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MEMORANDUM TO THE COMMISSIONERS

RECEIVED
FEB 24 2006
SOUTH DAKOTA PUBLIC UTILITIES COMMISSION

TO: Commissioners Sahr, Johnson and Hanson

FROM: Keith Senger, PUC Commission staff

DATE: February 24, 2006

RE: TC05-197

NOTE: The original memo contains information that Northern Valley Communications, LLC has requested to be treated as CONFIDENTIAL information. This Memo has had all confidential information removed.

On December 1, 2005, Northern Valley Communications, LLC (NVC) filed an ARSD 20:10:27:11 petition requesting the Commission grant an exemption from filing company specific cost based switched access rates and approve NVC's intrastate switched access rates which were established in accordance with ARSD 20:10:27:12. This memo will briefly explain NVC's petition, explain staff's position and provide staff's recommendations.

NVC is a certified LEC providing competitive local exchange telecommunication services in the Aberdeen exchange (a Qwest Corporation exchange). NVC is not the incumbent LEC with carrier of last resort obligation. NVC is a for-profit Competitive LEC who has entered into the service area of Qwest, the incumbent LEC. NVC is not offering service to the entire Aberdeen exchange.

It is staff's understanding that NVC is only providing facilities based competitive services. NVC is not reselling Qwest. Thus, NVC is providing the opportunity to receive services only to those end-user customers who have NVC facilities extended to their homes or businesses. This currently only includes some locations within Aberdeen city limits, a rural housing development and some areas near Bath. NVC is not providing service to many of the ILEC's high cost rural end-user customers.

Staff believes NVC is requesting two separate actions of this Commission. First, NVC is requesting the Commission approve a request for an exemption from filing company specific cost based switched access rates in accordance with ARSD 20:10:27:11. Second, NVC is requesting approval to continue to use the intrastate access rate of $0.1325 per minute which was previously approved in docket TC04-127 in accordance with ARSD 20:10:27:12. Although these two issues may be interrelated, this memo will address each separately.

Exemption from filing company specific cost based switched access rates.

NVC filed a petition requesting an exemption from filing company specific cost based access rates in accordance with ARSD 20:10:27:11. That rule requires the requesting LEC to prove 1) that the company lacks the financial, technical, or managerial resources to conduct a study, or 2) that the additional cost of filing a study would outweigh any benefits. Since NVC shares the same managerial and technical staff as its ILEC parent company who files cost studies, staff believes NVC cannot prove it lacks the managerial or technical staff. NVC's financial statement ***[begin confidentiality]***

[end confidential]. Thus, staff believes NVC cannot show it lacks financial capability. NVC further states that the costs associated with a cost study would "result in unnecessary operating cost that would eventually be passed on to the consumers in the form of higher consumer rate." Nevertheless, NVC has chosen to increase its intrastate switched access rates it charges to the IXCs by 64% in the two years preceding this filing. Therefore, staff believes NVC may be passing unjustified operating costs onto the IXC.

NVC has provided information that shows that it is a major competitor in the Aberdeen market. NVC's facilities pass about ***[begin confidential]*** ***[end confidential]*** of the total potential access lines in the Aberdeen exchange while serving about ***[begin confidential]*** ***[end confidential]*** of those potential customers passed.

NVC does provide a persuasive argument in that it does not use the Uniform System of Accounts. The FCC has made it clear they will not subject CLECs to the same regulatory requirement as the ILECs and thus does not require CLECs to use the Uniform System of Account. NVC instead used GAAP accounting. Since our cost study model and rules are designed around the Uniform System of Accounts it would be difficult to even file a study. Additionally, the FCC does not wish to require CLECs to file cost studies supporting access rates[1], and as will be discussed later, the FCC has also ruled that the costs of the CLECs are irrelevant when tariffing an access rate. Given these reasons and the FCC's rationale, staff supports granting NVC's request for an exemption from filing cost based rates on those grounds. **Staff recommends the Commission grant NVC's petition from filing a cost study.**

Intrastate Switched Access Rate

NVC is requesting an intrastate switched access rate of $0.1325. NVC argues that this rate was developed in accordance with ARSD 20:10:27:12 which allows companies receiving a 20:10:27:11 exemption to use the statewide average "LECA Plus"[2] intrastate access rate.

