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January 24, 2003

Secretary
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P. O. Box 360
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FILED³

JAN 24 2003

Re: Case No. TR-2001-65

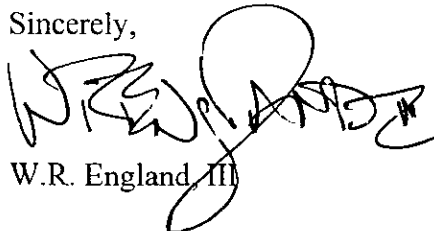
Missouri Public
Service Commission

Dear Mr. Roberts:

Enclosed for filing please find an original and eight (8) copies of the Reply Brief of the Small Telephone Company Group and Holway et al.

Please see that this filing is brought to the attention of the appropriate Commission personnel. A copy of the attached will be provided to parties of record. I thank you in advance for your cooperation in this matter.

Sincerely,



W.R. England, III

WRE/da

cc: Parties of Record

JAN 24 2003

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURIMissouri Public
Service Commission

In the Matter of an Investigation of the Actual)
 Costs Incurred in Providing Exchange Access)
 Service and the Access Rates to be Charged by) Case No. TR-2001-65
 Competitive Local Exchange Telecommunications)
 Companies in the State of Missouri.)

**REPLY BRIEF OF
THE SMALL TELEPHONE COMPANY GROUP AND HOLWAY ET AL.**

Introduction

The Small Telephone Company Group (STCG) and Holway Telephone Company et al. (Holway et al.) believe that their Initial Brief adequately addressed all of the issues in this case. Nevertheless, there are a few statements or assertions in the briefs of the other parties to which the STCG and Holway et al. believe a response is warranted. Accordingly, this response will be limited to the appropriate cost methodology (Issue #1) and what further action is necessary or appropriate (Issue #7). The STCG and Holway et al.'s limited response should not be considered acquiescence in or agreement with other contrary positions contained in other Parties' Initial Briefs. Rather, the STCG and Holway et al. believe that their Initial Brief anticipated and responded to those positions.

Issues

1. What is the appropriate cost methodology (i.e., TSLRIC, LRIC, embedded, stand alone, etc.) to be used in determining the cost of switched access?

As previously indicated, the Parties tend to fall into two camps regarding the appropriate cost methodology. There are those Parties who advocate use of a forward-looking economic cost (FLEC) model for determining the long run incremental cost of providing access (e.g.,

Southwestern Bell Telephone Company (SWBT), Sprint Missouri Inc. (Sprint), AT&T Communications of the Southwest (AT&T), and MCI WorldCom Communications Inc. (MCI), and then there are those Parties who believe that embedded costs most accurately and reliably quantify the actual cost of providing access (e.g., the STCG and Holway et al., the Missouri Independent Telephone Company Group (MITG), and ALLTEL Missouri, Inc. (ALLTEL)).¹

Despite their efforts to convince this Commission of the virtue of FLEC, the advocates of FLEC can not overcome the following undisputed facts:

- FLEC models are neither required, nor preferred, by the Telecommunications Act of 1996 for the purposes of determining the cost of switched access services.
- The Federal Communications Commission (FCC) neither requires, nor prefers, the use of FLEC models to determine the cost of access. In fact, while the FCC may have adopted the use of a FLEC model for the purpose of identifying “high costs” in administering the Federal USF, the FCC has specifically rejected the use of such models for purposes of determining the high costs of small incumbent local exchange carriers (ILECs).
(Schoonmaker Rebuttal, Ex. 39, p. 9)
- No state public utility commission has adopted the use of FLEC models for determining the cost of access. (Larsen Direct, Ex. 28, pp. 20-21)
- The Missouri Public Service Commission has not previously adopted or utilized FLEC for purposes of determining the cost of access. In fact, when presented with proposals to

¹The STCG and Holway et al. contend that the use of actual embedded, book costs allocated to the intrastate exchange access jurisdiction through the application of FCC Parts 36 and 69 rules is the most appropriate methodology for determining their member companies’ actual cost of providing switched access.

use FLEC or embedded costs for purposes of determining high costs for Missouri Universal Service Fund (USF), the Missouri Commission has determined that actual embedded costs would be used. (Order Establishing Technical meetings, p. 2, issued June 27, 2000, Case No. TO-98-329)

- None of the FLEC models identify the “actual” cost of providing access for the small ILECs. FLEC models rely on hypothetical networks and hypothetical costs of providing service. These models frequently rest on subjective judgments of the cost of various network components which are subject to a great deal of controversy and debate. (Schoonmaker Direct, Ex. 36, pp. 5-6) Unlike embedded costs (where costs are known), FLEC models rely on proxies or averages representing cost efficiency targets. (Warinner Rebuttal, Ex. 33, p. 12).
- FLEC models are subject to manipulation through the use of different “inputs.”²
- None of the FLEC models presented in the instant case are readily available or easily applied to the small ILECs. The FLEC models used to develop the traffic sensitive access costs of the large ILECs (which also underpins Staff’s model for developing small ILEC costs) are proprietary to the large ILECs and not readily available to other parties. (Tr. 196-200, 632, 706-707)

It is abundantly clear from the record in this case that FLEC models are simply “not ready for prime time” as far as small ILECs are concerned. The Commission should reject, out-of-hand, the notion that FLEC models can reliably and accurately predict the actual costs of

²The choice of input values can have a significant effect on the cost estimate that is produced by Staff’s model. (Tr. 124)

providing access for small ILECs in Missouri.

