

STATE OF NORTH DAKOTA
PUBLIC SERVICE COMMISSION

MIDCONTINENT COMMUNICATIONS,)
A SOUTH DAKOTA PARTNERSHIP,)
COMPLAINANT)
VS.) Case No. PU-05-451
NORTH DAKOTA TELEPHONE COMPANY,)
RESPONDENT)
)

**BRIEF OF MIDCONTINENT COMMUNICATIONS
ON INTERIM RESALE DISCOUNT**

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Midcontinent Communications, by its attorneys, hereby submits its brief concerning the interim resale discount to be adopted in the above-captioned proceeding. As shown below, the Commission should adopt an interim resale discount rate in the North Dakota Telephone Company (“NDTC”) Devils Lake exchange of 25.39 percent or, in the alternative, adopt a rate that falls within the FCC’s 17 to 25 percent safe harbor for interim rates. In doing so, the Commission should reject NDTC’s plainly inadequate discount showing.

I. Introduction

This proceeding is significant for many reasons, but most importantly it will, as Commissioner Wefald indicated, set the basis for the parties’ further negotiations and the baseline for the Commission’s adoption, if necessary, of final resale rates. As a consequence, the Commission should insist that any discount rate showing comply with the basic requirements of the FCC’s rules and with basic logic.

Unfortunately, NDTC has provided the Commission with no evidence that can be used to set a rational interim resale rate. NDTC has proffered what it belatedly described as a cost study that complies with the FCC's rules for "interim" cost studies, using an analysis that it conceded was not consistent with the requirements for a "final" cost study. However, there are no FCC rules that permit – let alone create separate requirements for – "interim" cost studies. Instead, the rules permit state commissions to set interim rates if they are presented with cost data that is inadequate to set a final discount.

Even if there were special rules for interim cost studies, NDTC's cost study is riddled with errors and other problems that would make it impossible for the Commission to rely on NDTC's conclusions. NDTC's study is based on a methodology that uses total expenses, rather than retail revenues in the denominator of the discount fraction. This approach is inconsistent with the standard practices of regulators across the country and results in excess profits for NDTC. In addition, the specific data plugged into the model is, at best, suspect. NDTC failed to provide explanations for many of its choices, and its witness was unable to identify where important potential avoided costs would be found in the study or what was contained in certain accounts. These significant issues make it impossible for the Commission to set a rational discount rate based on NDTC's claims.

In this context, the Commission has two alternatives. The first is to adopt a 25.39 percent interim discount rate based on Midcontinent's direct testimony. That testimony showed the steps necessary to correct the most significant errors in NDTC's analysis. While the Midcontinent analysis does not correct every mistake made by NDTC, it is considerably more accurate than the NDTC study, and therefore provides an appropriate interim discount percentage.

The second option is to adopt a discount within the FCC's safe harbor range of 17 to 25 percent or, at a minimum, the 16.15 percent discount rate used by Qwest and Missouri Valley. Use of the FCC range is appropriate when the Commission lacks the evidence necessary to support a specific finding. Given the flaws and errors in NDTC's showing, if the Commission does not conclude that it can rely on Midcontinent's analysis, a rate within the safe harbor would be a rational and supportable choice.

II. The Commission Should Not Base an Interim Rate on NDTC's Flawed Cost Study.

In its prefiled testimony, NDTC presented a cost study that claimed to support a wholesale discount rate of 9.36 percent. This study suffers from myriad flaws, ranging from a fundamental misconstruction of the requirements for calculating the resale discount to an inability to explain what expenses actually fall within specific accounts. In light of these facts, the only conclusion the Commission should reach is that NDTC's cost study is inadequate to support any conclusion regarding the interim resale discount.

A. The NDTC Cost Study Is Fundamentally Flawed Because It Does Not Conform to the Requirements of the Statute.

NDTC's cost study assumes that the way to calculate the resale discount is to divide avoided costs by the company's total expenses. While, as discussed below, there are several problems with the way NDTC calculates avoided costs and total expenses, the more significant error is the basic calculation of the discount fraction itself. NDTC's approach is contrary to the requirements of the Communications Act and to the practices of essentially every state that determines resale discounts. Moreover, it is illogical, and would lead to a situation in which NDTC would profit more from selling services at

wholesale than it does from selling the same services at retail. Thus, the basic calculation to obtain the discount in NDTC's cost study should be rejected.

The first reason to reject NDTC's approach is that it is inconsistent with the statute. Section 252(d)(3) of the federal Communications Act requires that

a State commission shall determine wholesale rates on the basis of *retail rates charged to subscribers for the telecommunications service requested*, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.¹

In other words, the starting point for the calculation of the resale discount is not expenses, but "retail rates . . . for the telecommunications service requested," that is, to determine a relationship between the services subject to resale and the costs avoided by the local exchange carrier by reason of the resale of those services. Avoided costs, then, are subtracted from those retail revenues, not from the telephone company's overall expenses, to determine the proper numerator in the discount fraction.

