

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

PETITION OF HAMILTON COUNTY)	
TELEPHONE CO-OP <i>ET AL.</i> FOR ARBITRATION)	
UNDER THE TELECOMMUNICATIONS ACT TO)	
ESTABLISH TERMS AND CONDITIONS FOR)	Docket Nos. 05-0644-
RECIPROCAL COMPENSATION WITH)	05-0649;
VERIZON WIRELESS AND ITS CONSTITUENT)	05-0657
COMPANIES)	Consolidated

PETITIONERS' REPLY BRIEF ON EXCEPTIONS

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TABLE OF CONTENTS

- I. Introduction and Summary of Reply Exceptions.....1
- II. Staff Correctly Identifies The Forward-Looking Costs Of Petitioners,
But Fails To Advocate HAI Inputs That Would Reflect Those Costs.....6
 - A. Staff’s Proxy, If Corrected or Averaged, Constitutes A Reasonable Approximation
Of Petitioners’ Forward Looking Costs And Can Be Used To Set A Rate9
 - B. Staff’s Proxy Further Validates The Use Of HAI With Petitioners’ Proposed Inputs11
- III. The Elements of the PAD To Which Verizon Wireless Objects Are Supported
By Substantial Record Evidence And Do Not Need To Be Changed15
 - A. HAI Inputs16
 - 1. Input 1 - Plant Type16
 - 2. Input 4 - End Office Switching Investment17
 - 3. Input 5 - Tandem-Routed Fraction of InterLATA & IntraLATA Traffic19
 - 4. Input 12 - Central Office Expense Factors20
 - 5. Input 18- Switching and Transport Minutes of Use.....20
 - B. Exception No. 6 – Burden of Proof22
 - C. Exception 7. SS7 Network Costs.....24
 - D. Exception 8. ICC Authority to Set Proxy Rates25
- IV. Conclusion26

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Petitioners, Hamilton County Telephone Co-Op, LaHarpe Telephone Company, Inc., McDonough Telephone Cooperative, Inc., Mid-Century Telephone Cooperative, Inc., Marseilles Telephone Company, Metamora Telephone Company and Grafton Telephone Company hereby reply to the exceptions filed by Staff of the Illinois Commerce Commission (“Staff”) and Verizon Wireless.

I. Introduction and Summary of Reply Exceptions

This case represents the first time that the Commission has considered the issue of reciprocal compensation rates for small, rural telephone companies in Illinois. The only issue in this case is the proper reciprocal compensation to be paid to these small, rural telephone companies by a wireless carrier that seeks only transport and termination of its wireless traffic to the small telephone companies’ subscribers.¹ Verizon Wireless has not requested any Unbundled Network Elements (“UNE”) from the Petitioners, and neither Verizon Wireless nor any other carrier has sought to have the Petitioners’ automatic federal exemptions under

¹ As the term implies, reciprocal compensation will actually be owed by both parties for the transport and termination of traffic to each other. But, given the agreed imbalance of traffic (70% of all traffic between Verizon Wireless and each carrier will be from Verizon Wireless and only 30% will be from the carrier), net payments will be made only to the small rural carrier.

Section 251(f) of the federal Telecommunications Act of 1996 (“Federal Act”) withdrawn. Therefore there are no UNE rates at issue.

With the exceptions noted in Petitioners’ Brief on Exceptions (“BOE”)², the Administrative Law Judge’s (“ALJ”) Proposed Arbitration Decision (“PAD”) provides a reasonable framework for the Commission’s final Arbitration Decision on this case of first impression. The PAD provides analysis of the forward-looking cost model presented by Petitioners and recommends a finding that Petitioners have met their burden of proof in establishing that HAI version 5.0a (“HAI”) can produce “a reasonable approximation” of forward-looking costs. The PAD also provides an analysis of the evidence with respect to each Input to the HAI model that was raised or challenged in the case.

The PAD excludes one Petitioner, LaHarpe, from its finding that the Petitioners have met their burden of proof with the presentation of the HAI model and their evidence regarding certain HAI Inputs because its forward-looking costs, as estimated by HAI, are somewhat higher than the rest of the group. While Petitioners in their BOE have shown why the Commission should disregard the ALJ’s exclusion of LaHarpe from the Burden of Proof/HAI finding, the ALJ’s recommended exclusion of LaHarpe provided the opportunity for the PAD to address the Proxy Rate issue, including a legal analysis of the Commission’s authority to set proxy rates.

The PAD correctly concludes, based on the Federal Act and *Iowa Utils. Bd. v. FCC*³, that state commissions has the authority to establish default proxy rates within their discretion as an alternative to forward-looking economic costs or bill-and-keep. In short, *Iowa Utils. Bd.*

² Most notable Petitioners take exception to the PAD’s recommendation that the termination rate (i.e. switching) to be paid by Verizon Wireless be set at zero (\$0.00). Although Petitioners agree that HAI can provide a reasonable approximation of their forward-looking costs, Petitioners disagree that HAI accomplishes that result when it entirely excludes switching and provides a termination rate of **zero** (\$0.00).