Staff's attempt to model the FLEC of the small ILECs has failed to hit the mark in this proceeding. Besides suffering from the same generic shortcomings as all FLEC models, Staff's model is further flawed because:

1. Staff's model produces "double imaginary" results. Staff's attempt to model the FLEC for small ILECs is largely premised on the proprietary FLEC models for the three large ILECs (SWBT, Sprint, and Verizon). The results of Staff's FLEC model are vigorously contested by SWBT and Sprint, with Sprint contending that Staff has substantially understated Sprint's access costs by approximately two-thirds. (Sprint Brief, p. 27) Next, Staff has taken its erroneous results for the large ILECs and applied a regression analysis of questionable validity to arrive at a purported FLEC for the small ILECs. Hence the term "double imaginary" – first in the erroneous determination of large ILEC costs and then in the application of a statistically invalid regression analysis. (Larsen Surrebuttal, Ex. 30, p. 9)
2. Staff's regression analysis does not produce results that are statistically valid. Staff's own regression analysis contains two (out of three) "R-squared" values that are 53% and 66%. These R-squared values mean that Staff's own model is only 53% and 66% "confident" that its model costs are reliable. (Larsen Direct, Ex. 28, pp. 24-25)
3. Staff's model produces counter-intuitive results. Staff's model produced a "pure" TSLRIC cost of access for Sprint that is 25% higher than Staff's

average TSLRIC cost for the small ILECs. This just doesn't make sense, given the fact that the costs in small, rural areas served by the small ILECs are higher than the costs in the more urban exchanges served by Sprint.

As Sprint witness Farrar explained:

“Any cost study that has Sprint, a larger company, having higher costs than these rural telephone companies, that's just wrong and it's – to me it's indicative of a – some sort of serious methodology flaw in the cost study. (Tr. 702-703) (emphasis added)

In light of the overwhelming shortcomings of FLEC models generally, and Staff's model specifically, the only appropriate manner in which to accurately determine the small ILECs' actual cost of providing switched access is to use embedded costs.

2. What, if any, course of action can or should the Commission take with respect to switched access as a result of this case?

Staff, at page 5 of its Initial Brief, states that “On average, the *intrastate* switched access rates charged by Missouri's LECs are 654% of the LEC's *interstate* access rates for what is essentially an identical service.” (Footnote omitted) This is not entirely correct. A review of Staff's testimony indicates that while the intrastate rates of large ILECs are, on average, 654% of their interstate rates, small LECs' intrastate rates are, on average, only 279% of their interstate access rates. (Johnson Direct, Ex. 1, Sch. 5, p. 1 of 13) Thus, to the extent Staff relies on this comparative analysis to recommend that the Commission initiate a second phase of this case to determine whether current switched access rates are just and reasonable, it would appear that the focus of that inquiry should be directed first at the large ILECs rather than the small ILECs.

Moreover, Staff's comparison of interstate and intrastate rates is misleading because not

all of a LEC's interstate costs are recovered through switched access rates. As the Commission is well aware, the FCC has mandated an end-user common line (EUCL) (or subscriber line charge (SLC)) which is currently \$6.00 per line per month for residential customers (Tr. 986). This end-user charge recovers a substantial portion of a LEC's interstate access costs. In Missouri, there is no state EUCL or SLC, so all intrastate access costs are recovered through intrastate access rates. Thus, comparing interstate and intrastate access rates is a classic "apples to oranges" comparison.

Southwestern Bell Telephone Company (SWBT) gratuitously suggests that the Commission's next "focus should be to recognize the negative impact small incumbent LECs' very high switched access rates have on customers throughout Missouri, and particularly customers located in more rural areas of Missouri." However, the evidence in this case clearly reveals that while the access rates of the small ILECs may be high, relative to SWBT's access rates, they are not high relative to small ILECs' actual, embedded costs of providing access. Moreover, the total access payments made by interexchange carriers (IXCs) to small ILECs are relatively small when compared to the access payments to large ILECs. Finally, history has shown that in those instances where small ILECs have made substantial reductions in their access rates, there has been no offsetting benefit to the end-user customers, such as increased toll competition or lower toll rates. (Tr. 1090)

First, the small ILECs' access rates are not high relative to their actual cost of providing access. The results of the small ILECs' embedded cost studies reveal that, in total, their access costs are not significantly different than their existing access revenues. For example, the actual cost of providing access, as shown by the small ILEC cost studies, is approximately 92% of their

current access revenues. (Schoonmaker Direct, Ex. 36, p. 19, Sch. RCS-6)

Second, while SWBT may criticize the small ILECs for their “very high” access rates, it must also be kept in mind that there is currently no state Universal Service Fund mechanism which would provide assistance to these small ILECs in recovering their high costs (largely due to the opposition of SWBT). Thus, the only real source of cost recovery for small ILECs is either from local or intrastate access charges. (Tr. 500-501) Access charges have necessarily been set at relatively high levels in order that local rates could remain affordable and universal service can be achieved.

