capital, improperly uses historical costs and is unsupported by the record. Verizon claims a capital structure that reflects an average of market and book values is inappropriate in setting TELRIC rates, as book values reflect historical costs.[9] Verizon states the Decision errs in finding that a market value capital is subject to too much volatility due to fluctuating stock prices. Verizon asks the Commission to adopt the market-based capital structure of 75% equity and 25% debt proposed by Verizon. Verizon also contends the Commission erred in declining to adopt Verizon's proposed risk premium of 2.74%.[10]

Verizon makes policy arguments and raises no legal argument warranting the granting of the rehearing. The Commission considered the record evidence presented in the parties' proposal and reached a reasonable conclusion.

The cost of capital is a critical input to a TELRIC cost model. The cost of capital is the cost a firm will incur in raising funds in a competitive capital market. The cost of capital is usually expressed as a weighted average of the cost of equity and the cost of debt for the firm, or a proxy group of firms, with a similar risk profile and in the same line of business as the firm. There are several key components used to calculate the

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[8] Accordingly, the *June 13, 2006 Order* renders Verizon's retroactive ratemaking and true-up arguments moot, and thus, there is no need for an analysis of these issues.

[9] Rehrg. App. at p. 2.

[10] Rehrg. App. at pp. 5-7.

weighted average cost of capital: cost of equity, cost of debt, capital structure of the firm, and proxy group.

The capital structure is how a firm finances its overall operations and growth by using different sources of funds. The capital structure of a firm refers to the ratio of debt and equity outstanding for the company, or proxy group.

In the Decision, the Commission used a similar approach in setting a capital structure for Verizon as it did for SBC in D.04-09-063.[11] In the Decision, the Commission adopted JC's approach of setting a target capital structure based on the average of market value[12] and book value[13] information for the proxy group of three ILECs.[14] The Commission adopted JC's proposed capital structure for Verizon of 66.44% equity and 33.56% debt, excluding short-term debt.[15] The Commission stated it has previously found that a forward-looking capital structure for a firm is based on a firm's target capital structure, and the best predictor of target capital structure for a firm uses both market and book value information, just as investors might do in valuing a company's assets.[16] The Commission used book value data as one input in projecting a forward-looking capital structure. As the Commission did in the SBC Decision, it rejected a capital structure based entirely on market value as too volatile and subject to fluctuations in stock prices.[17] Moreover, the Commission found the target capital

[11] *Opinion Establishing Revised Unbundled Network Element Rates for Pacific Bell Telephone Company d/b/a SBC California* ("*SBC Decision*") [D.04-09-063] (2004) __ Cal.P.U.C. __

[12] Market value is the current quoted price at which investors can buy or sell a share of common stock or a bond at a given time.

[13] Book values reflect values on a company's accounting books for past time periods.

[14] D.06-03-025, p. 77, citing to Decl. of JC/Murray 11/3/03, pp. 69-70; Decl. of JC/Murray, 11/9/04, p. 3.

[15] In the *SBC Decision* [D.04-09-063], we adopted 57% equity and 43% debt for SBC, which is more debt and less equity than we established in the Decision for Verizon. (*SBC Decision* [D.04-09-063], *supra*, p. 88 (slip op.).)

[16] *SBC Decision* [D.04-09-063], *supra*, [at p. 169 (slip op.); see also, D.06-03-025, p. 77.

[17] D.06-03-025, p. 77.

structures of other telecommunications companies compare reasonably to the proposed capital structures developed from book and market value information for Murray's proxy group.[18]

Verizon believes the Decision errs in providing that a company's "target capital structure" best reflects its forward-looking capital structure because the "target capital structure" reflects the fact that market equity tends to move toward book equity in the long run. Based on the record evidence, the Commission disagreed. In the Decision, the Commission stated:

> "JC's Murray cites several financial economists' views that ideally, a firm's target or optimal capital structure should be used in weighting the cost of equity and cost of debt. (Id., 11/3/03, p. 66; 8/6/04, p. 62.) Murray says respected researchers, such as Prof. R. Glenn Hubbard and Dr. William H. Lehr, have found evidence that, in the long run, market equity tends to move toward book equity. (*Id.* 8/6/04, pp. 62-63.) On the other hand, high market-to-book ratios predict future book profitability. Thus, on balance, this suggests the best prediction of a firm's target capital structure incorporates both book and market information. Murray, therefore, gives equal weight to the market and book capitalization of the companies in her proxy group. She recommends a capital structure of 66.44% equity, 28.63% long-term debt and 4.93% short-term debt. (Id., p. 43.) Murray provides information that this capital structure is highly consistent with the publicly stated target capital structures of other major ILECs, corroborating the reasonableness of her approach. (Id., 11/3/03, p. 69 and 8/6/04, p. 63.)[19]

[18] D.06-03-025, p. 77.