³ 219 F.3d 744, 756-57 (8th Cir. 2000), *aff’d in part and rev’d in part* sub nom. *Verizon Communications v. FCC*, 535 U.S. 467 (2002).

vacated the FCC rules which established specific minimum and maximum proxy rates (47 C.F.R. §§51.513, 51.611 and 51.707), but did not vacate 47 C.F.R §51.705(a)(2), which established and continues to provide authority for state commissions to set rates on the basis of default proxies. This conclusion in the PAD is both correct and important if the Commission ultimately decides to adopt a modified form of Staff's recommendation to use the Petitioners' interstate access rates as a proxy for forward-looking costs.

Staff has identified two substantive exceptions to the PAD⁴. Staff takes exception to the use of the HAI model and argues that the Commission should set Petitioners' reciprocal compensation rates at default proxy rates equal to each Petitioner's interstate access rates, which Staff asserts are the best available indicator of Petitioners' forward-looking costs. In the alternative, if the HAI model is approved by the Commission, Staff takes exception to the ALJ's conclusion that the HAI Input referred to as "Input 13"⁵ should be set at zero percent (0%) which causes Petitioners' reciprocal compensation rate for termination of Verizon Wireless' traffic to be set at zero (\$0.00). Staff argues that 25% should be used for Input 13.

While Petitioners' agree with many of the underlying arguments advanced by Staff in support of their two substantive exceptions, Petitioners cannot accept Staff's ultimate conclusions. Petitioners agree that interstate access rates (when properly adjusted either by recognizing the settlement rates which the four average schedule Petitioners actually receive for interstate access or by averaging) are a good indicator of Petitioners' forward looking costs for transport and termination of Verizon Wireless' traffic. Petitioners also agree with Staff that the

⁴ Staff also identifies two additional clerical points. Petitioners have no objections to Staff's clerical corrections and would further note that, at page 3, the PAD mistakenly identifies December 30, 2005 as its circulation date, although it did not actually get circulated until January 3, 2006.

⁵ The input numbers result from the original order in which the changes were discussed in testimony and then in briefs. As discussed at length in the briefs, "Input 13" refers to the end office non-line port cost fraction and has the impact of setting the percentage of switching or termination costs that are usage sensitive and therefore recoverable as part of reciprocal compensation.

PAD improperly sets reciprocal compensation rates that are more than 50% below this indicator of Petitioners' forward-looking costs. Contrary to Staff's position though, Petitioners have shown that the Commission need not set rates based on default proxy rates because, when proper Inputs are used (including the 70% default value for Input 13), HAI produces "a reasonable approximation" of the forward-looking costs for each Petitioner. If the Commission declines to use the HAI model to set forward-looking rates for Petitioners, Petitioners have shown that the existing interstate access rates for the average schedule Petitioners (rates set by NECA based on national averages) must be adjusted to reflect the network characteristics of those Petitioners that cause them to receive balancing payments from the average schedule pool.

Petitioners agree with Staff that the FCC clearly intended for recovery of some end office switching costs in reciprocal compensation rates, and that an adjustment to the HAI default value for Input 13 that results in a *zero* (\$0.00) termination rate is improper. Petitioners also agree with Staff that this Commission previous Order in the SBC UNE case (ICC Docket 00-0700) and the 8th Circuit United States Court of Appeals case regarding Qwest's reciprocal compensation and UNE port rate structure in Minnesota, *Ace Telephone Ass'n v. Koppendrayner*, 2005 U.S.App. LEXIS 2885 (December 29, 2005), do not control this case and neither support nor require the Commission to deprive the Petitioners of recovery of a portion of their switching costs for Verizon Wireless' termination of traffic on their network. Differing from Staff's position, however, Petitioners have shown that the HAI default input of 70%, not 25%, is the appropriate traffic sensitive factor to use in the model to set termination rates.

The error in Staff's reduced switching input is demonstrated by the internal contradiction of Staff's two exceptions. Staff properly criticizes the PAD for setting rates that are more than 50% below Petitioners' interstate access rates, but then supports an adjustment to the HAI

default value for Input 13 that results in rates that are likewise 50% or more below the access rates, which are Staff's own best estimate of Petitioners' forward-looking costs. Those rates are substantially lower for a single demonstrable reason: Staff has chosen to change Input 13 (the end office non-line port cost fraction that establishes the percentage of termination costs that are usage sensitive and therefore recoverable through reciprocal compensation) from 0.7 to 0.25, and by so doing, to reduce to 25% the modeled percentage of usage-sensitive switch costs from the 70% value used as the HAI default and relied upon by the FCC in setting forward-looking switching costs in its MAG Order. If -- consistent with not only the default HAI rate and FCC action, but also the record evidence provided by Petitioners -- switching costs are treated as 70% usage-sensitive, the discrepancy in Staff's position evaporates and the entire record points to a relatively uniform set of forward-looking rates.

