

**IN THE UNITED STATES DISTRICT COURT FOR THE
WESTERN DISTRICT OF MISSOURI
CENTRAL DIVISION**

SOUTHWESTERN BELL TELEPHONE,)	
L.P., d/b/a SBC MISSOURI,)	
)	
Plaintiff,)	
)	
v.)	Case No. 03-04148-CV-C-NKL
)	
MISSOURI PUBLIC SERVICE)	
COMMISSION, et al.,)	
)	
Defendants.)	

ORDER

This is an appeal of a proceeding in which the Missouri Public Service Commission (“MPSC”) determined the rates at which Plaintiff Southwestern Bell Telephone (“SBC”) must offer components of its telephone network known as “unbundled network elements” (“UNEs”) to competing telecommunications carriers in Missouri. SBC has filed a Motion for Summary Judgment [Doc. 76] requesting the Court to review the MPSC’s determinations regarding (1) SBC’s capital structure; (2) SBC’s “fallout factor”; and (3) the cost of sixteen particular network elements. For the reasons stated below, the Court will grant SBC’s motion with respect to the MPSC’s

capital structure determination, but will deny the motion as to the MPSC's other determinations.¹

I. Standard and Scope of Review

47 U.S.C. § 252(e)(6) provides for judicial review of the MPSC's determination. Because that statute provides for district court review without setting forth a specific standard applicable of review, the appeal is confined to the administrative record compiled by the MPSC. *Guar. Sav. & Loan Ass'n v. Fed. Home Loan Bank Bd.*, 794 F.2d 1339, 1342 (8th Cir.1986) (quoting *United States v. Carlo Bianchi & Co.*, 373 U.S. 709, 715 (1963)); *accord GTE South Inc. v. Morrison*, 6 F. Supp.2d 517, 523 (E.D. Va. 1998) (reaching same conclusion in Telecommunications Act case).

In evaluating the record, the Court reviews the MPSC's findings of fact under the arbitrary and capricious standard. *See Guar. Sav. & Loan Ass'n*, 794 F.2d at 1343; *GTE South*, 6 F. Supp.2d at 523 (arbitrary and capricious standard should be used to review state commission decisions under Telecommunications Act); *US W. Communications, Inc. v. Hix*, 986 F. Supp. 13, 19 (D. Colo. 1997) (same). In applying the arbitrary and capricious standard, the Court must consider "whether the [MPSC's] decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." *Guar. Sav. & Loan Ass'n*, 794 F.2d at 1343 (quoting

¹The Court recognizes that as a practical matter, these disputes may be moot, given the recent ruling by the Court of Appeals for the D.C. Circuit. Because they are not legally moot, however, the Court will address the pending motions.

Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 416 (1971), *abrogated on different grounds, Califano v. Sanders*, 430 U.S. 99 (1977)). “Although this inquiry into the facts is to be searching and careful, the ultimate standard of review is a narrow one. [The Court is] not empowered to substitute [its] judgment for that of the agency. *Id.* at 1343. This highly deferential standard of review is especially appropriate when reviewing findings of fact made by agencies enforcing the Telecommunications Act, because the findings may be highly technical and specific to any idiosyncrasies in the incumbent carrier’s network.

In contrast, because the MPSC is a state agency, its interpretation of federal law is not entitled to deference, and its legal findings are subject to *de novo* review. *See Orthopaedic Hosp. v. Belshe*, 103 F.3d 1491, 1495 (9th Cir. 1997), (reviewing state agency interpretation of Medicaid Act *de novo*); *Amisub (PSL), Inc. v. State of Colo. Dep’t of Soc. Servs.*, 879 F.2d 789, 795-96 (10th Cir. 1989) (“The state agency’s determination of procedural and substantive compliance with federal law is not entitled to the deference afforded a federal agency.”).