ARSD 20:10:27:12 does allow an ILEC receiving a 20:10:27:11 exemption to use the average schedule rate. However, staff believes that ARSD 20:10:27:12 was only intended to be used by incumbent LECs. The intent was to allow small, extremely high cost, rural South Dakota incumbent LECs a waiver from filing an expensive cost study. In return that small, high cost ILEC must use the LECA Plus rate, which in theory, should be a lower rate than had they filed a

[1] FCC 01-146 – Seventh Report and Order and Further Notice of Proposed Rulemaking.

[2] The "LECA Plus" rate is a term used by staff to identify the average rate of all cost companies with under 100,000 access lines using the formula identified in ARSD 20:10:27:12. It is derived by averaging all the "LECA" cost companies "Plus" two non LECA member cost companies.

company specific cost based rate. If ARSD 20:10:27:12 is extended to CLECs, it is possible for a CLEC providing service to low cost customers and whose company specific cost based rate would be less than that of the LECA PLUS rate, to simply apply for the 20:10:27:11 exemption and receive access revenue in excess of its costs.

Additionally, ARSD 20:10:27:12 became effective January 31, 1993. That is more than three years prior to the implementation of the Telecommunications Act of 1996 which allowed CLEC activity. When enacted, ARSD 20:10:27:12 did not envision the emergence of CLECs. Furthermore, ARSD 20:10:27:12 indicates that the rate is "based on the cost of all the telecommunications companies with less than 100,000 access lines". The statewide average LECA Plus rate that NVC is requesting includes the rural incumbent LECs with less than 100,000 access lines but excludes the competitive LECs in South Dakota serving fewer than 100,000 access lines. Thus, NVC's interpretation of the LECA Plus rate shows the intent of this rule was for incumbent LECs only.

If not the statewide average rate, then what rate should the CLEC be allowed to charge? The FCC has already answered that question.

FCC 01-146 Seventh Report and Order and Further Notice of Proposed Rulemaking in general forbids a CLEC from tariffing an interstate access rate that is in excess of the ILEC rate whose service territory they are competing in. Although the FCC's rules regarding interstate access are not binding on this Commission regarding intrastate access, the rationale and actions can be used as a guide. Staff concurs with the FCC and believes that NVC should adopt the ILEC rate for intrastate access. NVC is competing against the ILEC Qwest for end-user customers in the Aberdeen exchange. NVC's basic local service rate for the Aberdeen exchange is currently less than the Qwest basic local service rate. NVC is undercutting the Qwest price to gain end-user customers, a natural and expected result of competition. These end-users are the customers who have a competitive choice of providers (either the ILEC or the CLEC). However, by gaining an end-user customer, NVC also captures the IXC picked by the end-user (for originating access) and the IXC of any end-user that calls NVC's end-users (for terminating access) as captive customers. Unlike the end-user, the IXCs have no choice. The IXC is a captive customer of the CLEC's monopoly access rate. For every local service end-user customer that NVC "wins" from Qwest, the end-users see a decrease in the basic local service rate, but the IXCs see an approximate two fold increase in intrastate access rates. Staff believes this is inappropriate. Additionally, the other facilities based CLECs with approved intrastate access tariffs that are providing service in the Aberdeen exchange and competing for the same customers have adopted the ILEC Qwest intrastate access rates.

NVC argues that its costs to provide service are higher than Qwest's costs and higher than the other CLECs who are using coaxial plant. Although a logical conclusion, that fact remains unproven by NVC. However, if NVC's costs are higher than Qwest and the CLECs, then how can NVC provide basic local service to end-users at rates that are less than Qwest's basic service rates? Given NVC's 64% increase in access rates over the past several years, staff fears that NVC may be subsidizing local service with intrastate access revenues. Why is NVC only asking the IXC to pay more for that higher cost network?

