

STATE OF MICHIGAN
BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of)	
BARAGA TELEPHONE COMPANY for approval)	Case No. U-13238
of a total service long run incremental cost study.)	
_____)	

At the March 21, 2002 meeting of the Michigan Public Service Commission in Lansing, Michigan.

PRESENT: Hon. Laura Chappelle, Chairman
Hon. David A. Svanda, Commissioner
Hon. Robert B. Nelson, Commissioner

OPINION AND ORDER

On December 26, 2001, Baraga Telephone Company (Baraga) filed an application for approval of a total service long run incremental cost (TSLRIC) study. Previously, Baraga had adopted a joint cost study approved for the Michigan Exchange Carriers Association, Inc., (MECA) on behalf of its member carriers in the January 28, 1998 order in Case No. U-11448.¹ Accompanying Baraga's application is an affidavit explaining the company-specific study. The affidavit identifies major cost assumptions and notes points of departure from cost studies that the Commission has approved for other small providers.

In accordance with the schedule issued by the Commission's Executive Secretary, Ameritech Michigan and the Commission Staff (Staff) filed comments on February 26, 2002, and Baraga and the Staff filed reply comments on March 5, 2002.

¹ The March 14, 2000 order in Case No. U-12261 approved an updated MECA cost study, but Baraga did not participate in that study.

According to Ameritech Michigan, the cost study does not distinguish between Baraga's operations as an incumbent local exchange carrier (ILEC) in some areas and as a competitive local exchange carrier (CLEC) in other areas, but it appears to reflect only the costs of the ILEC operation. Because the costs of operating as an ILEC and a CLEC are likely to be different, Ameritech Michigan says, it would be inappropriate to apply the cost study to the CLEC operation. Ameritech Michigan requests clarification that the cost study does not address Baraga's CLEC operation.

Baraga replies that, in addition to providing local exchange service as an ILEC, it now provides service as a CLEC in four adjacent exchanges, including one in which Ameritech Michigan is the ILEC. Baraga says that its four CLEC exchanges have the same cost characteristics as its ILEC exchanges. It says that it uses the same host switch to serve all of the exchanges and that expanding service as a CLEC has produced economies of scale and reduced its overall per-minute costs for switching and transport. It says that the cost study it prepared for this case does in fact encompass both its ILEC and CLEC operations. It says that requiring one small provider to prepare two separate cost studies would be unduly costly.

The Staff supports Baraga's position, arguing that Baraga operates as a single entity. The Staff says that the purpose of a TSLRIC study is to determine the costs for the entire network, regardless of the number or type of services provided.

The Commission agrees with Baraga and the Staff that there is no reason to require separate cost studies for operations as both an ILEC and a CLEC. A fundamental purpose of a TSLRIC study is to determine the costs of all services provided using the same facilities. TSLRIC principles require a cost study to "capture all relevant changes in the total cost of the firm caused by the decision to offer the service" and "reflect the entire quantity of the output provided." Order

dated September 8, 1994, Case No. U-10620, Ex. A at 3, 4. Whether a provider is classified as an ILEC or a CLEC, or both, does not alter this inquiry. The Michigan Telecommunications Act (MTA) establishes TSLRIC as the cost standard for basic local exchange providers without distinguishing between ILECs and CLECs.² See MCL 484.2304,³ 484.2304a.

In its comments, the Staff notes that Baraga's study uses an eight-year economic life for switching equipment, which is a departure from the ten-year life used in other cost studies, including those approved for comparable small providers, Westphalia Telephone Company (Westphalia) in the January 22, 2002 order in Case No. U-13177 and Winn Telephone Company (Winn) in the February 1, 2002 order in Case No. U-13191. The Staff says that the affidavit accompanying Baraga's study offers no justification for the change.

Baraga replies that reducing the economic life is appropriate in light of the accelerating pace of switching technology and the falling cost of replacing existing equipment with new non-proprietary equipment. In this sense, it says, the concept of economic life, as affected by technological obsolescence, means something different than the accounting concept of a depreciable life. It claims that an eight-year switching life would also have been appropriate in the Westphalia and Winn cost studies.

Baraga has not advanced a persuasive rationale for departing from the economic life assumption used in prior cost studies by comparable providers. Baraga relies on a generalized trend without showing how that trend specifically translates into the eight-year assumption

² The MTA does not use the terms "ILEC" or "CLEC."

³ MCL 484.2304(1) requires basic local exchange rates to be "just and reasonable." As defined in MCL 484.2102(y), a "just and reasonable" rate cannot be less than TSLRIC.

used in its cost study. The Commission will require Baraga to use a ten-year economic life for switching equipment, as is the case with comparable providers.