This is not a novel conclusion. In fact, it is exactly what the FCC said in the *Local Competition Order*:

The statutory pricing standard for wholesale rates requires state commissions to (1) identify what marketing, billing, collection, and other costs will be avoided by incumbent LECs when they provide services at wholesale; and (2) calculate the portion of the retail prices for these services that is attributable to the avoided costs.²

If, as the statute requires and the FCC concluded, wholesale rates are to be determined by subtracting avoided costs from retail rates for resold services, you cannot accomplish that goal by calculating the discount on the basis of total expenses. The only way to do it is to use retail revenues subject to resale in the denominator of the discount fraction .

¹ 47 U.S.C. § 252(d)(3) (emphasis supplied).

² Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, *First Report and Order*, 11 FCC Rcd 15499, 15955 (1996).

This is the conclusion that other states have reached in determining resale discounts. As Mr. Gates testified, other states use a carrier's revenues subject to resale, not expenses, in the denominator of the fraction used to determine the resale discount, and other carriers routinely base their calculations on retail revenues as well.³ In fact, even NDTC's witness conceded that there is a "trend" towards the states using retail revenues instead of expenses during his rebuttal testimony and that "it is becoming the industry standard."⁴ Thus, using expenses as the denominator in the resale discount fraction would be inconsistent with the standard practices of other states.

Using total expenses in the denominator is wrong for several obvious reasons. Midcontinent will be reselling NDTC's local retail services, and CLECs are not allowed to resell access and other wholesale services. Consequently, the denominator of the discount fraction should be limited to revenues subject to resale, that is, local retail revenues. NDTC's attempt to increase the size of the denominator – thereby reducing the size of the discount dramatically – is simply wrong and should be rejected.

Moreover, using retail revenues rather than total expenses as the denominator of the discount fraction also makes the most sense in mathematical terms. Using retail revenues is the only way to ensure that the incumbent phone company's profits remain the same before and after wholesale resale begins. If, instead, the discount is calculated by dividing avoided costs by total expenses, the incumbent's profit actually increases

³ Tr. at _____. [All transcript citations to be provided when a transcript is available.]

⁴ Mr. Meredith initially argued that this "trend" applied only to "final" resale cost studies, but later acknowledged that there have been few, if any, "interim" resale cost studies. Moreover, for reasons described in more detail below, the Commission should accord little or no weight to Mr. Meredith's views on issues relating to regulatory actions at the FCC and other states. *See infra* n. 20.

when a competitor begins to offer resale.⁵ The reason for this is simple – if avoided costs are spread across all expenses, some of the avoided costs will be attributed to services that are not subject to resale, such as access, rather than to the services for which the costs actually are avoided. That means the discount is lower than it should be, and the incumbent's profit margin on resold services actually is higher than its profit margin on services it sells at retail.

As Mr. Gates explained during his direct testimony, the correct way to avoid this mismatch between avoided costs and expenses is to apply the avoided costs to retail revenues.⁶ When the discount fraction in the study is calculated in that way, there should be little or no difference between the carrier's profits with or without resale, which is what the statute anticipates, and the carrier will not "recover" the costs that it does not incur (the avoided costs) in the wholesale rates.

In this context, it is worth noting that even NDTC's cost study, which supposedly is based on total expenses, recognizes that some portions of its expenses must be excluded from the calculation of the discount fraction. That is why NDTC performed what Mr. Meredith described as "Part 64" exclusions.⁷ The reason that these expenses were excluded, according to Mr. Meredith, is that they were not subject to regulation.⁸ This is inconsistent, however, with NDTC's position that all operating expenses must be considered. In reality, the right place to draw the line is not between regulated and nonregulated services, but between services subject to wholesale resale and those that are

⁵ This effect is illustrated in Exhibit 1 to this brief. As Exhibit 1 explains, if NDTC's model were used and all of NDTC's retail services were sold at wholesale rates, NDTC's profit would increase by \$667,128, or by about one third over its profits as reported in its 2005 annual report.

⁶ Tr. at ____ (Gates Direct).

⁷ Tr. at ____ (Meredith Direct cross-examination). Part 64 of the FCC's rules assigns costs to regulated and nonregulated activities.

⁸ Tr. at ____ (Meredith Direct cross-examination).

not. If NDTC had drawn the line properly, its study would have looked much different and, as shown below, the resale discount it calculated would have been much higher.

B. NDTC's Theory that There Are Separate Standards for "Interim" and "Final" Cost Studies Simply Is Wrong.

In the middle of the hearing, NDTC's witness offered the claim that there were different standards for interim discount calculations and final discount calculations.⁹ This claim was proffered as an explanation of NDTC's decision to use total expenses rather than retail revenues in its discount calculation.¹⁰ The problem with this theory is that is entirely unsupported by the FCC's rules, the *Local Competition Order* or the results of state proceedings.¹¹ Indeed, it appears that this theory was invented by NDTC's expert.

First, there is no FCC rule that mandates the use of different standards for calculating interim and final wholesale discounts. As Mr. Meredith acknowledged during cross-examination, all the FCC's rules say about interim rates is that a state commission may use the 17 to 25 percent safe harbor if it cannot determine a final rate.¹² If anything, the FCC rules demonstrate that there is only one kind of cost study for wholesale discounts, not that there are separate interim and final methodologies and studies.