The FCC has weighed in on the issues of high CLEC costs and the CLEC's monopoly power. In its order, the FCC concluded that the IXCs are subject to the monopoly power of the CLEC and found it necessary "to constrain the extent to which the CLECs can exercise their monopoly power and recover an excessive share of their costs from the IXC."[3] To do this, the FCC limited the CLEC's access rate to that of the ILEC. The FCC further concluded that the high startup costs of a CLEC may be reasonable but that is not justification for tariffing an access tariff rate in excess of the ILEC. The FCC refused to let the CLECs subsidize their local service offering through access rates. In support the FCC stated that under normal market conditions, market entry is gained by offering service at a price lower than that of the competitors, exactly what NVC is doing for end-user customers. By limiting the CLEC access rate to that of the ILEC, the FCC is mimicking normal market entry for access rates and limiting the monopoly power the CLEC wields over the IXC.

In response to this FCC action, CLECs argued that they provide a service that is superior to that of the ILECs. The FCC acknowledges that CLECs may be offering state-of-the-art facilities capable not only of POTS but also of providing broadband services to the end-user customers. However, the FCC concluded that this is not justification for tariffing an interstate access rate greater than that of the ILEC. First, the FCC concluded the IXC does not receive any benefit from these state-of-the-art facilities capable of providing broadband services. Even if the IXC did receive some benefit for originating or terminating traffic over the CLEC facilities versus the ILEC facilities, the CLEC is free to negotiate a separate rate with the IXC; however, it may not tariff a rate greater than the ILEC rate. Second, the FCC found that it was very important to send the appropriate price signals to the end-user. If the CLEC service truly is a superior service, any increased costs associated with those facilities should be appropriately priced to the end-user who is receiving the benefits, not the IXC. This ensures market discipline and sends proper price signals which allows the end-user to decide if the superior service is worth the increased price.

Rural Exemption

The FCC in its order also created a "Rural Exemption" which allows certain "rural" CLECs to tariff the NECA rate instead of the ILEC rate for interstate access in some rural service territories. The FCC allows a "CLEC competing with a non-rural ILEC where no portion of the CLEC's service area falls within (1) any incorporated place of 50,000 inhabitants or more, based on the most recently available population statistic of the Census Bureau or (2) an urbanized area, as defined by the Census Bureau"[4] to charge the NECA rates.[5] NVC qualifies for this Rural Exemption for the interstate jurisdiction. The argument has been made that the FCC decision to allow "rural" CLECs to use the NECA rate for the interstate jurisdiction is similar to ARSD 20:10:27:12 and justification for such action. Staff does not believe this is sound rationale justifying the usage of ARSD 20:10:27:12 by CLECs.

The FCC selected the 50,000 inhabitants and the urbanized area criteria based on the geography, population, density, etc. of the nation. The FCC rejected several other broader criteria proposals (such as all customers living outside of zone 1 of the nation's top 50 MSAs or 100,000 access lines) because the FCC found these proposals would have been too encompassing and too broad. The FCC's intent was to limit this exemption to the most rural areas of the nation. When viewing the intrastate jurisdiction, staff believes that the FCC's national view is too encompassing and too broad for South Dakota's intrastate jurisdiction. The 50,000 inhabitants criteria excludes only Sioux Falls and Rapid City or 24% of the state

[3] FCC 01-146 – Seventh Report and Order and Further Notice of Proposed Rulemaking, paragraph 39.
[4] Ibid. Paragraph 76.
[5] Ibid. Paragraphs 80 and 81.

population for receiving the Rural Exemption. Thus, the entire remaining area within the state (76% of the state population) would qualify for the exemption. Using this criteria, a CLEC providing service in Aberdeen, South Dakota's third largest city, would be eligible for the exemption. On a relative scale, Aberdeen to South Dakota is like Chicago to the United States. The FCC did not intend for Chicago to qualify for the rural exemption. The FCC did not include 76% of the US population eligible for the CLEC rural exemption. It is irrational to use those criteria on an intrastate jurisdiction.