Baraga's study projected demand (in minutes-of-use) on the assumption that network usage would increase by 0.72% per year, which is the annual average for 1985-97, as reported by the Federal Communications Commission. Baraga also adjusted its demand projection by assuming that it would lose usage attributable to dial-up Internet service when those customers migrate to digital subscriber line (DSL) service, which does not use the same equipment to switch both Internet and voice traffic. The assumption in the cost study is that the 30% of Baraga's dial-up customers that use the Internet most intensively, ranked in order of their on-line minutes-of-use, will migrate to DSL. The top 30% account for about 70% of Baraga's dial-up usage. As recently as the end of 1999, Baraga did not provide any DSL service.

The Staff objects to Baraga's adjustment for the effect of DSL migration. The Staff argues that the underlying assumptions are unwarranted and that any adjustment should be supported with recent company-specific data. It says that an adjustment of this magnitude, which reduces Baraga's minutes-of-use by 35%, is unreasonable in the absence of a showing that actual usage is declining at the rate implied by the adjustment.

The Staff says that, according to Baraga's own data, dial-up minutes increased by 43% from September to December of 1999 (when Baraga did not provide DSL service) and its total access lines increased by 8.5% from 1999 through the study timeframe (i.e., the midpoint of the prospective five-year study period). The Staff contends that, if anything, the trend of increasing dial-up usage supports an adjustment increasing minutes-of-use by more than the assumed 0.72% per year in Baraga's cost study.

The Staff says that Baraga's data is stale and does not support an assumption that the top 30% of Internet users will migrate to DSL. The Staff suggests that Baraga could have presented more recent data, given that it is the primary Internet service provider (ISP) in its local calling area. At a minimum, the Staff claims, Baraga should have supported the adjustment with recent data regarding the number of customers and minutes of Internet usage attributable to both dial-up and DSL service.

Baraga faults the Staff for overlooking two undeniable propositions: (1) a DSL customer using the Internet bypasses Baraga's voice switch and reduces usage, and (2) more intensive Internet users are more likely to adopt DSL service. Baraga says that, even though a mere 81 of its customers accounted for 30% of its Internet users in December 1999 (out of a total of 275 Internet users), by April 2001, its ISP had signed up 235 high-speed Internet subscribers. It claims that DSL migration is too significant to ignore. However, it adds, assumptions are necessary because the deployment of DSL is in its infancy. Even if the Commission were to reject its assumption that the upper 30% of Internet users will migrate to DSL, Baraga says, the Commission should adopt a lesser adjustment based on Internet customers' average minutes-of-use.

Baraga says that the Staff's reliance on a 43% increase in dial-up usage during the last four months of 1999 is absurd. Not only does the Staff fail to account for seasonal variations, Baraga says, but simply extrapolating the trend forward would mean that those users, who averaged 1.8 hours per day on-line in December 1999, would now be on-line more than 24 hours a day.

One flaw in Baraga's proposed adjustment for DSL migration is that the actual data reflect conditions as they existed prior to Baraga's roll-out of DSL service. In the absence of more up-to-date data, predicting the effect of the Internet on customers' usage patterns is extremely difficult, given the rapid changes brought about by the introduction of Internet technologies and their

uneven rate of assimilation by the public. The Staff is correct to suggest that increases in Baraga's overall demand due to dial-up Internet service could more than counteract the effect of DSL migration and may be far larger than implied by a 0.72% annual increase in minutes-of-use. Thus, the Staff's position assumes a gradual increase in usage in line with historical trends. For purposes of this study, and in view of the limited data that is available, the Commission determines that the Staff's position best approximates the potential effects of two countervailing trends: the recent increase in dial-up Internet usage (which tends to increase overall usage) and the even more recent migration to DSL (which may reduce switched minutes-of-use).

On March 14, 2002, Governor Engler signed into law a long-anticipated package of broadband legislation, 2002 PA 48-50. Viewed in context, this event is part of an extensive effort by the State of Michigan to secure the development of a broadband infrastructure that will provide ubiquitous, economical service, particularly in remote or underserved areas. The Commission has supported this effort wholeheartedly, fully endorses the broadband legislation, and reaffirms its commitment to promoting broadband policies prospectively. In keeping with this commitment, the Commission would indicate that it does not oppose TSLRIC adjustments based on the effects of a broadband roll-out, so long as they are firmly grounded in recent data based on actual usage. The Commission would be willing to consider a proposed adjustment to the current cost study, with appropriate supporting data, if presented to it on rehearing in this case.

The Staff finds the shared and common cost factors used in the cost study to be excessive. It says that they are far more than those used by comparable carriers. It faults Baraga for not undertaking a qualitative analysis of its three-year expense averages (1997-99) in light of its historical cost experience. For example, the Staff notes, Baraga's executive expenses increased from 1997 to 1998 by 41%, but Baraga did not attempt to explain or justify the increase. The Staff recom-

mends that Baraga's shared and common costs be limited to a 35% combined factor, with 40% of that factor allocated to shared costs and 60% to common costs.

The Staff also criticizes Baraga's study for reducing common costs for unregulated activities. The Staff says that a TSLRIC study covers the entire company's operation, including both regulated and unregulated activities.