Further, the FCC did not adopt separate standards for interim and final cost studies in the *Local Competition Order* as it implemented the Act's requirements. In fact, the FCC specifically disclaimed any intent to adopt a particular model, concluding that "we do not adopt as presumptively correct any avoided cost model."¹³ Instead, the FCC identified key criteria to guide the resale discount calculation and codified those

⁹ Tr. at __ (Meredith Rebuttal).

¹⁰ Tr. at __ (Meredith Rebuttal)

¹¹ Mr. Meredith acknowledged that this is the only proceeding he has been involved in that required calculation of an interim resale discount. Tr. at __ (Meredith Rebuttal cross-examination).

¹² 47 C.F.R. § 51.711, Tr. at __ (Meredith Rebuttal cross-examination).

¹³ *Local Competition Order*, 11 FCC Rcd at ____.

principles in its rules. Thus it is no surprise that Mr. Meredith, when asked, could not identify any place in the *Local Competition Order* where the FCC adopted any cost model, interim or otherwise.¹⁴

NDTC compounded its error by claiming that the FCC had approved the MCI cost study as the model to be used in determining wholesale discounts and that the MCI study required use of total operating expenses for all services. As noted above, the FCC specifically disclaimed the adoption of any model, let alone the MCI model. Equally significant, the FCC's safe harbor range is not the range calculated by the MCI study – it is lower at both the bottom and top.¹⁵ This, as the *Local Competition Order* establishes, is because the FCC relied on multiple analyses and models, including studies conducted in Illinois and Georgia, to reach its conclusions.¹⁶ Further, there is no evidence that the MCI study used total expenses in the denominator of the discount fraction. The *Local Competition Order* does not specifically state which operating costs are used, and Mr. Meredith admitted that he had not reviewed the study himself.¹⁷ In other words, NDTC's study is not based on the MCI study, but on Mr. Meredith's assumptions about the MCI study.

¹⁴ Tr. at ____ (Meredith Rebuttal cross-examination). Midcontinent also notes that NDTC's claim that there are separate standards for interim and final cost studies was made for the first time during rebuttal testimony. There is nothing at all in Mr. Meredith's prefiled direct testimony to suggest that there is any special methodology for interim discount rate calculations, or that the study he presented was based on different principles than those that would apply to a final discount study. Meredith Direct at 2. This suggests that the claim that there are different standards was invented by Mr. Meredith during the hearing.

¹⁵ The MCI model as filed with the FCC resulted in a range of 25.6 to 33.2 percent. *Local Competition Order*, 11 FCC Rcd at 15959. As Mr. Meredith acknowledged after reading the order during his testimony, the range of rates under the MCI model with certain modifications made by the FCC was 18.8 to 25.98 percent. Tr. at ____ (Meredith Rebuttal cross-examination).

¹⁶ *Local Competition Order*, 11 FCC Rcd at 15962-4. Mr. Meredith acknowledged on cross-examination that this was the case. Tr. at ____ (Meredith Rebuttal cross-examination).

¹⁷ *Local Competition Order*, 11 FCC Rcd at 15944-5; Tr. at ____ (Meredith Rebuttal cross-examination). In fact, it is impossible to tell from the FCC order whether the MCI study excluded non-regulated costs, as Mr. Meredith did. As a consequence, it is apparent that Mr. Meredith simply made a series of assumptions about the MCI study based on his interpretation of the FCC order,

It is difficult to overstate the significance of NDTC's efforts to mislead the Commission about the relevant FCC requirements and how those requirements relate to the study presented at the hearing. One example, however, may provide sufficient focus on how misleading NDTC's testimony was. NDTC's Exhibit 20 is headed "Algebraic Reduction of FCC Discount Rate Formula," and the second page of the exhibit is headed "Numeric Example of FCC Formula without Cost Onsets."¹⁸ The natural reading of these headings – perhaps the only reading – is that these pages summarize the operation of formulas adopted by the FCC in the *Local Competition Order*. This impression is reinforced by the citations to the order at the bottom of both pages of the exhibit. Further, when cross-examined about whether the FCC had adopted the MCI model in the *Local Competition Order*, Mr. Meredith claimed at first that the citation to paragraph 930 of the order was an error, and that the place where the FCC adopted the model was somewhere else in the order.¹⁹ Nothing could have been further from the truth: There was no paragraph in the order that adopted the MCI model. In fact, the FCC not only did not adopt that model, but held that it would not adopt *any* model. Simply put, the characterization of the formula on NDTC's Exhibit 20 as the "FCC Discount Formula" was entirely incorrect, and NDTC should have known this from the start.²⁰

The second page of the exhibit, headed "Numeric Example of FCC Formula without Cost Onsets," is equally misleading. As noted above, there is no specific FCC model. Further, as Mr. Gates described during his direct testimony, there is nothing in

¹⁸ Exhibit R20 at 1, 2.