The FCC created the rural exemption based on the fact that multi-state ILEC's access rates are an average rate for the entire service territory. For Qwest, the interstate access rate is an average of dense, high populated service areas like Minneapolis, Denver and Seattle, but also includes areas like rural Timber Lake and Morristown. Given the vast differences in these areas, the FCC was convinced that it was unfair to force a CLEC serving extremely rural areas to be forced to accept the averaged rate that included areas like Denver, so the FCC created the Rural Exemption. However, for the intrastate jurisdiction, the demographics are different. Qwest's intrastate rate is an average of its South Dakota service territory, but the difference between Morristown and Sioux Falls is not nearly the same as the difference between Morristown and Denver. This further indicates that the 50,000 inhabitants criteria do not fit the South Dakota intrastate demographics.

Additionally, a CLEC does not have the carrier of last resort obligation. Therefore, a CLEC could move into an exchange area, cherry pick the low cost high revenue producing customers, and essentially could provide service for less than the ILEC costs. Allowing a CLEC, whose costs may be less than the ILEC, to charge a rate that is approximately twice that of the ILEC is absurd and could "...create perverse incentives for uneconomic competitive entry by CLECs into rural areas..." [6] Staff questions if NVC's entry into the Aberdeen exchange may be just such a case, especially since NVC indicated that they are relying on the high intrastate access rates to make its business plan work.

Staff believes that just because the FCC has granted an exemption for the CLEC to use the NECA rate for the interstate jurisdiction is by no means justification to use the LECA Plus rate for the intrastate jurisdiction for over 76% of the state's population.

It also needs to be noted that the costs to a LEC to originate or terminate an interstate call over specific local exchange facilities is no different than originating or terminating an intrastate call over the same facilities. The pricing of each may be different due to jurisdiction differences[7], but the cost is the same. This holds true for NVC. The cost to originate or terminate a call over its Aberdeen local exchange facilities (the only facilities of NVC) is the same whether the call is an interstate or an intrastate jurisdictional call. However, in the case of NVC which is a single state and single exchange CLEC, the pricing difference would only be affected by the jurisdictional rule differences and not the facilities difference since NVC has facilities in only one exchange.

[6] Ibid. Paragraph 70

[7] Multi-state ILEC's interstate rate will include an allocated portion of the facility costs and expenses for the entire service territory divided by the total interstate MOU. The intrastate rate will include an allocated portion of facility costs and expenses for only the state jurisdiction, divided by the intrastate MOU. That and the different rules between the different jurisdictions create a price difference between interstate and intrastate jurisdictional origination and/or termination pricing; but the cost to the LEC is the same for the specific facilities.

Based on the information that staff has received, in 2004 NVC has collected ***[begin confidential]*** ***[end confidential]*** in interstate related access fees (collected from IXCs via the NECA rate and federal access fees collected from the end-users). Staff can find no other revenue that NVC received related to interstate access jurisdiction. NVC originated and terminated ***[begin confidential]*** ***[end confidential]*** interstate minutes for that same period. By dividing the interstate revenues by the interstate MOU, staff calculated the 2004 interstate access revenue per MOU to be approximately ***[begin confidential]*** ***[end confidential]*** per minute. The cost for NVC to originate or terminate an interstate call is the same as an intrastate call yet NVC is requesting approval of an intrastate rate of $0.1325 per minute – about twice the rate that the FCC has deemed appropriate for the interstate jurisdiction. It is somewhat voracious that NVC would be charging the NECA rate for interstate, but request the LECA Plus rate for the intrastate, especially since the cost for each is the same. It is also important to note that other active CLECs in the state, including those providing service in Aberdeen and competing for the same customers as NVC have, at their own request, tariffed the Qwest rate and not the LECA Plus rate for the intrastate jurisdiction.

