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August 15, 2003

Secretary
Missouri Public Service Commission
P. O. Box 360
Jefferson City, Missouri 65102

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Missouri Public Service Commission

Re: Case No. TR-2001-65

Dear Mr. Roberts:

Enclosed for filing, please find an original and eight copies of the Small Telephone Company Group and Holway Telephone Company et al. Response to Staff.

Please note that page 3 of the Response contains "highly confidential" information. Accordingly, that page is contained in a separate envelope. I would appreciate it if you and the parties receiving copies of the Response would maintain the confidential nature of this information consistent with the terms of the Protective Order issued by the Commission in this case.

Please see that this filing is brought to the attention of the appropriate Commission personnel. Copies of the attached are being provided to parties of record. If you have any questions regarding this filing, please give me a call. I thank you in advance for your attention to and cooperation in this matter.

Sincerely,

Brian T. McCartney

Brian T. McCartney

BTM/da
Enclosure
cc: Parties of Record

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

THE SMALL TELEPHONE COMPANY GROUP AND HOLWAY TELEPHONE COMPANY ET AL. RESPONSE TO STAFF

Come now the Small Telephone Company Group (STCG)[1] and Holway Telephone Company, KLM Telephone Company, Green Hills Telephone Corporation, and Iamo Telephone Company (Holway et al.) and for their Response to Staff's Second Phase Proposal, state to the Missouri Public Service Commission (Commission) as follows:

[1] BPS Telephone Company, Cass County Telephone Company, Citizens Telephone Company of Higginsville, Missouri, Inc., Craw-Kan Telephone Cooperative, Inc., Ellington Telephone Company, Farber Telephone Company, Fidelity Telephone Company, Goodman Telephone Company, Inc., Granby Telephone Company, Grand River Mutual Telephone Corp., Kingdom Telephone Company, Lathrop Telephone Company, Le-Ru Telephone Company, McDonald County Telephone Company, Mark Twain Rural Telephone Company, Miller Telephone Company, New Florence Telephone Company, New London Telephone Company, Orchard Farm Telephone Company, Oregon Farmers Mutual Telephone Company, Ozark Telephone Company, Peace Valley Telephone Co., Inc., Rock Port Telephone Company, Seneca Telephone Company, Spectra Communications, Inc., Steelville Telephone Exchange, Inc., Stoutland Telephone Company.

SUMMARY

The STCG and Holway et al. agree with Staff that the Commission should address some threshold issues that have been raised in this case before embarking on any additional "phases" in this investigation. First, the Commission should make a determination about its jurisdiction over the access rates of Missouri's various local exchange carriers. Second, the Commission should make a decision about which cost model or models it will use in the event it decides to move forward with a second phase of its access investigation. Third, the Commission may want to consider the implications that this case will have on other proceedings such as the Missouri Universal Service Fund case and cases involving expanded local calling scopes.

DISCUSSION

A. Jurisdiction

The STCG and Holway et al. agree with Staff that the Commission should address and resolve jurisdictional issues before moving forward with another phase of this case. First and foremost, the Commission should examine the extent of its jurisdiction over the access rates of Missouri's various types of local exchange companies (LECs). If the Commission does not have jurisdiction to review and set the rates for certain Missouri LECs whose access rates make up the vast majority of the intrastate access costs, then a second phase to address the access rates of those LECs serving a small minority of Missouri customers does not make much sense.

1. **Price Cap ILECs**. As a threshold matter, the Commission has no jurisdiction to rebalance or reduce the access rates of Missouri's price cap carriers such as SWBT, Sprint, and CenturyTel. It is the access rates of these carriers that are most out of line with their interstate counterparts and that account for the overwhelming majority of access costs in Missouri. For example, according to Staff's analysis the intrastate access rates of large ILECs (i.e. SWBT, CenturyTel, Sprint and ALLTEL) are, on average, 654% of their interstate rates. Small ILEC intrastate access rates, on the other hand, are, on average, only 279% of their interstate rates. (Johnson Direct, Ex. 1, Sch. 5, p. 1).

Of even greater significance is the fact that total access payments made by AT&T to all Missouri LECs were approximately ** ** for the most recent year. Of those total access payments, ** ** **(or ** **)** were paid to the three large price cap incumbent local exchange carriers (ILECs) and only ** ** **(or ** **)** were paid to small ILECs. (Tr. 1206-7; Ex. 55; STCG/Holway Reply Brief, p. 7) If the Commission has no jurisdiction to review and revise the access rates of the large ILECs because of their price cap status, it makes little sense to embark on further proceedings in this docket when only a very small minority of total intrastate access rates can possibly be affected.