[19] D.06-03-025, p. 76.

The testimony of JC/Murray further supports the Commission's determination on this issue.[20] In her testimony, Witness Murray provides the following quotation from Professor. R. Glenn Hubbard and Dr. William H. Lehr:

> "Rather, the relevant market weighting is the target weighting of debt and equity that an informed management team would employ over the long run. This target weighting almost certainly has much less equity, and much more debt, than the current market weightings."[21]

We will modify the Decision to include reference to this additional evidence. Further, we note the need to correct a clerical error involving a citation. The statement: She recommends a capital structure of 66.44% equity, 28.63% long-term debt and 4.93% short-term debt" is found in Witness Murray's Declaration, 11/9/04, on page 3 rather than in Witness Murray's Declaration, 8/6/04, page 43.

Verizon also states the Decision erred by declining to adopt Verizon's proposed risk premium adder of 2.74% to its cost of capital to compensate for risks inherent in the pure UNE environment required by TELRIC. Verizon states that without the risk premium, it would be unable to recover its operating expenses and investment, including cost of capital, over the life of its network. Verizon contends the Commission wrongly concludes that Verizon's UNE and retail operations face the same level of risk. Verizon also alleges the Commission wrongly finds that models such as the Capital Asset Pricing Model ("CAPM") adequately capture the risks that Verizon faces in providing UNEs.

The Commission disagreed. Verizon raised arguments which we addressed in the Decision and rejected. In the Decision, we agreed with JC's Murray that Verizon

[20] JC/Murray Decl., 8/6/04, para. 129, quoting R. Glenn Hubbard and William H. Lehr, "TELRIC and the Cost of Capital," at 4.13.

[21] This essay was included in a set of essays entitled *Pricing Based on Economic Cost: The Role and Mechanics of TELRIC*, submitted by AT&T as an *ex parte* presentation to the FCC in the *TELRIC NPRM* docket, on December 6, 2003.

has not justified a premium over the market based cost of capital calculated using CAPM[22] and a weighting of the portion of debt and equity in the company's capital structure. The Commission maintained the view that quantitative models, such as CAPM, do a reasonable job of capturing investors' views of the risks facing Verizon in the UNE market.[23] Further, the Commission was persuaded by the testimony of Murray which indicated any risk from UNEs is no greater than the risk Verizon faces in its retail operations, particularly since Verizon does not have to incur "sunk investments" specifically for UNE purposes.[24] Verizon's network assets have many revenue-generating uses other than the provision of UNEs. We further noted and as the Division of Ratepayer Advocates ("DRA") and XO pointed out, the Commission has already rejected previous risk adder proposals, such as Pacific Bell's proposal in D.99-11-050.[25] Therefore, the Commission rejected Verizon's proposal for a risk adder of 2.74% to its cost of capital.

B. Verizon's arguments related to high-capacity loop and transport inputs have no merit.

Verizon contends the adopted DS-1 and DS-3 rates do not reflect Verizon's costs and are significantly lower than the rates adopted for SBC California. Verizon argues the Commission changed inputs in HM 5.3 to produce understated DS-3 loop[26] rates and DS-1 and DS-3 transport[27] rates. Verizon states the Commission selectively

[22] The CAPM formula is: Cost of equity = Risk free rate + (Market risk premium) x (Beta).

[23] D.06-03-025, p. 79.

[24] See JC/Murray Decl, 8/6/04, pp. 66-69.

[25] See D.06-03-025, p. 79; see also, D.99-11-050, *mimeo.* at 37-43.

[26] A high capacity loop is a transmission path from the central office to the interface at the customer premises and vice versa which supports transmission of high capacity digital signals. A DS-3 loop is a high-speed circuit for Internet access or voice and video. It is the equivalent of 28 T1s, each of which may be used to connect to diverse locations, or the circuit can carry up to 45 Mbps of data between two locations.