Verizon Wireless has identified eight separate exceptions to the PAD. Five of these exceptions relate to the ALJ's conclusions with respect to individual Inputs to the HAI model. For three of these items, Verizon Wireless argues that the PAD's acceptance of the Petitioners' position is improper based upon its characterization of Petitioners' evidence as being based on "embedded costs." On the last of these, Verizon Wireless has agreed to the use of the model with the default minutes of use that are contained therein, but it is nonetheless requesting that the Commission make a statement in the Order that costs are overstated and enter a declaratory ruling that requires small, rural carriers to update the minutes of use figures in any future arbitration. Another exception by Verizon Wireless based on the same argument is that Petitioners did not meet their burden of proof. Verizon Wireless also takes exception to the PAD's recommended finding that SS7 charges are appropriate arguing in essence that it must also pay for this function from other carriers whose networks are traversed by its traffic. Finally,

Verizon Wireless takes exception to the ALJ's conclusion that the Commission has the authority to set default proxy rates for reciprocal compensation in its discretion.

Not surprisingly, Verizon Wireless quibbles with the PAD to advocate pushing the rates down as low as it can get them and attempts to prevent the Commission from exercising its discretion to set *any* proxy rate. Cynically, Verizon Wireless suggests that the Commission use HAI to establish the lowest possible binding rates while further suggesting the Commission hold that Petitioners have not proven that HAI can even be used for this purpose. In an abrupt about-face, Verizon Wireless also suggest that the Commission set a rate for LaHarpe based on the average of Verizon Wireless' preferred HAI rates for the other six Petitioners, despite its adamant testimony that averages are contrary to the Federal Act.

Verizon Wireless' apparent goal is to undercut the bargaining position of small rural LECs like Petitioners, to keep such LECs from making any use of the Federal Act and FCC rules in their reciprocal compensation negotiations and to make an example of any such LECs that try to assert their rights. For the most part, the PAD avoided this unnecessary, unreasonable and extreme trap and, contrary to Verizon Wireless' exceptions, the PAD should not now be amended to fall into that trap. The PAD must, however, recognize and rectify the inconsistency of Staff's two positions by directing the parties to use the 0.7 default input for the end office non-line port cost fraction (Input #13) and establishing a rate that is the best available approximation of the Petitioners' forward-looking costs to transport and terminate the calls originated by Verizon Wireless.

II. Staff Correctly Identifies The Forward-Looking Costs Of Petitioners, But Fails To Advocate HAI Inputs That Would Reflect Those Costs

Throughout this process, Staff has advanced three core points -- none disputed. First, for Petitioners, the network architecture of terminating local wireless calls under a reciprocal

compensation regime is the same as for terminating long distance calls under an access regime. Second, the current federal access charge rate regime requires the same pricing elements as the reciprocal compensation regime and limits those elements to usage-sensitive costs, again like reciprocal compensation. And, third, while it is widely assumed that, for Tier 1 LECs (like SBC), operations will become substantially more efficient and therefore make forward-looking costs cheaper than historical costs, there is no basis to make a similar assumption about the operations for small, rural LECs like Petitioners and, in fact, the opposite may be true. Based on these observations, all of which Petitioners agree with and none of which Verizon Wireless has seriously disputed, Staff concludes that access rates are the closest available reasonable approximation of Petitioners' forward-looking costs.⁶ In deference to the fact that access rates rely directly on historical costs and to the FCC's requirement that forward-looking costs not rely on historic costs, Staff suggests that the Commission use these access rates as a proxy rather than as a model. The FCC's rules clearly provide for proxies as an alternative to a model. 47 C.F.R. § 51.705(a).

Consistent with its position, Staff's primary complaint about the PAD is that it sets rates that are less than half the forward-looking costs. According to Staff (Staff BOE at 5):

The PAD appears to justify use of the HAI model by comparing the forward-looking rates generated by the model using the Petitioners' recommended input values with the existing FCC approved interstate access rates – the default proxy recommended by Staff. PAD at 43. According to the PAD, the Petitioners' recommended adjustments to the HAI model produce rates that roughly match what each Petitioner actually collects for interstate access. The Commission then makes a leap of faith by concluding that the model, with further adjustments, can therefore be used to establish reasonable forward looking costs for each Petitioner. Unfortunately, this deduction is based on faulty logic. Such faulty

⁶ Petitioners also agree with this conclusion subject to recognition that part of the "rate" for the four average schedule Petitioners comes not directly through the access rate, but from the NECA pooling mechanism used to recognize company-specific cost differences.

logic leads to Commission approved input values to the HAI model that produce reciprocal compensation rates that are more than 50% below the existing interstate access rates. The record in this proceeding does not support such a finding. As Dr. Staranczak explained there is no reason to believe that forward looking transport costs for small companies are less than historical costs. Dr. Staranczak's testimony was not challenged by any other party to this proceeding and consequently the Commission cannot endorse use of a model that, for small companies, estimates forward looking transport costs to be 50% below historical costs.

Staff also states (Staff BOE at 7):

Terminating a local call is architecturally the same as terminating an interstate call. Therefore the costs of terminating a local call should be similar to the costs of terminating an interstate call.