2. **Rate of Return Regulated ILECs**. Because the small companies' access rates account for only a small percentage of statewide access costs (e.g. ** ** for AT&T) any access cost reductions that result from such investigations are not likely to be significant. While the Commission has jurisdiction to increase or reduce the access rates of rate of return ILECs, the Commission may only do

so in a company-specific examination of those carriers after examining all relevant circumstances and factors. Even assuming that the Commission wants to make significant reductions in the access rates of small, rate of return regulated ILECs, the likely result will be unacceptably high increases in Missouri customers' local rates. Moreover, past access rate reductions by the small rural ILECs have not resulted in lower rates from interexchange carriers (IXCs), and none of the IXC witnesses were willing to make any specific commitments regarding future flow through of access rate reductions by small companies. (Tr. 752, 1077-78, 1090)

In fact, history demonstrates that small ILEC access rate reductions have not been flowed through to interexchange rates. For example, Missouri's small ILECs have collectively, through recent earnings investigations, reduced their access rates by $2.6 million, but AT&T could not point to any specific flow through of those access rate reductions. Instead, AT&T implemented an in-state access recovery fee which its long distance customers must pay in addition to per minute charges. (Tr. 1090) AT&T admitted during the hearing in this matter that a $9 million reduction in access charges by Verizon and Sprint was not enough to cause a change in AT&T's statewide toll rates. (Tr. 1091-92) So when AT&T proposed that a $9 million reduction in small ILEC access rates could be achieved by a $6 per month, per line increase in small ILECs' local rates, it begs the question – why rebalance local rates and access rates when the customer is not likely to see any tangible benefit in return for a substantial increase in local rates?

B. Cost Model

The STCG and Holway et al. agree with Staff that if the Commission does want to pursue a second phase in its access investigation, then an appropriate cost model must first be chosen. However, the STCG and Holway et al. believe that Staff's hypothetical forward-looking cost model is flawed and inappropriate for use in determining small company costs.[2] The small companies' actual embedded cost studies are the most accurate and reliable evidence presented in this case.

1. **Actual embedded costs**. This case was established to investigate "all of the issues affecting exchange access service, including **particularly the actual costs incurred in providing such service** . . ."[3] To this end, the STCG and Holway et al. used their actual embedded costs, rather than hypothetical models, in preparing their cost studies. This embedded cost methodology is the best approach to determine the actual costs of Missouri's small rural telephone companies to provide switched access services.

First, the use of actual costs is consistent with traditional rate of return regulation, which examines a regulated company's actual cost of operation for a historic period of time (i.e. a "test year"). Second, actual costs present the most accurate information about the level and type of service that is actually being provided to Missouri customers. Third, the FCC has specifically rejected the use of forward-looking cost models for small rural carriers. (Schoonmaker Direct, Ex.

[2] The large ILECs also dispute the accuracy and validity of Staff's hypothetical cost model.
[3] *Order Adopting Procedural Schedule, Clarifying Scope of this Proceeding, and Concerning Motion to Waive Service Requirement and Motion to Compel Discovery*, issued March 14, 2002 (emphasis added).

36, pp. 5-6) And finally, as a practical matter, because the small rate of return ILECs are the only companies with access rates that are fully subject to the Commission's jurisdiction, the STCG and Holway et al.'s company-specific cost studies are the most accurate and appropriate if the Commission decides to begin a second phase in this case.[4]

2. **Forward-looking cost studies**. A number of parties, including Staff and large price cap ILECs such as SWBT and Sprint, have presented forward-looking cost studies in this case. None of the various forward-looking cost models in the present record are appropriate to use for the small companies. First, none of the company-sponsored models (i.e. SWBT and Sprint cost models) are appropriate for "other" LECs. Indeed, Staff recognizes that "none of the models offered by other parties are capable of directly generating cost estimates for the other carriers."[5] Second, although Staff touts its model as universally applicable to all LECs, it is not. In fact, Staff's model is particularly ill-suited for small ILECs, and it fails to identify the "actual" costs that Missouri's small rural ILECs incur to provide access. Rather, Staff's consultant used a forward-looking model that relied on hypothetical networks and hypothetical costs of providing service. Staff's model is seriously flawed and suspect in the following ways:

[4] If the Commission does determine that a second phase in this case is necessary, then the small companies' embedded cost studies may need to be updated to reflect any recent changes in costs. Staff recognizes that "cost studies may need to be re-run or revised depending on the Commission's decisions." Staff's Second Phase Proposal, p. 7.