¹⁹ Tr. at ____ (Meredith Rebuttal cross-examination)

²⁰ Mr. Meredith's plainly erroneous claims concerning the FCC's adoption of the MCI model and the existence of separate interim and final cost study rules cast serious doubt on his credibility and on all of his testimony. These are central issues in this proceeding, and Mr. Meredith made obviously incorrect affirmative claims as to both of them. Consequently, Midcontinent submits that the Commission should accord little or no weight to Mr. Meredith's testimony.

the FCC rules that allows for “cost onsets” in the calculation of the wholesale discount.

As Mr. Gates noted, the only reference to expenses associated with wholesale operations was at paragraph 928 of the *Local Competition Order*, and the FCC accounted for those costs in determining the default safe harbor rates.²¹

Thus, there is no legal justification at all for adopting NDTC’s cost model in this proceeding. Rather, the only approach that is justified is to divide avoided costs by retail revenues to determine the retail discount fraction. As described below, that is the approach the Commission should adopt.

C. The Commission Cannot Rely on the Data in the NDTC Cost Study.

NDTC’s failure to construct its cost study properly makes it impossible to rely on Mr. Meredith’s conclusions. Even if the study were constructed properly, however, the evidence shows that the Commission could not adopt NDTC’s conclusions because the underlying data is improperly supported and otherwise flawed. These flaws are large and small, ranging from NDTC’s failure to provide a witness who could authenticate the data used in the study to incorrect decisions about specific avoided and unavoidable costs.

Collectively, they render the cost study unreliable and unsuitable for use in this proceeding.²² These problems are particularly disturbing in light of Mr. Meredith’s claim that he had been working on the cost study since March, even before the Commission’s initial order in this proceeding.²³

²¹ Tr. at ___ (Gates Direct).

²² Midcontinent does not dispute NDTC’s decision to use whole-company data, rather than Devils Lake-specific data, in the cost study. It is Midcontinent’s view that, unless NDTC keeps separate books for the Devils Lake exchange, which does not appear to be the case, attempting to allocate costs on an exchange-by-exchange basis is overly burdensome and would raise questions about the accuracy of the allocation.

²³ Tr. at ___ (Meredith Direct cross-examination).

The first problem with NDTC's underlying account data is that it is not authenticated in any way. Mr. Meredith testified that the information was provided to him by NDTC, and that the majority came from NDTC's December, 2005 ledger, prepared by NDTC.²⁴ He had no independent knowledge of the accuracy of the data provided to him, and did not know whether the information was the same information used to prepare the company's annual report.²⁵ Moreover, Mr. Meredith did not testify that he took any steps to verify the accuracy of the information provided to him, including the question of whether specific expenses were placed in the correct accounts.²⁶ Indeed, as described below, he could not explain the discrepancies between the amounts he used from the ledger and the amounts in NDTC's annual report. In all of these areas, Mr. Meredith depended on NDTC.

Mr. Meredith, as a consultant, should not be expected to have knowledge of the issues noted above, although he could have and should have tested the veracity of the data. To establish a proper foundation for the acceptance of the cost study, however, NDTC should have provided a witness who does have that knowledge. This additional witness would have provided a link in the chain of proof that Mr. Meredith was unable to provide: He knows only that he looked at certain records; he does not know that they were accurate and prepared in accordance with the FCC's accounting rules. Without that information, neither Mr. Meredith nor the Commission can conclude that the cost study is

²⁴ Tr. at ____ (Meredith Direct cross-examination).

²⁵ Tr. at ____ (Meredith Direct cross-examination).

²⁶ This is significant because certain expenses are presumptively avoidable and others are not. Thus, if an avoidable expense is placed in the wrong account, it would not be treated properly in an avoided cost study.

accurate or even that any part of the study is accurate.²⁷ Without being able to reach such a conclusion, the Commission cannot rely on the cost study to set any discount rate.

This issue becomes more significant because of Mr. Meredith's inability to explain differences between the numbers reported in the cost study, which he said he was given by NDTC, and the numbers in NDTC's annual report. For instance, Mr. Meredith could not explain why there was a difference of \$32,467 between his "Total Customer Service" category and the "Customer Operations" line on the annual report.²⁸ These differences suggest that there are errors of some sort in Mr. Meredith's calculations, but it is impossible to divine the sources of those errors without a witness who understands the underlying company accounting.

Another consequence of Mr. Meredith's lack of knowledge of NDTC's financial matters is that he performed no independent analysis of whether most affected costs could be avoided, and instead merely copied most of the data into his spreadsheet.²⁹ He acknowledged, in fact, that he made no effort to identify costs (avoided or otherwise) associated with specific services affected by wholesale resale, and instead simply used the accounts as provided to him by NDTC.

²⁷ During redirect examination, Mr. Meredith indicated that it is his understanding that NDTC's books are audited. Tr. at __ (Meredith Redirect). While that certainly is the case, it does not address the issue of the authentication of the data used by Mr. Meredith because he did not testify that he had compared the data he used with the company's audit or even with the company's annual report. In fact, it appeared that Mr. Meredith was unfamiliar with the annual report. Tr. at __ (Meredith Direct cross-examination).