FCC rules require that reciprocal compensation rates utilizing a cost study be based on forward looking costs. However, there is no FCC requirement that a default proxy be based on forward looking costs. Further, although interstate access rates are based on historical costs, as Staff explained, there is no *a priori* reason that forward looking costs should be lower than historical costs for small companies because technological change disproportionately favors large companies. PAD at 42-43. Staff's reasoning was not challenged by any party to this proceeding. Nevertheless, the PAD implicitly elected to adopt reciprocal compensation rates that are more than 50% below the existing interstate access rates, a decision that is not supported by Staff's unrebutted testimony in this proceeding.

In short, Staff recognizes that Petitioners' interstate access rates are a reasonable approximation (in fact, in Staff's view, the best reasonable approximation) of Petitioners costs of transport and termination. Establishing any rate that does not comport with those costs would be an improper result.

Moreover, Staff correctly distinguishes Verizon Wireless' claims that Staff's proxy is blocked by the longstanding FCC bar to setting forward-looking rates on the basis of historic costs or charging access for the termination of local traffic. In the first instance, as Staff explained, the FCC rules clearly provide alternatives: one is to model forward-looking costs and

the other is to establish a proxy. If the prohibition on the reliance on historic costs extended, as Verizon Wireless argues, to the proxy approach, the proxy would not be an “alternative” and the FCC never would have established the proxy or left it standing after the FCC withdrew its rules purporting to set the proxy rates. *See Iowa Utils. Bd.*, 219 F.3d at 756 (noting the FCC’s decision to disavow the proxy prices in order to support its position that it was not trying to set specific prices, but rather was merely designing a pricing methodology). In the second instance, the Commission is not proposing to allow Petitioners to charge Verizon Wireless for local traffic out of any access tariff,⁷ but to establish in the context of an arbitration a rate that is a reasonable approximation of Petitioners costs to transport and terminate traffic.

A. Staff’s Proxy, If Corrected or Averaged, Constitutes A Reasonable Approximation Of Petitioners’ Forward-Looking Costs And Can Be Used To Set A Rate

Petitioners agree that Staff’s arguments are unrebutted but for one point. As explained in Petitioners’ post-hearing Brief (at 61-66), the only flaw in Staff’s proxy rates is that they do not reflect the fact that four of the Petitioners are average schedule companies. As average schedule companies, only part of what they are entitled to recover for interstate access comes directly from their access rates. Alternatively, Staff’s idea to use the interstate access rates could be the basis for an appropriate proxy if a single proxy rate were set for all Petitioners equal to the average interstate access rate in order to factor out the highs and the lows much like the Commission did in its Second Interim Order in the Universal Service case. ICC Docket Nos. 00-0233/00-0335.

⁷ In this regard, this case is entirely different from the recent decision of the Missouri Supreme Court in *Alma Telephone Co. v. Public Service Commission*, SC86529 (Mo. S. Ct. Jan. 10, 2005). There, the Missouri Supreme Court affirmed the action of the Missouri Public Service Commission, which correctly refused to allow carriers to amend their access tariffs to include the termination of local wireless calls without the benefit of negotiating or arbitrating reciprocal compensation agreements with the affected wireless carriers.

In response to Staff's interstate access proxy proposal, Petitioners proposed a single, reasonable modification; that the Commission establish a rate for the four average schedule Petitioners (Hamilton County, Marseilles, Metamora and Mid-Century) equal to their NECA 24-month average traffic-sensitive settlement per switched access minute. As explained in Petitioner Ex. 2, lines 795-848, the average schedule companies are participants in NECA's traffic-sensitive switched access pool and, accordingly, charge the tariffed rates established by NECA based on average cost characteristics for rural LECs throughout the country. However, as participants in a pooled process, the rates charged by these four Petitioners are not the rates actually received from the pool for settlement purposes. These companies report to NECA the amount of money received from IXC's using the NECA switched access rates and NECA then pays each company an amount equal to the difference between what they receive from the IXC's and the amount of money NECA has determined that the companies should receive in order to earn a reasonable rate of return based on NECA's average schedule formula. The fact that each of the four companies is a net recipient from the NECA pool reflects unique Illinois-specific cost characteristics not present in other states. Using the NECA interstate settlement rates instead of the NECA tariffed rate as the proxy would correct for the non-Illinois characteristics in the NECA rate and would be consistent with the methodologies used to set the proxy rate for the other three Petitioners that are cost companies under Staff's proposal. Schedule JPH-12 to Petitioners Ex. 2 shows revised interstate switched access rates for the four average schedule company Petitioners based on their actual settlement amounts.

For purposes of setting a proxy rate for local traffic, the Commission should consider the actual costs of providing service for similar types of service as shown by the settlement rate. The

settlement rates shown in Schedule JPH-12 to Petitioners Ex. 2 are a better proxy for the companies' costs than the tariffed rates shown in Schedule JPH-7 to Petitioners Ex. 1.