(a) **Staff's model produces "double imaginary" results**. Staff's attempt to model the costs of Missouri's small rural ILECs is premised on flawed forward-looking cost models for Missouri's three largest ILECs (SWBT, Sprint, and CenturyTel).[6] Staff then took its flawed cost study results for large ILECs and applied a questionable regression analysis to arrive at a purported forward-looking cost for small ILECs. Thus, Staff's model produces "double imaginary" results: first in the erroneous calculation of the large ILEC costs, and then second in the application of a statistically invalid regression analysis.

(b) **Staff's results are not statistically valid**. Staff's own regression analysis contains two (out of three) "R-squared" values that are 53% and 66%. This means that Staff's own model is only 53% and 66% confident that its results are reliable. These are unacceptable results for any regression analysis.

(c) **Staff's model produces counter-intuitive results**. Finally, and most significantly, Staff's model produces a TSLRIC cost of access for Sprint that is 25% higher than Staff's average TSLRIC cost for Missouri's small ILECs. This simply 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. Sprint's witness explained:

> Any cost study that has Sprint, a larger company, having higher access 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. 702-3)(emphasis added).

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[5] Staff's Second Phase Proposal, pp. 7-8.

[6] The results of Staff's model are vigorously contested by SWBT and Sprint. For example, Sprint contends that Staff substantially understated Sprint's access costs by approximately two-thirds.

In any event, if the Commission is going to embark on further phases in this investigation, it must first decide on the appropriate cost model. Given the instant record, it is clear that no forward-looking cost model has been submitted that accurately and reliably predicts the costs of Missouri's small ILECs. So if the Commission decides to use forward-looking costs for Missouri's small ILECs, the first order of business would be to reopen the record and take additional evidence as to the appropriate forward-looking cost model for small rural ILECs.

C. Other Issues

Staff proposes that the Commission should address issues related to the Missouri Universal Service Fund (MoUSF) and expanded calling scopes in this case. The STCG and Holway et al. have participated actively in the various phases of the MoUSF proceeding and in numerous cases involving expanded calling scopes in Missouri.

1. **Missouri Universal Service Fund (MoUSF)**. Staff believes that Commission guidance is necessary to address certain issues presented in the MoUSF case (TO-98-329). The STCG and Holway et al. agree that access rates were also an issue in the MoUSF proceeding. If the Commission does choose to begin a second phase in this case, then the Commission may need to examine the issues from the MoUSF in conjunction with the second phase. The Commission should also note that the MoUSF issues identified by Staff are contested among the parties, and there has been no resolution as to whether MoUSF funding can be used for access rebalancing.

2. **<u>Expanded Calling Scopes</u>**: The Commission's authority to establish expanded calling plans is limited by Missouri statutes and case law which restrict the Commission's ability to order telephone companies to expand their service areas. (*See* STCG and Holway et al.'s Initial Brief, pp. 46-50) Staff states that "the Commission has not determined whether access charge reform can be achieved through expanded calling." (Staff's Proposal, p. 8)

Access charges and expanded calling are clearly related. However, simply expanding calling scopes will not address the problem of high access charges. Rather, expanded local calling puts <u>upward</u> pressure on access rates. The Office of Public Counsel's witness testified that reducing access rates in conjunction with expanding local calling will result in two revenue losses (i.e. one loss due to reduced access rates and another loss due to elimination of access revenues on toll calls that become local calls as a result of expanded local calling). (Tr. 443)

CONCLUSION

Before embarking on an additional phase in this proceeding, the Commission should address the issue of its jurisdiction over the access rates of Missouri's LECs. Next, the Commission should consider whether an additional phase in this case is necessary if it only has jurisdiction over a small minority of Missouri's access costs.

In the event the Commission does choose to embark upon a second phase in this case, then the Commission should determine the appropriate cost model to use in that phase. If the Commission decides to use a forward-looking cost model, then the record in this phase of the proceeding will need to be reopened for further evidence on the appropriate forward-looking cost model for Missouri's small ILECs. Finally, the Commission may wish to consider the implications that this case may have on other pending proceedings involving the MoUSF and expanded calling scopes.

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ATTORNEYS FOR STCG and HOLWAY et al.

CERTIFICATE OF SERVICE

The undersigned does hereby certify that a true and accurate copy of the foregoing was mailed, via U.S. Mail, postage prepaid, this 15th day of August, 2003, to all attorneys of record in this proceeding.

Brian T. McCartney

W.R. England III / Brian T. McCartney