²⁸ Mr. Meredith noted that he had removed approximately \$95,000 from the "Total Customer Services" accounts, but that change would merely increase the difference between the two accounts. Tr. at __ (Meredith Direct cross-examination). It also is noteworthy that Mr. Meredith would make such a significant adjustment without any documentation.

²⁹ Even where it appears that Mr. Meredith engaged in some independent analysis, it is not clear how and why he reached his conclusions. For instance, he testified that he had assumed that NDTC's customer service staff would be reduced from twelve to three, and that this would be the minimum staff necessary. Tr. at __ (Meredith Direct cross-examination). He did not explain, however, how he knew that there were twelve employees, how he knew how much employee time would be required or even how he knew what their salaries are.

The lack of independent analysis was confirmed by Mr. Meredith's inability to identify where certain types of costs would be found in the cost study or to explain what types of costs fell within many of the categories and USOA accounts included in the study. When asked during cross examination, for instance, Mr. Meredith could not say which accounts would contain the costs related to NDTC's web site and to its customer mailings, both of which would be treated as avoided costs.³⁰ He also could not say what types of costs fell within the product management, sales and product advertising categories, even though these particular categories all would be important elements in determining avoided costs.³¹ Similarly, Mr. Meredith was unable to identify what portion of the depreciation account was allocated to the company's fiber upgrade or to DSL service, which he said was not subject to resale.³² Given the limits of Mr. Meredith's knowledge, it was impossible to cross examine him on these issues and it also is impossible to confirm that NDTC properly allocated costs in these and nearly any other category. That makes it impossible to rely on the study itself.

The same problem affects the adjustments Mr. Meredith made to subtract costs related to unregulated services. While he testified that he had removed unregulated costs via the "Part 64 Adjustment" in his schedules, he also acknowledged that he did not know whether costs for unregulated services like voice mail and inside wire maintenance had been excluded from the study.³³ If these services were not excluded from the study, then the resale discount, even using NDTC's incorrect methodology, would be too low.

³⁰ Tr. at ____ (Meredith Direct cross-examination).

³¹ Tr. at ____ (Meredith Direct cross-examination). This is particularly significant because NDTC allocated \$0 to sales and product advertising. Meredith Direct, Schedule 2. This allocation is somewhat surprising considering that NDTC recently hired an account executive responsible for sales of various services, as acknowledged during the January hearing. Jan. 23 Tr. at 167 (Dircks).

³² Tr. at ____ (Meredith Direct cross-examination).

³³ Tr. at ____ (Meredith Direct cross-examination).

Moreover, even where Mr. Meredith did engage in his own analysis, much of it was faulty or unsupported. He assumed not just that NDTC would fire certain customer service employees, but that it would grant them eight weeks of severance pay.³⁴ He did not consider the possibility that NDTC would simply reassign the employees, which would avoid severance entirely (and would be likely in light of NDTC's plans to expand into video service) and he did not check with NDTC to see what its severance policies might be.³⁵ He also assumed that Midcontinent would make more than twice as many customer service inquiries, on a per line basis, as NDTC's current customers generate, without any apparent justification.³⁶ Similarly, he assumed that NDTC will incur costs to audit Midcontinent every year, even though NDTC is not required to audit Midcontinent at all.³⁷

While NDTC may incur some of what Mr. Meredith referred to as "cost onsets," – a cost category not even addressed by the *Local Competition Order* – NDTC's amortization period for those costs is unrealistic. Mr. Meredith assumed that resale would stop after two years, but in reality the Commission's order lifted the rural exemption for an unlimited period of time.³⁸ Consequently, it is wrong to use such a short amortization period. Even adding one year to the amortization schedule, without

³⁴ Meredith Direct, Schedule 7.

³⁵ Tr. at __ (Meredith Direct cross-examination). As Mr. Gates indicated, it also is inappropriate to consider severance costs in an avoided cost calculation because they are a consequence of competition, and competitors should not have to pay for competitive losses of the incumbent. Tr. at __ (Gates Direct).

³⁶ Mr. Meredith testified that NDTC receives about 30,000 inquiries per year for its 18,000 lines, which is something less than two inquiries per line, but that he assumed that Midcontinent would generate four inquiries per line per year. Tr. at __ (Meredith Direct cross-examination). Of course, it is likely that Midcontinent would generate fewer, not more, inquiries on a per-line basis, because many of the inquiries received by NDTC from its retail customers would be handled by Midcontinent.

³⁷ Tr. at __ (Meredith Direct cross-examination). It is unclear that these costs should be included as "onsets" under any circumstances, as they are not costs of offering resale, but costs of enforcing NDTC's rights.

³⁸ Tr. at __ (Meredith Direct cross-examination).

any adjustment to eliminate severance pay or for “recurring onsets” that are too high, reduces the total onsets by nearly \$20,000, or about 17 percent.