In the alternative, Staff's proposal to use NECA rates would also be a reasonable proxy if the average rate for all Petitioners is used, rather than individual company rates. Averaging is especially appropriate for proxy purposes. Averaging will eliminate any apparently aberrant high or low numbers produced by any model or method of calculation. The Commission previously recognized the benefits of averaging model results across a group of companies in setting proxy rates in its Second Interim Order in ICC Docket Nos. 00-0233/00-0335 consolidated. The use of the average also establishes a single proxy rate for the small rural telephone companies involved in this consolidated proceeding. Staff witness, Dr. Staranczak, himself, proposed a single rate as the "affordable rate" for all small rural telephone companies in Illinois in the Universal Service case.

If the Staff's proxy is corrected either by reflecting the NECA pool payments to the four average schedule Petitioners or by averaging the interstate access rates of all seven Petitioners, Staff has developed a wholly adequate means of establishing a "reasonable approximation" of Petitioners' forward-looking costs. If the Commission does not accept Petitioners' position on Input 13 so that Petitioners can recover a portion of their switching costs from Verizon Wireless' use of the switch, then the Commission should accept Staff's proposal to use the Petitioners' interstate access rates (with Petitioners' adjustments) as the reciprocal compensation rates for the Petitioners.

B. Staff's Proxy Further Validates The Use Of HAI With Petitioners' Proposed Inputs

Either as corrected or as averaged, Staff's proxy constitutes a reasonable approximation of Petitioners' forward looking costs and can be used by this Commission to set a rate. Staff,

however, steadfastly overlooks the obvious corollary to their determination that access represents a reasonable approximation of Petitioners' forward-looking costs, *i.e.*, that HAI with the inputs advocated by Petitioners, which render nearly identical rates, is also a reasonable approximation of Petitioners' forward-looking costs. The other corollary of Staff's determination is that its own HAI calculations result in a rate which is demonstrably too low. The only difference in the HAI rates that Petitioners advocate and those that Staff "advocates"⁸ is the percentage of switching that it deemed to be usage sensitive. In lieu of the default input of 0.7 (or 70%), Staff proposes an input of 0.25 (or 25%), which has the affect of substantially reducing rates modeled by HAI. Staff further proposes to give LaHarpe an "averaged" HAI rate based on Staff's conclusion that LaHarpe is an outlier (a conclusion with which Petitioners disagree as explained in their Brief on Exceptions at 26-28). The outlier here, however, is Staff's HAI rate. When compared against an average of Staff's own proposed proxy rates (\$0.024358) or against an average of Petitioners proposed HAI rates (\$0.028535) or against the HAI rates that result from using the PAD's proposed inputs, except for Input 13 (\$0.025936) it is the resulting average of Staff's HAI rate (\$0.015767⁹) that is out of sync.

⁸ Petitioners are cognizant that Staff is not affirmatively advocating the use of its HAI rate, but only providing an estimate in case the Commission, consistent with the PAD, decides to use HAI to set a rate.

⁹ Due to Staff's view that LaHarpe is an "outlier," Staff's average HAI rate excludes an individual rate for LaHarpe. Staff's proxy rate does not exclude LaHarpe.

The following table shows the individual company specific rates under various proposals:

	Company	Petitioner's HAI	PAD's HAI Inputs, but 70% for Input 13	Staff's post-PAD proposed HAI	Staff Interstate Access - Corrected*	PAD's HAI Inputs
Company Specific Rates	Grafton	\$0.02443	\$0.02303	\$0.014420	\$0.040350	\$0.00964
	Hamilton	\$0.02970	\$0.02719	\$0.020330	\$0.023293*	\$0.01652
	LaHarpe	\$0.04963	\$0.04288		\$0.039520	
	Marseilles	\$0.01730	\$0.01651	\$0.008090	\$0.016203*	\$0.00342
	McDonough	\$0.02774	\$0.02497	\$0.019490	\$0.027910	\$0.01645
	Metamora	\$0.02120	\$0.02003	\$0.011480	\$0.022958*	\$0.00673
	Mid-Century	\$0.02974	\$0.02694	\$0.020790	\$0.038225*	\$0.01738
	<i>Average all Petitioners</i>	\$0.028535	\$0.025936		\$0.029780	
	<i>Averages w/o LaHarpe</i>	\$0.024818	\$0.023117	\$0.015767		\$0.01169
	<i>Averages w/o LaHarpe, Marseilles & Metamora</i>	\$0.027903	\$0.025533	\$0.018759		\$0.014998

* These rates include the modifications reflected in JPH-12 to Petitioners Ex. 2 to the rates of the four average schedule Petitioners that draw from the NECA pool for the reasons discussed in Section V of Petitioner's Brief (at 61-66).

Staff's insistence on reducing the switching input below the default is not supported by the record evidence. First, as Staff recognizes in its Brief on Exceptions (at 10-11), this Commission's earlier decision in the SBC ULS case (Docket No. 00-0700) has no bearing on this case. As Staff notes (at 11):

In Staff's view, no findings in Docket 00-0700 are directly applicable to the question of whether local exchange carriers may recover a portion of its switching costs via reciprocal compensation rates. As such, no evidence needs to be presented to allow us to depart from that decision. As the parties to this proceeding agree, default values for inputs should be accepted where there is evidence to suggest that these values are not appropriate.