II. Discussion

A. Capital Structure Determination

Under the Telecommunications Act of 1996, incumbent local exchange carriers (“LECs”) such as SBC may charge any requesting telecommunications carrier a “just and reasonable rate” for access to its unbundled network elements (“UNEs”). 47 U.S.C. § 252(d)(1). To determine what rates are just and reasonable, the FCC has adopted as

its standard “total element long-run incremental cost” (“TELRIC”). Under that standard, UNE prices are to be “based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC’s wire centers.” 47 CFR § 51.505(b)(1). As the FCC recently noted, TELRIC must be calculated within the context of a competitive market:

TELRIC is based on the assumption that competition would constrain the value of an incumbent LEC network and the price that could be charged for use of that network. In other words, the “cost” of the element . . . for purposes of section 252(d)(1) equals the price that an incumbent LEC would be able to charge for an element in a competitive market.

In re Review of the Commission's Rules Regarding the Pricing Of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers, 18 F.C.C.R. 18,945 ¶ 16 (Sept. 15, 2003).²

One of the three main cost components that constitute a network element’s TELRIC is the “risk-adjusted cost of capital.” *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 F.C.C. Rcd. 15499 ¶ 703 (Aug. 8, 1996) (*vacated in part on other grounds*, 124 F.3d 934 (8th Cir. 1997)).³ FCC regulations require that the TELRIC of a network element be calculated

²Hereinafter cited as “TELRIC NPRM.”

³The other components are operating expenses and depreciation cost. *Id.*

using a “forward-looking cost of capital.” 47 C.F.R. § 51.505(b)(2). The forward-looking cost of capital, much like the TELRIC of which it is a component, must be calculated within the context of a competitive market. As the FCC recently clarified, “in establishing a TELRIC-based cost of capital, state commissions must reflect the risk of participating in a market with facilities-based competition.” TELRIC NPRM ¶ 22 (citing *In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, 18 F.C.C. Rcd. 16,978, 17,396 ¶ 680 (Aug. 21, 2003) (*vacated in part on other grounds*, 359 F.3d 554 (D.C. Cir. 2004))).⁴ In other words, regulators “should adjust the cost of capital to reflect the risks faced by the incumbent as competition is introduced into its local market.” TELRIC NPRM ¶ 17. To this end, FCC regulations specify that “embedded costs,” defined as “costs the incumbent LEC incurred in the past and that are recorded in the incumbent LEC’s books of accounts,” “shall not be considered in a calculation of the forward-looking economic cost of an element.” 47 C.F.R. §51.505(d)(1).

To determine the cost of capital in the proceedings at issue, the MPSC calculated the weighted average of the cost of debt and the cost of equity.⁵ To make this calculation, SBC proposed that the MPSC use a 13% cost of equity and a 7.18% cost of debt, combined with a market value capital structure consisting of 86% equity and 14%

⁴Hereinafter cited as the “Triennial Review Order”.

⁵The calculation is (forward-looking cost of debt x percentage of debt in the capital structure) + (forward-looking cost of equity x percentage of equity in the capital structure).

debt. This would have resulted in a weighted average cost of capital of 12.19%.⁶ The MPSC adopted SBC's proposed 13% cost of equity, as well as the 7.18% cost of debt, but rejected SBC's proposed market value capital structure. Instead, the MPSC used SBC's historical capital structure as reported in SBC's books. Using this book value capital structure, which consisted of 46% debt and 54% equity, the MPSC determined that the appropriate cost of capital was 10.32%.⁷

SBC does not dispute the MPSC's general method of calculating the cost of capital. Rather, SBC argues that the MPSC erred when it used SBC's book value to predict the capital structure of a hypothetical LEC. The Court agrees. As discussed above, FCC regulations explicitly prohibit the consideration of embedded costs in calculating the forward-looking economic cost of an element. *See* 47 C.F.R. §51.505(d)(1). Instead, FCC regulations mandate that cost of capital calculations be made within the context of a competitive market environment.

The MPSC argues that it did not base its capital structure figures on historical book values for the reason that they were historical book values; rather, it selected that hypothetical capital structure because of its determination that the capital structure as reported in SBC's books better reflected the risks facing a hypothetical company. As

⁶ $(7.18\% \times 14\%) + (13\% \times 86\%) = 12.19\%$

⁷ $(7.18\% + 46\%) + (13\% \times 54\%) = 10.32\%$

the Joint Sponsors argue, the MPSC used SBC's book values only as a "starting point" for its ultimate cost of capital determination.