Mr. Meredith’s treatment of order processing costs also was incorrect. He assumed that these costs would not be avoided at the same level assumed by the FCC because NDTC would incur manual processing costs.³⁹ However, the parties’ proposed interconnection agreement specifically calls for Midcontinent to pay order processing fees, so any costs incurred by NDTC to process Midcontinent orders will be recovered outside the resale rate.⁴⁰ That means that these costs essentially can be avoided at a 100 percent level, not the 76 percent level proposed by NDTC. The same is true of PIC change charges, which Midcontinent will pay in full.

Finally, one of the more significant errors in Mr. Meredith’s analysis was the exclusion of DSL service. He testified that he had excluded DSL from his avoided cost calculations because the resale agreement excludes it from the services to be purchased by Midcontinent.⁴¹ This conclusion is wrong for two different reasons. The first is that DSL is not excluded from the resale agreement. The agreement contains a specific list of excluded services, and DSL is not one of them.⁴² In other words, the premise that DSL would not be subject to resale is incorrect. Second, even if the agreement did exclude DSL from wholesale resale, it would be incorrect to exclude avoided costs relating to DSL because DSL is a service subject to resale under the FCC’s rules.⁴³ Since the

³⁹ Meredith Direct, Schedule 4.

⁴⁰ Exhibit R15 (“Proposed Interconnection Agreement”), Attachment 2, § 2.2.1.

⁴¹ Tr. at __ (Meredith Direct cross-examination).

⁴² Proposed Interconnection Agreement, Attachment 1.

⁴³ While the FCC placed some limits on resale of wholesale DSL offerings, it has maintained the obligation to offer DSL on a wholesale basis when it is offered as a retail telecommunications service. Deployment of Wireline Services Offering Advanced Telecommunications Capability, *Second Report and Order*, 14 FCC Rcd 19237 (1999). As Mr. Meredith testified, NDTC has opted under the FCC’s *Wireline Broadband Order* to treat DSL as a telecommunications service. Tr. at __ (Meredith Direct cross-examination).

calculation of the discount is premised on the notion that it covers avoided costs from all services subject to resale, excluding DSL unavoidably sets the discount too low.⁴⁴ In either case, the omission of DSL from Mr. Meredith's calculations is significant.

In sum, there are so many problems with the cost study and the data used to prepare it that it is plainly unsuitable to be used to calculate even an interim wholesale discount. Even if NDTC could address one or several of these concerns, the remaining problems still would be significant and render the study fatally flawed. Thus, the Commission cannot use the NDTC cost study as the basis to set the resale discount.

III. The Commission Should Either Adopt Midcontinent's Calculations or Set a Rate Based on the FCC's Interim Safe Harbor.

Given the myriad flaws in NDTC's analysis, the Commission has two realistic options in this proceeding. The first is adopt Midcontinent's calculations, which properly base the discount rate on a rational relationship between avoided costs and retail revenues subject to resale. The second is to select an interim discount rate within the safe harbor range of 17 to 25 percent in the FCC's rules.

A. Midcontinent's Calculations Provide an Appropriate Basis for Setting an Interim Discount Rate.

The Commission's first option is to use Midcontinent's calculations to set the interim discount rate. There are several advantages to this approach: Midcontinent's calculations are based on the requirements of the statute and the practices of other states; Midcontinent has corrected some of the specific errors in NDTC's calculations; and the

⁴⁴ It might be appropriate to exclude avoided costs associated with DSL if NDTC also had based its proposed discount rate on the revenues for services subject to resale (assuming that DSL had been excluded from resale by agreement of the parties, which is not the case). In that circumstance, excluding DSL from both the numerator and denominator of the fraction used to calculate the discount potentially would result in a more accurate calculation of the discount for other services. However, excluding DSL from the numerator (that is, avoided costs) and including it in the denominator necessarily results in a resale discount that is too low.

Midcontinent calculation is reasonable in light of other data available to the Commission. While adoption of the Midcontinent calculation would leave some of the flaws of the NDTC study in place, the result still would be much closer to the likely correct result than any other option. Thus, it would be reasonable to adopt Midcontinent's proposed 25.39 percent discount.⁴⁵

The first reason that the Commission should adopt Midcontinent's approach is that it makes an appropriate comparison between avoided costs and retail revenues subject to resale, consistent with the statute. As described above, the wording of Section 252(d)(3), the FCC's explication of that provision and the standard practices of other state commissions all are consistent with the Midcontinent approach.⁴⁶ The reason that other state commissions and carriers have concluded that they should divide avoided costs by retail revenues subject to resale is that this approach makes sense: The only costs that can be avoided by the incumbent LEC are those that relate to the services subject to resale, and so putting retail revenues subject to resale in the denominator of the discount fraction matches the avoided costs with the right services. Putting all costs (or all revenues) in the denominator, as NDTC's study does, would create a mismatch

⁴⁵ NDTC may argue in its brief that it was not afforded an adequate opportunity to review Midcontinent's proposal. This claim would be incorrect for three distinct reasons. First, NDTC was on notice that Midcontinent would be permitted to provide additional live direct testimony for the specific purpose of responding to NDTC's cost study, and NDTC was given the right to present live rebuttal testimony in response to any additional direct testimony. This is documented in the revised prehearing order. Amended Prehearing Order, Case No. PU-05-541, dated June 27, 2006. Second, NDTC had an opportunity to cross-examine Mr. Gates on the proposal, which NDTC's counsel chose not to exercise, even after Midcontinent's counsel offered the opportunity for a recess to review the discount calculation. Tr. at _____. Third, it was evident from the rebuttal testimony that NDTC was aware of the central difference between the NDTC and Midcontinent approaches before the hearing (based on Mr. Gates's prefilled direct testimony) because Mr. Meredith's testimony on the issue of using expenses or revenues in the denominator of the discount calculation was made in response to the prefilled testimony of Mr. Gates, not the live direct testimony, and because he had a prepared exhibit showing the supposed "FCC formula" for calculating discount rates. Tr. at _____. (Meredith Rebuttal).