[27] DS1 and DS3 transport circuits are transport facilities dedicated to a particular carrier for

(*footnote continued on next page*)

incorporated five user-adjustable inputs and a hard-coded input and algorithm change contained in JC's rebuttal version of HM 5.3 (HM 5.3 Rev), to arrive at its DS-3 loop and DS-1 and DS-3 transport rates.[28] These inputs were for certain electronic components used to determine the cost of DS-3 loops and for certain electronic components used to determine the fixed and mileage rates for DS-1 and DS-3 dedicated transport. Verizon alleges HM 5.3 Rev was a model filed for the first time on rebuttal and Verizon was denied the opportunity to evaluate and comment on the propriety of these inputs through discovery, testimony and hearings. Verizon also contends the DS-1 and DS-3 transport and DS-3 loop inputs include inadequate installation and engineering labor costs.[29]

This due process argument has no merit. The Commission addressed many of these same arguments in the Decision. The Commission may exercise discretion in choosing modeling inputs as long as they are reasonable and supported by the record. There is ample language in the Decision to support the challenged conclusions. Based on the evidentiary record, each of these input changes is appropriate and well-founded.

In the Decision, the Commission adopted the HM 5.3 model for Verizon's permanent UNE rates, a model proposed by JC.[30] We concluded that although this model had some flaws, the alternative model had more significant flaws that were also difficult to operate and modify.[31] The Commission chose to use HM 5.3 for interoffice transport and high capacity loops because we found it appropriate to use one model throughout for

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(footnote continued from previous page)

transmission between ILEC wire centers. A DS1 can carry 24 calls simultaneously, while a DS3 has 28 times that capacity.

[28] Rehrg. App., pp. 10-11.

[29] Rehrg. App., pp. 11-12.

[30] See generally, JC/Mercer Declaration (Decl.), 11/3/03.

[31] D.06-03-025, pp. 57-58.

consistency in inputs and assumptions. The Decision also found that most of the inputs and assumptions in HM 5.3 could be modified.

In this instance, the Commission found that HM 5.3 produced some results that we considered unreasonable, and therefore we considered modifying inputs in HM 5.3 related to high capacity loops and transport.[32] The Commission only considered changing two input categories MCI described which related to revised equipment costs. The two input categories are (1) revised prices for SONET multiplexer (interoffice transmission equipment) and Digital Cross-Connect (DCS) equipment based on current Verizon supply contracts, and (2) a revised input fraction for interoffice circuits requiring inter-ring connections based on Verizon's data for interoffice equipment costs.[33]

The Decision found JC's rebuttal version of HM 5.3 (HM 5.3 Rev) contained updated inputs in these areas, and in fact were Verizon's own actual contract prices for this equipment and which appeared in Verizon's own cost study filed in direct.[34] The initial HM 5.3 did not contain the latest updated inputs because Verizon had not supplied to JC the underlying contract support. Therefore, these updated inputs were not available to JC to be used in HM 5.3. After the initial November 2003 cost filings in this proceeding, Verizon provided JC its underlying contract support which allowed JC to obtain Verizon's actual contract price data for Digital Cross-Connect (DCS) equipment. In order to properly calculate DS-1 and DS-3 transport rates, and DS-3 loop rates, the Commission extracted the updated inputs from HM 5.3 Rev and inserted them into HM 5.3. The Commission did not use the HM 5.3 Rebuttal model itself.

In addition, the Decision also used Verizon's own cost study data that JC used in HM 5.3 Rev to refine the HM 5.3 input for the fraction of interoffice circuits that

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[32] D.06-03-025, pp. 108-110.

[33] D.06-03-025, pp. 109-110.

[34] D.06-03-025, pps.108-110; see also, MCI motion, 5/5/05 p. 7-8, and HM 5.3 Rebuttal version, 11/9/04, Switching IO Module, Tandem and STP investment worksheet, cell P30.

require inter-ring connections.[35] We were able to use Verizon's data concerning its existing network to calculate a more realistic value for the fraction of interoffice circuits that require inter-ring connections. This input change was also reasonable, and supported by the record.