The Court finds no persuasive support for the contention that FCC regulations permit state commissions to use an incumbent LEC's book values even as a "starting point" for cost of capital determinations. Such an interpretation is foreclosed by the plain language of the regulations, which state simply that embedded costs "shall not be considered . . ." 47 C.F.R § 51.505(d)(1). The MPSC's interpretation is also foreclosed by the FCC's interpretation of its own regulations:

We conclude that our decision remains sound to base UNE prices on the forward-looking cost of providing UNEs. This approach is supported both by the Supreme Court's endorsement of our forward-looking cost methodology and its concerns regarding alternative pricing methodologies that rely *in whole or in part* on embedded costs.

TELRIC NPRM ¶ 37 (emphasis added).

Even assuming that FCC regulations permit state commissions to consider competitive book values as a "starting point," the record suggests that the MPSC did quite the opposite. The MPSC's Report and Order conclusively demonstrates that the MPSC failed to adjust SBC's book values to account for the risk a hypothetical company would face in a competitive market environment. Indeed, the MPSC considered a hypothetical company operating in a *monopolistic* environment rather than a competitive environment:

Staff's witness, Dr. Ben Johnson, testified that an appropriate capital structure for the hypothetical UNE wholesale provider could best be determined by using book value rather than market value for SBC's

equity. This has the advantage of measuring the value of the equity that has actually been invested in SBC's telephone network rather than more recent market fluctuations. *The use of a book value capital structure permits the approximation of a capital structure that more closely reflects the monopolistic wholesale provisioning of UNEs rather than the riskier business undertaken by telephone holding companies in the modern competitive environment.* Using this method, Johnson arrived at a 46 percent debt to 54 percent equity ratio.

The Commission concludes that the use of the 46 percent debt to 54 percent equity ratio advocated by Staff is appropriate. As indicated, any target capital structure that the Commission chooses to adopt will be hypothetical. There is no way to know exactly what a company providing only wholesale UNEs to CLECs would look like. *However, it is reasonable to believe that such a company, operating in a heavily regulated, virtually monopolistic environment, would look a lot like [SBC] would have looked before the coming of retail competition and the recent run-up of stock prices.* The hypothetical target capital structure advocated by Staff most closely approximates the capital structure of that hypothetical company and will be adopted.

MPSC August 6, 2002 Report and Order, pp. 68-69 (MPSC Tab 138) (emphasis added).

The MPSC's approach is at odds with the TELRIC methodology, which requires the consideration of market risk instead of the risk reported in an incumbent LEC's books. *See* TRO ¶ 680 (“[t]he objective of TELRIC is to establish a price that replicates the price that would exist in a market in which there is facilities-based competition. In this type of competitive market, all facilities-based carriers would face the risk of losing customers to other facilities-based carriers, and that risk should be reflected in TELRIC prices.”); *see also In the Matter of Petition of Worldcom, Inc. Pursuant to Section 252(E)(5) for Preemption of the Jurisdiction of the Virginia State Corp. Comm'n regarding Interconnection Disputes with Verizon Va. Inc.*, 18 F.C.C.R. 17,722 ¶ 63 (Aug. 29, 2003) (rejecting argument that cost of capital should be calculated

under the assumption that Verizon would remain the dominant carrier in the market, and noting that “a TELRIC-based cost of capital should reflect the same competitive assumptions that are used to determine network investment.”) (citing TRO at ¶¶ 680-682).

B. Fallout Factor

SBC utilizes an electronic ordering system to handle many of its UNE service orders (the LEX/EDI system). Due to limitations of the LEX/EDI system, the system initially rejects certain orders and humans must intervene to manually route the orders for processing. The percentage of service orders rejected by the LEX/EDI system is called the “fallout factor.” SBC claims that its current fallout factor is eight percent, although the MPSC believes the correct figure is in excess of forty-nine percent. Due to the need for human intervention, a system with a higher fallout factor is more costly to operate.