⁴⁶ See *supra* Part II(A).

between the two parts of the discount fraction.⁴⁷ As Mr. Meredith admitted, the trend in state proceedings is to use revenues subject to resale in the denominator.⁴⁸

In addition, the adjustments to the specific figures in the NDTC cost study that were provided by Midcontinent also were appropriate. As described above, NDTC failed to account for the service order charges that Midcontinent will pay and made unreasonable assumptions about severance pay.⁴⁹ As described by Mr. Gates, NDTC also improperly allocated costs associated with local order processing and PIC change charges and made a math error in the calculation of local order processing.⁵⁰

NDTC did not provide any meaningful reasons to reject Midcontinent's approach. Somewhat ironically, NDTC claimed during the hearing that Midcontinent should not have used NDTC's avoided cost calculation as the basis for the numerator of the equation because NDTC had included some avoided expenses related to interexchange service in the avoided cost calculation.⁵¹ There is no evidence for this claim in the schedules to NDTC's testimony, which do not describe any costs associated with NDTC's provision of interexchange service as included in avoided costs.⁵² Moreover, this claim is inconsistent with the affirmative statement in Mr. Meredith's prefilled direct testimony that his calculations were performed "in accordance with" FCC requirements.⁵³ If his calculations followed the FCC's guidelines, then presumably he did not include any costs

⁴⁷ Tr. at ____ (Meredith Direct cross-examination) (acknowledging that the denominator of the NDTC equation included costs associated with services not subject to resale).

⁴⁸ Tr. at ____ (Meredith Rebuttal cross-examination).

⁴⁹ See *supra* Part II(C).

⁵⁰ Tr. at ____ (Gates Direct), Exhibit P19 at 2, lines 12 & 13. Mr. Meredith argued on rebuttal that the discrepancy in the local order processing category was because he had subtracted \$95,000 category, but he never explained why he had done so, and there is no explanation in any of the schedules attached to his prefilled testimony. Tr. at ____ (Meredith Rebuttal).

⁵¹ Tr. at ____ (Meredith Rebuttal).

⁵² See Meredith Direct, Schedules 2 to 4.

⁵³ *Id.* at 2.

of services that were not subject to wholesale resale in his calculation of avoidable costs.⁵⁴ In any event, NDTC should not be permitted to impeach its own calculations.

When Midcontinent's adjustments are made and the correct methodology is applied, the calculations show that the correct discount rate is 25.39 percent.⁵⁵ The reasonableness of this rate can be confirmed in several ways. For instance, as Mr. Gates testified, a similar calculation that is based on the expenses associated with the services subject to resale (rather than revenues), yields a discount rate of 28.6 percent.⁵⁶ In addition, the rate is very close to the high end of the interim range approved by the FCC in the *Local Competition Order*. Since, as Mr. Gates testified, you would expect higher discounts from smaller carriers because of the greater efficiencies of larger carriers, it is unsurprising that the NDTC discount would be at or near the top of the FCC range.⁵⁷ Consequently, the Commission can be confident that an interim discount calculated using Midcontinent's method will be reasonable.

B. The Commission Could Reasonably Conclude that It Should Adopt an Interim Rate Based on the FCC's Safe Harbor.

Although the evidence is sufficient for the Commission to adopt Midcontinent's proposal for an interim discount, the Commission also has the alternative of adopting a rate within the FCC's safe harbor. As described at the hearing, the FCC's rules specify when the interim rates may be used and the specific range of rates that would be acceptable:

- (a) If a state commission cannot, based on the evidence available to it, establish a wholesale rate using the methodology prescribed in § 51.609,

⁵⁴ Of course, if he did, then there is an additional reason to conclude that NDTC's cost study is inadequate.

⁵⁵ Exhibit P19 at 1.

⁵⁶ Tr. at ____ (Gates Direct).

⁵⁷ Gates Direct at 7.

then the state commission may elect to establish an interim wholesale rate as described in paragraph (b) of this section.

(b) The state commission may establish interim wholesale rates that are at least 17 percent, and no more than 25 percent, below the incumbent LEC's existing retail rates, and shall articulate the basis for selecting a particular discount rate. The same discount percentage rate shall be used to establish interim wholesale rates for each telecommunications service.⁵⁸

The Commission could reasonably conclude that the criteria for using the safe harbor range in Section 51.611 have been met. In particular, NDTC's failure to provide a coherent, properly supported cost study is a sufficient basis for adopting a rate from the safe harbor range. This is true both because NDTC adopted an incorrect methodology and because of the other flaws described above.