Even though small ILEC rates may be high relative to SWBT’s access rates, the total access payments by IXC’s to small ILECs are relatively small when compared to access payments to large ILECs. (Tr. 1208) For example, total access payments made by AT&T to all Missouri ILECs for the most recent year were approximately **\$_____.** Of those total access payments, **\$_____** (or **__%**) were paid to large ILECs and only **\$_____** (or **__**) were paid to small ILECs. (Tr. 1206-1207, Ex. 55) MCI WorldCom Communications Inc. (MCI) recognized the relative insignificance of small ILEC access rates when it stated in its Initial Brief as follows:

“As a threshold matter, the Commission should determine whether it has jurisdiction to address access rates for price cap regulated ILECs. This is key to any meaningful switched access reform because the price cap regulated ILECs carry the majority of the switched access traffic in Missouri.” (MCI Brief, p. 10-11) (emphasis added)

In other words, any meaningful access rate reform in Missouri must start with large ILECs not the small ILECs. Unfortunately, if the Commission is precluded from adjusting the access rates of large ILECs because of price cap constraints, then no meaningful access rate reform can be

achieved simply by reducing the access rates of small ILECs.

Another way to put the small ILECs' access rates in perspective is to look at AT&T's proposal to add \$1.00 to all ILECs' local exchange rates which would result in a statewide access rate reduction of approximately \$45.5 million. However, approximately \$44 million of that statewide access rate reduction will come from large ILECs and only \$1.5 million will come from the small ILECs. (Tr. 1175 - 1176) Using this example and increasing the "shift" to local rates to \$6.00 per line, small ILECs would make a collective \$9 million reduction in access rates. (Tr. 1178) Yet when Sprint and Verizon made a collective \$9 million access rate reduction in their first year of rate rebalancing, this was not a significant enough access rate reduction for AT&T to flow it through to its statewide toll rates. (Tr. 1091 - 1092)

The instant record is not clear as to what portion of a \$9 million reduction in small ILEC access rates would flow to SWBT. What is known is that SWBT does not provide originating toll service in any of the exchanges of the small ILECs even though some small ILECs have made substantial reductions to their access rates as a result of recent earnings investigations. Therefore, any access rate reduction SWBT receives as a result of rate rebalancing by the small ILECs will only benefit SWBT end-user customers and not the end-user customers of small ILECs. (This, of course, assumes that SWBT passes through small ILEC rate reductions to its toll rates.)

There are also no assurances that future access rate reductions in small ILEC exchanges will provide the necessary incentive for SWBT to begin providing originating toll service in small ILEC exchanges. When Commissioner Lumpe pointedly asked whether SWBT and its long distance company would provide toll service statewide if access rates were lowered, SWBT

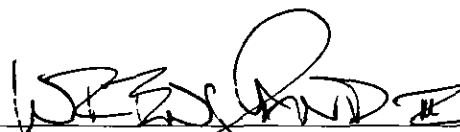
witness Unruh dodged the question by responding as follows:

“I - - I - - I don’t and can’t represent Southwestern Bell’s long-distance company, so I - - I won’t be able to speak to anything they might or might not do.” (Tr. 564)

Thus, if small ILECs reduce their access rates, there is no guarantee that SWBT will begin providing toll service in the small ILEC exchanges and there is no assurance that SWBT’s reduced access expense will be flowed through to its (or its affiliate’s) toll rates (which, by the way, would only benefit SWBT end-user customers). SWBT’s gratuitous suggestion that the Commission begin an investigation of small ILEC access rates should be seen for what it is, and that is simply a self-serving attempt to reduce expenses and increase SWBT profit margins.

WHEREFORE, in light of the foregoing, the STCG and Holway et al. respectively request the Commission to find that the most appropriate way to determine the actual cost of providing switched access service for small ILECs is through the use of actual embedded, book costs allocated to the intrastate exchange access jurisdiction through the application of FCC Parts 36 and 69 rules. Moreover, there is no evidence in the instant record that the existing access rates of the small ILECs are not lawful and reasonable and any proposed adjustment to those rates in the context of this proceeding would be unnecessary and inappropriate.

Respectfully submitted,



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Certificate of Service

I hereby certify that a true and correct copy of the above and foregoing document was mailed or hand-delivered, this 24th day of January, 2003 to:

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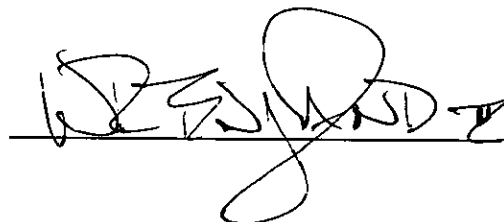
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A handwritten signature in black ink, appearing to read "CRAIG S. JOHNSON", written over a horizontal line.