As the Commission noted in the Decision, we merely substituted updated equipment cost inputs, provided by Verizon, into the initial HM 5.3 model. The input changes were based on updated equipment price information provided by Verizon to JC, and which JC did not receive in time to use in its initial cost filings and were not put in HM 5.3. Thus, the Commission found the revised inputs to be the newest cost information for Verizon based on actual Verizon data.

While the Decision acknowledged that HM 5.3 Rev did not provide a more detailed description of these input changes in rebuttal testimony, the input changes are entirely reasonable.[36] Verizon was not denied the opportunity to evaluate and comment on its own electronic inputs that were in the record and supported by its own witnesses.

In the Decision, the Commission observed:

> "We disagree with Verizon's claim of a due process violation. The inputs at issue were provided in rebuttal based on Verizon's own cost data and in response to Verizon's criticism of HM 5.3. While description of these inputs changes were not provided, cites were provided indicating Verizon as the information source. Again, we emphasize that we are not relying on any new modeling algorithms or formulas in accepting these inputs. We merely substitute these cost inputs for those in the initial HM 5.3 filing because they represent the newest cost information for Verizon based on actual Verizon data. Verizon does not dispute that this is its actual cost information, although it claims installation

[35] Interoffice ring architecture in HM 5.3 is a dedicated ring-like network architecture designed to inter-connect central offices for the purpose of creating redundancy in the network which in turn creates reliability and efficiency in the transport of data.

[36] D.06-03-025, pp. 109-110.

> costs were removed. After review, we find that installation costs are included in these inputs and we can use them.
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> While Verizon has not been granted [evidentiary] hearings or additional discovery to further litigate these inputs, it has been given the opportunity to comment on their use. Indeed, Verizon defends our use of changes it presented on rebuttal to labor rates. (Verizon, 12/21/05, p.5.) We see little difference between the updated labor inputs and updated DS-3 cost inputs, both provided on rebuttal, and continue to believe that use of either is appropriate in this proceeding. Moreover, the Commission frequently exercises discretion in choosing modeling inputs as long as they are reasonable and supported by the record. [footnote omitted] Verizon should not be surprised the Commission is now choosing from competing modeling inputs since the Commission's modeling criteria specifically required that "cost studies must allow parties to modify inputs and assumptions. (ALJ's Ruling Revising Schedule, 7/23/02, p.4.)"[37]

The Commission also relies on an exhibit in which Joint Commenters show that the DS-3 inputs ultimately used in the Decision equal the total of Verizon's contract material costs plus costs for engineering, splicing, placing and testing the equipment.[38] Consequently, based on the record, the Commission found that adequate installation costs are included in the inputs.

Verizon alleges there are discrepancies between SBC's rates and Verizon's rates.[39] We believe there is no legal error. As we mention above, the Commission used Verizon's own updated cost data to come up with Verizon's rates. Also, as the Joint Respondents point out, Verizon fails to observe that the transport elements are labeled

[37] D.06-03-025, pp. 111-112.

[38] See XO and CBeyond's Reply Comments, 12/21/05, p.8, citing Exhibit JCD-REB-14; "Input Tables for HIP" tab, cells D455:F466, Testimony of JC/Donovan, 11/9/04.

[39] SBC is now AT&T.

differently and are stated on a different basis in the Decision and the *SBC Decision*.[40] In the *SBC Decision* [D.04-09-063], *supra*, at Appendix A (slip op.), the transport termination rate adopted for SBC is stated on a "fixed" basis per dedicated transport facility, i.e., it applies once per facility. In contrast, the rate element the Commission adopted for Verizon in the Decision is stated on a "fixed per termination" basis, i.e., once at each circuit termination or twice per facility. Because the transport termination rate element as defined in the Verizon docket is applied twice in pricing the UNE, it needed to be divided by two relative to the calculation in the SBC docket, where the transport termination element is defined so that it applies once.[41] In addition, the record establishes that the material prices for transport equipment have been decreasing, and the capacity of the technology has been advancing.[42] Therefore, UNE prices should be lower to reflect those trends, given that the Verizon UNE prices are based on more current input data.

C. Verizon's retroactive ratemaking arguments have been rendered moot.

Verizon alleges the Commission's requirement that Verizon true-up the interim rates adopted in D.03-03-033 to the permanent rates adopted in the Decision constitutes retroactive ratemaking and is prohibited under both the Telecommunications Act of 1996 and Public Utilities Code section 728. Specifically, Verizon claims: (1) a true-up of the 1997 rates constitutes retroactive ratemaking and is unlawful; (2) the 1997 decision lacked any true-up provision; (3) the CPUC meets none of the exceptions to the bar on retroactive rulemaking; and (4) the CPUC lacks statutory authority to impose

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[40] Joint Respondents Response, p. 16-19.