Further, there is other evidence that supports use of the safe harbor range. For instance, Midcontinent's proposal is just above the safe harbor range, and is based on an appropriate methodology for calculating discounts. If, contrary to the evidence, the Commission wished to give some weight to NDTC's calculations, the average of the NDTC and Midcontinent rates is 17.38 percent, which is within the safe harbor range.⁵⁹

While NDTC might argue that the FCC's safe harbor range is too high, there is significant evidence that it is reasonable. In particular, Missouri Valley's agreement to use the Qwest discount rate shows that a discount of 16.15 percent is reasonable for a rural telephone company in North Dakota.⁶⁰

Use of the safe harbor also is consistent with the arbitrator's decision in the 1997 Qwest arbitration. That proceeding adopted a 16.15 percent rate, which later was ratified

⁵⁸ 47 C.F.R. § 51.611(a), (b).

⁵⁹ Alternatively, combining Midcontinent's analysis of a rate based on the expenses associated with resold services with NDTC's proposal, the average would be 18.98 percent, also within the safe harbor range.

⁶⁰ Contrary to NDTC's speculation, Missouri Valley was not compelled to adopt the Qwest rate. As the Commission's own files reflect, the Midcontinent-Missouri Valley agreement was entirely voluntary. If Missouri Valley had felt the rate was too high, it would have insisted on a lower rate or not entered into the agreement. It also should be noted that the agreement was negotiated after Missouri Valley separated from Qwest, so this agreement did not represent an adoption of the existing Qwest agreement.

by the Commission. Significantly, the rate issue was litigated vigorously and decided based on specific evidence as to the appropriate discount to be adopted.⁶¹ While the parties later entered into a stipulated agreement, the discount rate was consistent with the litigated result. Thus, if the Commission cannot conclude that it should adopt the Midcontinent proposal, it can adopt a rate from the FCC's safe harbor range and be confident that the rate is reasonable.

NDTC may argue that, to the extent there is any doubt about the interim rate, it should be set at the lowest reasonable number to avoid potential injury to NDTC. There is no merit to that argument. First, the true up (which, as shown below, is not in dispute) ensures that NDTC would recover any revenue that it should have received if the discount were later determined to be too high. Second, as shown in Mr. Fischer's testimony in the earlier phase of this proceeding, NDTC will not be materially harmed by resale even under the most optimistic assumptions about Midcontinent's ability to gain market share.⁶² Third, given the myriad methodological and other errors in NDTC's cost study, all of which had the consequence of lowering the proposed discount rate, it is unlikely that the correct discount rate is nearly as low as NDTC has proposed. Fourth, the argument for a low rate ignores the Congressional intent to promote the development of competition, which must be weighed heavily against any small harm that NDTC could demonstrate.⁶³ Thus, the Commission should not hesitate to adopt a discount rate that is supported by the evidence.

⁶¹ AT&T of the Midwest, Inc., Interconnection Arbitration Application, Case No. PU-453-96-497, Arbitrator's Decision (Mar. 19, 1997).

⁶² Mr. Fischer's testimony established that, with a discount rate of 16.15 percent and 30 percent penetration by Midcontinent, NDTC's total profits would drop by \$7,031, which is less than four tenths of one percent of its 2005 profits. Exhibit P5, Prefiled Direct Testimony of Warren R. Fischer, at 18. Even at a 25 percent discount rate, NDTC's profits would decline only by about \$11,000.

⁶³

IV. There Is No Dispute Concerning the Appropriate Mechanism for a True Up to the Final Discount Rate.

The other issue in this proceeding is how to implement a true up from the interim discount rate the Commission will adopt now to the final discount rate, whether that rate is negotiated between the parties or determined by the Commission. There is no dispute between the parties as to how that calculation should be made.

In his direct testimony, Mr. Meredith proposed a formula for calculating the true up.⁶⁴ This formula essentially calculates the amount that should have been paid under the final discount and compares it to the amount paid under the interim discount. Under NDTC's proposal, if Midcontinent pays more than would have been required by the final discount, it will receive a refund from NDTC; if the final discount is lower than the interim discount, Midcontinent will make an additional payment to NDTC. Mr. Meredith further proposed that any payment should be made within 30 days of the date when the Commission establishes a final discount rate. Midcontinent offered an exhibit during the hearing showing an example of how Mr. Meredith's formula would work, and he agreed that the example was correct.⁶⁵

Based on the testimony and Mr. Meredith's statements concerning the operation of the true up formula, Midcontinent agrees that NDTC has proposed an appropriate true up mechanism. Consequently, it urges the Commission to adopt the NDTC proposal as set forth in the testimony and described in the hearing.

V. Conclusion.

For all these reasons, the Commission should adopt an order consistent with Midcontinent's proposals in this proceeding.

⁶⁴ Meredith Direct at 3-4.

⁶⁵ Exhibit P17; Tr. at __ (Meredith Direct cross-examination).

Respectfully submitted,

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