Likewise, Staff recognizes that the Eighth Circuit's recent decision in *Ace Telephone Ass'n v. Koppendraye*, 2005 U.S. App. LEXIS 2885 (December 29, 2005) has no bearing on the determination of the switching costs in this case.¹⁰ Therefore, Staff appears to agree with

¹⁰ A copy of the Eighth Circuit's slip opinion was provided to the Commission by Verizon Wireless. A copy of the same opinion as rendered by Westlaw was attached to Verizon Wireless' Brief on Exceptions.

Petitioners that the Commission is working from a blank slate in setting the appropriate input for switching.

Given this blank slate, the Commission could have expected Staff to revert to Mr. Koch's observation that, "[i]n the absence of evidence that suggests that a particular input is inappropriate, the default value of the model should generally be accepted." Staff Ex. 2, lines 300-06. Instead, staff states (at 11):

While the Docket 00-0700 finding does suggest that the default value for this input is too high, it does not preclude the recovery of these types of costs. As there is no evidence in the proceeding that would pinpoint what that exact input value might be, Staff's proposal is the most reasonable of the parties.

Ultimately, without record citation, Staff asserts that "any additional cost for terminating these calls will be substantially less than the default rate set by the HAI model as well as by Petitioners." Staff Brief on Exceptions at 12.

If, as Staff correctly observes, no evidence needs to be presented to allow the Commission to "depart" from the SBC ULS case, it makes no logical sense to rely on the evidence in that case, particularly given the total lack of commonality between the specific carriers at issue (SBC Illinois versus Petitioners), between the types of carriers (a Tier 1 carrier versus small, rural carriers) and the type of switch purchase at issue (the regular purchase of substantial amounts of switching equipment for high local loop volume use versus the occasional purchase of a single switch for a few thousand local loops). Moreover, Staff simply ignores without comment the evidence presented by Petitioners about Nortel's sworn statements.

Staff's position also ignores the actions of the FCC (discussed in Petitioners Brief on Exceptions at 18-20) in establishing 70% as the appropriate usage-sensitive measure for switching for large high-cost companies and, more importantly, for the very interstate access rates that Staff advocates as its proxy. Although Staff relies on the fact that "[n]on-traffic

sensitive costs were driven out of interstate termination rates during the MAG proceeding” (Staff Ex. 1, lines 279-80), Staff’s conclusion that the elements of interstate access are identical to the elements of reciprocal compensation puts its position on HAI in conflict with its position on the establishment of proxies. In other words, Staff’s proposed proxy rates are based on rates developed using a 70% usage-sensitive switch assumption, yet Staff proposes an input value of 25% for HAI rate development purposes even though Staff acknowledges that the facilities used to terminate wireless calls will be the same as those used to terminate interstate access calls.

In short, while the Commission is acting on a clean slate, it is not acting in an evidentiary void. Not only has no party introduced any probative evidence that would call the HAI default input into question, Petitioners have put on substantial evidence that at least 70% of their switching costs are usage-sensitive, and the FCC has repeatedly concluded that it is appropriate to use 70% as the usage-sensitive input for switching. Moreover, reinserting the 0.7 switching input in Staff’s model makes the resulting HAI rates fully consistent with the proxy rates that Staff has testified are its closest estimate of the forward-looking costs of Petitioners.

Ultimately, the best available record evidence, as agreed by Staff and Petitioners, is that interstate access reasonably approximates Petitioners’ forward-looking costs. The Commission can use a proxy to set those rates (as corrected) directly or can use them as a sanity check to determine whether HAI is producing a reasonable estimate, but it would be an error to use HAI to set rates that were not even half of access.

III. The Elements of the PAD To Which Verizon Wireless Objects Are Supported By Substantial Record Evidence And Do Not Need To Be Changed

Verizon Wireless has identified eight separate exceptions to the PAD. Five of these exceptions relate to the ALJ’s conclusions with respect to individual Inputs to the HAI model. For each of these items, except one, Verizon Wireless argues that the PAD’s acceptance of the

Petitioners' position is improper based upon its characterization of Petitioners' evidence as being based on "embedded costs." On the last of these, Verizon Wireless has agreed to the use of the model with the default minutes of use that are contained therein, but it is nonetheless requesting that the Commission enter a declaratory ruling that requires small, rural carriers to update the minutes of use figures in any future arbitration. Another exception by Verizon Wireless based on the same argument is that Petitioners did not meet their burden of proof. Verizon Wireless also takes exception to the PAD's recommended finding that SS7 charges are appropriate arguing in essence that it must also pay for this function from other carriers whose networks are traversed by its traffic. Finally, Verizon Wireless takes exception to the ALJ's conclusion that the Commission has the authority to set default proxy rates for reciprocal compensation in its discretion.