[41] Id.

[42] See Joint Respondents Response, p. 18-19; JC/Mercer-Turner, 8/6/04, amended 10/12/04, pp. 37-44.

retroactive rate increases.[43] Verizon asks the Commission to remove the portions of the Decision ordering a true-up of the rates charged from March 2003 to the present.[44]

Verizon's claim that the Decision improperly imposes a true-up of the interim rates to the permanent rates established in the Decision is moot. By truing up the interim rates to the permanent rates, the Commission has not engaged in retroactive ratemaking.[45] D.03-03-033, which established interim UNE rates for Verizon, subsequently modified by D.05-01-057, contained true-up provisions which expressly put Verizon and all other interested parties on notice that the interim UNE rates were under review and subject to true-up payments when the CPUC adopted permanent rates.

On December 5, 2005, the United States District Court in San Francisco found the interim rates in D.03-03-033 did not comply with federal law (*Verizon v. Peevey et al.*, No. C03-2838 TEH (N.D. Calif., rel. Dec. 5, 2005) ("*December 5, 2005 Order*").[46] As a remedy, the Court vacated the interim UNE rates established in Decision 03-03-033 and modified in Decision 05-01-057, and the UNE rates previously adopted in D.97-01-022 ("1997 rates") were reinstated, subject to adjustments (or "true-ups") once permanent rates were established.[47]

On February 21, 2006, Verizon filed a Motion for Reconsideration of the *December 5, 2005 Order* that the 1997 rates be subject to true-up. Verizon argued the Court's decision to vacate the interim rates established in D.03-03-033 means the Commission now lacked any authority to rely on the true-up provision in D.03-03-033.

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[43] Rehrg. App. at pp. 14-19.

[44] Rehrg. App. at p. 19.

[45] The rule against retroactive ratemaking requires the Commission to adopt general rates that apply prospectively. (See Pub. Util. Code, §728; see also, *Southern Cal. Edison Co. v. Public Utilities Com.* (1978) 20 Cal.3d 813, 816; *Pacific Tel. & Tel. co. v. Public Util. Com.* (1965) 62 Cal.2d 634, 650-651.)

[46] The Court found that the interim rates for UNEs set by the Commission in D.03-03-033 failed to comply with the Telecommunications Act of 1996 because they were not based on the required TELRIC methodology.

[47] *December 5, 2005 Order* at p. 16.

On March 20, 2006, the Commission issued D.06-03-025, which established permanent UNE rates for Verizon. In the Decision, the Commission stated:

> "As set forth in D.03-03-033, Verizon must adjust, or "true-up" the interim rates it has charged since March 2003 for loops and switching to the new rates adopted in this order. In other words, Verizon must calculate whether its interim rates are higher or lower than today's newly adopted rates, and whether it has over or under-collected the appropriate revenues for any UNEs it sold at interim rates. . . .
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> On December 5, 2005, the U.S. District Court vacated interim rates established by D.03-03-033 and reinstated UNE rates originally adopted for Verizon in D.97-01-022. . . Thus, any billing adjustments must also consider the effect of this court action on UNE rates."[48]

On April 19, 2006, Verizon filed the instant application for rehearing. In its rehearing application, Verizon appears to rely on the District Court invalidating the true-up provision in D.03-03-033, which the Court did not. On June 13, 2006, the U.S. District Court denied Verizon's Motion for Reconsideration of the *December 5, 2005 Order*. (*Verizon v. Peevey et al.,* No. C03-2838 TEH (N.D. Calif., rel. June 13, 2006.) ("*June 13, 2006 Order*"). The Court rejected Verizon's assertion that the entire 2003 rate order (D.03-03-033), as opposed to only the challenged interim rates, must be vacated.

The Court concluded "there is no substantial doubt in the Court's mind that the [Commission] would have adopted a true-up provision even if it had known that the interim rates it attempted to set would be declared invalid. Moreover, even if such doubt were present, Verizon has not persuaded the Court that it must bar the [Commission] from considering a true-up on remand because it is not clear that the rule against retroactive ratemaking applies in this instance."[49] Consequently, the federal district court upheld the true-up provision in D.03-03-033.