Population and population density are two of the main factors affecting cost of service. Larger population and denser the population means a lower cost per access line. Aberdeen is South Dakota's third largest city. The LECA Plus rate is an average of much smaller higher cost areas than Aberdeen. The LECA Plus only includes costs from one of the 15 largest cities in South Dakota (the one being Brookings which is the fifth largest). How appropriate is it to use this high cost average intrastate access rate for a relatively lower cost area like Aberdeen? Especially since NVC is not providing service to some of the highest cost areas in the Aberdeen exchange. Furthermore, NVC getting the LECA Plus rate in Aberdeen has no averaging affect on the LECA rates because NVC (or any CLEC for that matter) is not associated with LECA. The CLEC just assume the rate.

If we are going to subsidize the CLEC to compete, maybe we should limit the subsidy to areas that are underserved and don't have other competition. If we allow NVC to use the LECA Plus rate in Aberdeen, what will stop Midcontinent Communications or PrairieWave Black Hills (formerly Black Hills FiberCom) from using it in Aberdeen, Rapid City and Sioux Falls? How can NVC sell its own long distance product to the end-users (retail) for 9.9 cents per minute when it is charging the IXC 13.25 cents per minute to the IXC to originate or terminate (26.50 cent for both) a long distance call (wholesale)?

Given the rationale used by the FCC and the facts discussed above, staff believes NVC should follow the lead of the other CLECs and level the competitive playing field in the Aberdeen exchange. **Staff would recommend that the Commission deny the intrastate access rate NVC has requested and order NVC to mirror Qwest tariffed intrastate switched access rates.**

All of the above noted recommendations are based on the assumption that the Commission has the legal authority to "temporarily waive or suspend" ARSD 20:10:27:12 and set NVC's intrastate access rates at something other than what is spelled out in ARSD 20:10:27:12. Staff believes that NVC has followed ARSD 20:10:27:12 in setting its intrastate switched access rate.

Staff believes that ARSD 20:10:27:02 and 20:10:27:03 may give the Commission the authority to waive or suspend ARSD 20:10:27:12 and use an alternative method. The Commission has in fact done so many times when it sets the intrastate access rates at the Qwest rate for other CLECs receiving an exemption. The only difference with this filing is that it is staff, not the

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CLEC advocating the waiver or suspension of ARSD 20:10:27:12. If the Commission accepts staff's position, the Commission would have to "on its own motion" waive or suspend ARSD 20:10:27:12. Staff believes this memo gives the Commission "good cause" for doing such.

The question as to whether or not the Commission can do what staff is recommending is a legal question and beyond my qualifications. If the Commission should find that under the current rules it can't require a CLEC receiving an ARSD 20:10:27:11 exemption to implement a rate other than that spelled out in ARSD 20:10:27:12, then staff believes, without conceding any of the above arguments, that the Commission will have to allow NVC to use ARSD 20:10:27:12 if the exemption is granted.

If the Commission should approve the intrastate switched access rate that NVC is requesting (either by choice or by legal requirement), staff believes it is necessary that the rate be subject to refund with interest [8] and be limited to three years (as has been done in the past) or until any Commission order or rule change regarding CLEC switched access rates is issued by this Commission that supersedes the order in this docket, which ever is shorter.

Additionally, Staff acknowledges there are potential negative effects if its recommendations are adopted. Such a decision may have negative financial impacts on NVC which could outweigh any burden placed on the IXCs. Such a decision could also slow the deployment of advanced services in South Dakota. Staff gave only limited consideration to these potential negative effects when making its recommendations.

Staff also notes the patchwork nature for funding rural telecommunications, and the deployment requirements of the 1996 Telecom Act, may require consideration of all revenue sources and options when changes are made to any one funding source. Staff understands the policy challenges can be complex. There are no easy solutions. Staff appreciates this difficulty, but at the same time believes there needs to be some consideration of what may be more fitting answers to rate questions than what now exist.

[8] NVC's proposed rate is based on the 2004 LECA Plus rate which uses the 2004 LECA rate. The 2004 LECA rate is an interim rate subject to refund with interest because it includes 2004 unapproved cost studies. Therefore, the rate that NVC is requesting is an interim rate not yet approved by the Commission.