A. HAI Inputs

1. Input 1 - Plant Type

Verizon Wireless challenges the ALJ's conclusion in the PAD that Petitioners' practices with respect to the placement of distribution plant, feeder plant and interoffice plant as buried or underground, rather than aerial, reflect an efficient network configuration. Verizon Wireless characterizes the Petitioners' decisions on how to configure their networks as an "embedded cost." Petitioners' expert, Mr. Hendricks, provided opinion testimony that the Petitioners' decisions on how to configure their networks was based on a number of factors related to geography, weather and cost of construction. He also presented Schedule JPH-15 to Petitioners Ex. 2 to show what the Petitioners' current practices are with respect to such network configuration. Verizon Wireless did not refute this evidence.

Contrary to the assertions by Verizon Wireless in its BOE, "buried plant" is not the most expensive of the plant type options, "underground plant" (which is cabling placed in conduit or

other protective structures) is the most expensive. Petitioners have assumed a very small amount of underground plant (10% in only the 5th and 6th zones). The ALJ's conclusion in the PAD that buried plant is the most efficient is supported by the fact that Petitioner's proposed rates are lower than what they would be had default plant type assumptions been used.

The fact that these plant type practices are actually being utilized by the Petitioners does not make them "embedded costs." The evidence presented by the Petitioners supports the inference set forth in the PAD that Petitioners have selected the lowest cost network configuration, given the existing location of the their wire centers as required by 47 C.F.R. § 51.505(b)(1).

Petitioners have met their burden of proof and established a *prima facie* case supporting the use of the input adjustment to the HAI model for aerial, buried and underground plant based on Illinois specific factors related to geography, weather, and cost of construction and showing that Petitioners' inputs for this item are reasonable and forward looking. Thus, the burden to rebut Petitioners' *prima facie* showing on this input adjustment shifted to Verizon Wireless. *City of Chicago*, 133 Ill. App. 3d at 443. Verizon Wireless did not meet its burden of showing that the costs incurred by the Petitioners relative to this input adjustment are unreasonable because of inefficiency or bad faith. *Id.* Verizon Wireless also did not rebut the legal presumption of reasonableness on the part of the utility's management. *Id.* Verizon Wireless attempted to make their case through result-oriented analysis and general objections, not credible evidence. If parties are of the opinion that these costs are not reasonable, they must prove it, not simply raise questions and concerns. *See City of Chicago*, 133 Ill. App. 3d at 442-43.

2. Input 4 - End Office Switching Investment

Verizon Wireless challenges the ALJ's conclusion in the PAD that the default input value in the HAI model for this Input does not accurately reflect an appropriate forward looking switch

investment figure for the Petitioners. Verizon Wireless characterizes the Petitioners' switch investment figures as being based on "embedded costs." The evidence in the record clearly shows that Petitioners did not use their embedded costs to set their proposed forward looking cost value for this Input. Petitioners compared their proposed Input value to actual 2004 financial data for the companies, and Schedule JPH-17 to Petitioners Ex. 2 shows that the Petitioners proposed \$658.25 switching input value produces an assumed switching investment value for the Petitioners that are 58.23% of the Petitioners' 2004 actual switching investment.

Petitioners' expert, Mr. Hendricks, provided opinion testimony that the switches being used by the Petitioners are a forward-looking technology and that Petitioners' actual switch investments reflect the maximum switching cost efficiencies because switch vendors provide switch upgrades at steep discounts to existing customers relative to what a new customer could obtain by purchasing a stand-alone switch at the current software release level contained in the existing customers networks. Verizon Wireless did not refute this evidence.

Despite the fact that the Petitioners' actual switch investments reflect maximum switching cost efficiency and forward looking technology, Petitioners proposed Input value produces additional efficiencies. Mr. Hendricks presented opinion testimony that the default Input value proposed by Verizon Wireless is inappropriate because it would produce a switching investment for the Petitioners that is 47.62% of the current actual switch investment and that such efficiency gains are unachievable even in the most aggressive forward-looking scenario. Verizon Wireless did not refute this evidence.

The fact that Petitioners' proposed Input value for switching investment was compared to actual switching investment does not mean that the Input value was improperly based on "embedded costs." The evidence presented by the Petitioners supports the conclusion in the

PAD that the default input value in the HAI model for this Input does not accurately reflect an appropriate forward-looking switch investment figure for the Petitioners and that Petitioners' Input value should be adopted.

Verizon Wireless' proposed replacement language for the PAD on this Input item purports to find support in the record showing that one of the Petitioners, McDonough, has a per line switch investment of \$276. Verizon Wireless' \$276 for McDonough is the result of incorrect mathematics and is very misleading. Specifically, it is improper to divide actual switch investment by access lines and compare the resulting number to the proposed per line switching investment input figure because switching costs in HAI are derived from two key investment input values – Schedule JPH-2 to Petitioners Ex. 1, p. 40. The other key switch investment input value is the slope term value of -14.922, which reduces the calculated switch investment. When accounting for how the model actually models switch investment, the proper comparison is that provided in Schedule JPH-17 to Exhibit 2, which shows that the modeled switch investment for McDonough using the Petitioners proposed inputs is \$1,289,386, a figure that is very close to actual investment of \$1,202,064. (Verizon Wireless' erroneous calculations would generate a model number of \$2,866,679.) Moreover, while Verizon Wireless mentions only McDonough (no doubt because McDonough is the only Petitioner with modeled switch investment higher, albeit slightly higher, than actual), the rest of the Petitioners have modeled switch investment very much lower than actual. *See* JPH-17 to Petitioner Ex. 2.