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[48] D.06-03-025, pp. 134-135.

[49] The court in clarifying its original intent stated that the disputed sentence in the *December 5, 2005 Order* shall be modified to read that the 1997 rates "may," rather than "shall," be subject to

(*footnote continued on next page*)

D.03-03-033 expressly put Verizon and all other interested parties on notice that the existing UNE rates were under review and subject to true-up payments when the CPUC adopted permanent rates. As set forth in D.03-03-033, Verizon must adjust, or “true-up” the interim rates it has charged since March 2003 for loops and switching to the new rates adopted in the Decision.

Consequently, on April 11, 2008**,** the Commission issued D.08-04-040 which resolves outstanding issues in this proceeding relating to the “true-up” or adjustment of interim unbundled network element rates to the permanent rates adopted for Verizon in the Decision.[50] D.08-04-040 lifted the stay of billing adjustments established through Ordering Paragraph 4 of D.06-03-025 and ordered payment of billing adjustments.[51] (*Id.* at p. 17 (slip op.).)

IV. CONCLUSION

We have reviewed each and every allegation of error asserted by Verizon in its application for rehearing of D.06-03-025, and are of the opinion that legal error was not demonstrated. However, we modify D.06-03-025 to include additional evidentiary support for the capital structure adopted and we correct a clerical error involving a

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(footnote continued from previous page)

true-up.” (*June 13, 2006 Order*, *supra,* at p. 12.) The Court provided: “When the Court ordered that the reinstated 1997 rates "shall be subject to true-up once permanent UNE rates are established," the Court did not intend to require that such rates must actually be trued-up. Instead, as the [Commission] properly interpreted, this language was intended only to indicate that the [Commission] may, at its discretion, consider whether the reinstated 1997 should be subject to true-up.” (*Id.* at p.12.)

[50] *Decision Adopting Billing Adjustment Process* [D.08-04-040] (2008) ___ Cal.P.U.C.3d ___.

[51] Pursuant to Ordering Paragraph 4 of D.06-03-025, Verizon was ordered to calculate any billing adjustments owed to or by interconnecting carriers based on the modification of interim rates to the rates in D.06-03-025. However, the payment of any billing adjustments or “true-up” was stayed pending the outcome of further proceedings in this docket to consider payment options or other mitigations to lessen any negative effects of the true-up.

citation. Therefore, for the reasons stated herein, we deny the rehearing of D.06-03-025, as modified.

THEREFORE, IT IS ORDERED that:

1. D.06-03-025 is modified as follows:

a. Paragraph 1 on Page 11 is modified to read as follows:

> "JC's Murray cites several financial economists' views that ideally, a firm's target or optimal capital structure should be used in weighting the cost of equity and cost of debt. (*Id.*, 11/3/03, p. 66; 8/6/04, p. 62.) Murray says respected researchers, such as Prof. R. Glenn Hubbard and Dr. William H. Lehr, have found evidence that, in the long run, market equity tends to move toward book equity. (*Id.* 8/6/04, pp. 62-63.) On the other hand, high market-to-book ratios predict future book profitability. Thus, on balance, this suggests the best prediction of a firm's target capital structure incorporates both book and market information. Murray says Hubbard and Lehr further provide the relevant market weighting is the target weighting of debt and equity that an informed management team would employ over the long run. This target weighting almost certainly has much less equity, and much more debt, than the current market weightings. (*Id.* 8/6/04, pp. 62-63.) Murray, therefore, gives equal weight to the market and book capitalization of the companies in her proxy group. She recommends a capital structure of 66.44% equity, 28.63% long-term debt and 4.93% short-term debt. **(**Id., 11/9/04, p. 3.) Murray provides information that this capital structure is highly consistent with the publicly stated target capital structures of other major ILECs, corroborating the reasonableness of her approach. (*Id.*, 11/3/03, p. 69 and 8/6/04, p. 63.) (D.06-03-025, p. 76).

2. The rehearing of D.06-03-025, as modified, is hereby denied.

This order is effective today.

Dated January 29, 2009, at San Francisco, California.

MICHAEL R. PEEVEY
President
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
TIMOTHY ALAN SIMON
Commissioners