In determining what rates SBC could charge, the MPSC adopted a fallout factor of two percent. In doing so, the MPSC relied upon the fact that SBC has achieved a fallout factor of only one percent with its Easy Access Sales Environment (EASE) system, which handles SBC’s retail and resale orders. The MPSC reasoned that SBC could achieve a similar fallout factor by modifying its LEX/EDI system. The MPSC relied in part on the testimony of the Joint Sponsors’ expert, Steven Turner, who stated that current technology is capable of achieving a fallout factor of two percent:

The fallout rate that I have implemented in [SBC]'s cost studies that relate to system issues is two percent. As indicated earlier, some [Operational Support Systems] currently in place have fallout rates of one percent. It is my opinion that existing [Operational Support Systems], when operated and maintained efficiently as [SBC] currently is operating and maintaining its EASE system should experience fallout rates of that magnitude.

(Joint Sponsor Ex. 27 HC.)

SBC argues that the MPSC's fallout factor is erroneous because it assumes the existence of technology that is not currently available. SBC points out that its EASE system is available only for mass market services consisting of simple retail and resale service orders, and that the EASE system is currently not capable of being used for the more complex UNE orders at issue here.

However, under TELRIC, the cost of providing a UNE or service will often be "valued in terms of a piece of equipment an incumbent may not own." *Verizon Communications*, 535 U.S. at 501. The FCC has recently reiterated that "TELRIC assumes that the value of an incumbent LEC's network is constrained by the most efficient technology available, even if the incumbent LEC itself does not deploy, or plan to deploy, that technology." TRO at ¶ 670. Accordingly, a technology is not "unavailable" merely because SBC does not currently possess it.

Moreover, SBC's claim that current technology is incapable of handling complex orders is called into question by Turner's testimony that the banking industry currently utilizes technology to handle millions of cash orders per day throughout the world with a fallout factor of zero. This testimony implies that cash orders are sufficiently similar to

UNE orders that the technology used to handle the former could be adapted to handle the latter. Instead of attempting to cast doubt on this testimony or to explain how currently available technology could not be readily adapted to process UNE orders, SBC simply argues that the technology is currently not being used to handle UNE orders. For the reasons discussed above, that argument is irrelevant. Even if the technology used by the banking industry has not yet been utilized by incumbent LEC's, the MPSC reasonably concluded that such technology is currently available. Because SBC has not shown that the MPSC's factual findings were arbitrary or capricious, summary judgment will be denied as to this claim.

C. Zero Rated Elements

SBC proposed to the MPSC a non-recurring charge of \$0.16 for each of the sixteen network elements. Apparently, SBC based its proposed rate on a fallout factor well in excess of two percent. Assuming a fallout factor of two percent, the MPSC concluded that the cost of providing these elements was 4/10ths of a cent, which the MPSC rounded to zero.

As discussed above, the MPSC's decision to apply a fallout factor of two percent was reasonable. Consequently, SBC cannot challenge the 4/10ths of a cent rate on that basis. Nor can SBC challenge the MPSC's decision to round the rate down to zero. As the Joint Sponsors pointed out in their Suggestions in Opposition, SBC agreed to round the price down to zero after it was clear that the MPSC would apply a fallout factor of two percent. In its Reply, SBC did not attempt to respond to that assertion. Because

SBC consented to the rounding of the figure to zero, it cannot claim that the MPSC was unreasonable doing so.

III. Conclusion

Accordingly, it is hereby

ORDERED that SBC's Motion for Summary Judgment [Doc. 76] is GRANTED in part and denied in part. The motion is granted with respect to the MPSC's capital structure determination. The MPSC's capital structure determination is vacated. SBCs summary judgment is denied as to all other claims. The case is REMANDED to the MPSC for reconsideration of the appropriate capital structure and resulting rates.

s/ Nanette K. Laughrey
NANETTE K. LAUGHREY
United States District Judge

Dated: June 17, 2004
Jefferson City, Missouri