The Staff says that it is inappropriate to apply shared and common cost factors to the charges that Baraga pays to other providers for providing directory assistance, local operator handled charges, busy line verification, and dual party relay to Baraga's retail customers. The Staff notes that the Commission rejected a similar markup in a cost study performed for MECA in the March 14, 2000 order in Case No. U-12261.

In reply, Baraga asserts that its development of shared and common costs is consistent with the forward-looking costs of an efficient new competitor. It argues that analyzing historical cost trends in individual expense accounts would not be forward-looking and, in any event, relatively few types of expense account for most of its overall expense. It contends that its costs are not comparable to those approved for other small providers, but that its cost study reflects its own unique cost structure. It also contends that the Staff focuses on certain individual cost items in isolation from their larger context, but that the company's overall costs from 1997 to 1999 increased at an annual average rate of 8%, which is in line with inflation. Baraga contends that much of its non-labor costs are payments made for various services provided by third parties, for which there are few potential efficiency savings. It argues that an efficient new company could not make do with a smaller staff or hire a workforce comparable to its own without paying more compensation, due to the lack of skilled workers in the area.

Baraga defends its 38% adjustment reducing common costs for unregulated activities. It says that 38% is the percentage of total revenues that are unregulated. It claims that an efficient new competitor providing only regulated services would not incur those common costs.

Baraga also defends its application of shared and common cost factors to the charges it pays third-party providers for directory assistance, local operator handled charges, busy line verification, and dual party relay. It says that the charges it pays for those services are direct costs and, as such, must be assigned their share of the total company shared and common costs. Otherwise, it says, it will underrecover its shared and common costs.

The Commission finds that the Staff's proposed treatment of shared and common costs is reasonable and should be adopted. As explained in prior orders, it is not reasonable to proceed on the basis of an unsubstantiated assertion that Baraga's shared and common costs are dramatically higher than those approved for other small providers. See order dated December 20, 2000, Case No. U-12637 (Peninsula Telephone Company cost study); order dated January 22, 2002, Case No. U-13177 (Westphalia cost study). If in fact Baraga's cost structure is unique or markedly different from the others, it should document the differences as they affect cost-related characteristics of its operation and service territory, correlate them to their effects on costs, and demonstrate how they justify higher shared and common costs on a forward-looking, economic basis.

The Commission agrees with the Staff's other assertions related to Baraga's treatment of shared and common costs. It is inappropriate to reduce common costs on the basis of unregulated revenues. As the Staff notes, TSLRIC covers the total company's operation, including both regulated and unregulated activities. Moreover, it is not self-evidently true that "an efficient competitive entrant coming in and providing only [plain old telephone service] would not incur [the] costs" represented by the 38% adjustment, as Baraga asserts. Baraga's reply aff. at 8.

Providing additional unregulated services could, and perhaps should, reduce the common cost factor through efficiencies attained by using the same company overhead and resources to earn more revenues.

As the Staff states, it is improper to apply shared and common cost factors to the charges that Baraga pays to other providers that provide directory assistance, local operator handled charges, busy line verification, and dual party relay to Baraga's retail customers. Order dated March 14, 2000, Case No. U-12261, at 7.

Consistent with the November 16, 1999 order in Case No. U-11831, at 39-40, Baraga should not be required to file a TSLRIC study every two years, but should not be permitted to file in less than two years unless the company can demonstrate that there has been a fundamental change in circumstances. The company may file revised cost studies as it deems appropriate, although the Commission will not permit it to file cost studies for individual or a few services (except new services). It must perform and file cost studies for the entire network. Furthermore, the Commission, acting on its own motion or at the request of another party, retains the authority to require the company to file as well. Finally, Baraga may continue to file an individual study, or it may join with other companies as it did in Case No. U-11448.

The Commission FINDS that:

- a. Jurisdiction is pursuant to 1991 PA 179, as amended, MCL 484.2101 et seq.; 1969 PA 306, as amended, MCL 24.201 et seq.; and the Commission's Rules of Practice and Procedure, as amended, 1992 AACCS, R 460.17101 et seq.
- b. The TSLRIC study filed by Baraga should be approved as modified by this order.

THEREFORE, IT IS ORDERED that the total service long run incremental cost study filed by Baraga Telephone Company is approved as modified by this order.

The Commission reserves jurisdiction and may issue further orders as necessary.

Any party desiring to appeal this order must do so in the appropriate court within 30 days after issuance and notice of this order, pursuant to MCL 462.26.

MICHIGAN PUBLIC SERVICE COMMISSION

/s/ Laura Chappelle
Chairman

(S E A L)

/s/ David A. Svanda
Commissioner

/s/ Robert B. Nelson
Commissioner

By its action of March 21, 2002.

/s/ Dorothy Wideman
Its Executive Secretary

THEREFORE, IT IS ORDERED that the total service long run incremental cost study filed by Baraga Telephone Company is approved as modified by this order.

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Suggested Minute:

“Adopt and issue order dated March 21, 2002 approving, as modified, the total service long run incremental cost study filed by Baraga Telephone Company, as set forth in the order.”