3. Input 5 - Tandem-Routed Fraction of InterLATA & IntraLATA Traffic

Verizon Wireless challenges the ALJ's conclusion in the PAD that a 90% input value for this item more accurately reflects the Petitioners' traffic patterns. Verizon Wireless asserts that it would be reasonable to assume that all interLATA and intraLATA calls would be routed to a third-party tandem in a forward-looking network design and argues for a 100% input value.

Petitioners assumed that only 90% of such traffic would be routed to the tandem, which has the result of reducing its estimated forward looking costs relative to Verizon Wireless' proposal. The ALJ's conclusion in the PAD is reasonable and need not be changed.

4. Input 12 - Central Office Expense Factors

Verizon Wireless challenges the ALJ's conclusion in the PAD that the most appropriate value to use for this Input is the one proposed by the Petitioners. Verizon Wireless characterizes the Petitioners' proposed value as being based on "embedded costs." The evidence in the record clearly shows that Petitioners did not use their embedded costs to set their proposed forward looking cost value for this Input. Petitioners compared their proposed Input value to actual 2004 cost data for the companies, and Schedule JPH-18 to Petitioners Ex. 2 shows that the Petitioners proposed 7.0% input value results in a modeled central office switching expense factors that is lower than the 7.68% factor derived from the Petitioners' actual 2004 costs of providing service. Petitioners' expert, Mr. Hendricks, provided opinion testimony that Petitioners proposed value is more appropriate because it is based on data is more recent than the default HAI data, it is based on rural (not non-rural) carrier costs, and it is Illinois-specific. In addition, since the actual investment is reflective of forward-looking technology, it is reasonable to expect expense-to-investment ratios currently experienced by Petitioners to be reflective of forward-looking costs, especially with the additional savings assumed. Therefore, the ALJ's conclusion that Petitioners' proposed value for this Input reflect some savings when compared to actual costs and should not result in undue expense assumptions does not run afoul of the FCC's rules.

5. Input 18- Switching and Transport Minutes of Use

Verizon Wireless has agreed to accept use of the default minutes of use in the HAI model despite its belief that this data is outdated and that minutes of use have increased. In its

exception on this item, Verizon Wireless requests that the Commission make a statement in the final Arbitration Decision that Petitioners' forward looking costs are overstated due to the fact that current minutes of use data was not available. Verizon Wireless also requests that the Commission indicate in the Arbitration Decision that small, rural carriers using HAI in any future arbitration will be expected to update the minutes of use figures.

Verizon Wireless' requested statements are not necessary or appropriate. What Verizon Wireless does not mention (although it is clearly aware of), is that most small, rural carriers do not have any regulatory requirement to measure local minutes of use and therefore do not have the capacity to measure local minutes of use. Petitioners Ex. 2, lines 336-39. The capacity to conduct those measurements is very expensive. *Id.* Its purpose in making this demand is clearly to create another cost impediment to a small company proving its costs.

Verizon Wireless' seeks to gloss the issue over by simply proposing (without note in its argument) to strike the explanation that minutes of use are simply not available for average schedule companies because they do not record local minutes. Verizon Wireless also ignores the simple explanation that minutes of use for small companies are in flux given the increased presence of wireless competitors (which tends, in total, to subtract minutes from the wireline carrier) and the decreased use of dial up minutes given the expansion in broadband coverage. Nevertheless, Verizon Wireless' proposal would simply and improperly strike the ALJ's conclusion that "the record suggests that this figure [minutes of use] is in flux for the various companies at this time" because "dial up internet service appears to be declining, even in rural areas, and customers continue to increasingly rely on wireless minutes in place of wireline minutes."

B. Exception No. 6 – Burden of Proof

The ALJ concluded in the PAD that the Petitioners met their *initial* burden of proof *in presenting their case*. Verizon Wireless' exception with respect to this conclusion completely ignores the word "initial," just like it ignores the authority cited by Petitioners in their Brief regarding the shifting of the burden.

The law with respect to the shifting of the burden is clear and well established:

[o]nce a utility makes a showing of the costs necessary to provide service under its proposed rates, it has established a *prima facie* case, and the burden then shifts to others to show that the costs incurred by the utility are unreasonable because of inefficiency or bad faith.

City of Chicago v. Illinois Commerce Comm'n, 133 Ill. App. 3d 435, 443 (1st Dist. 1985). The rule is "simply a reflection of the standard legal presumption of reasonableness on the part of the utility's management." *Id.*

Like the appellants in the *City of Chicago* decision, Verizon Wireless attempts to make its case through result-oriented analysis and general objections, rather than with credible evidence. Petitioners' thorough presentation of HAI constitutes *prima facie* evidence that the costs produced are forward-looking and reasonable. If parties are of the opinion that these costs are not reasonable, they must prove it, not simply raise questions and concerns. *See City of Chicago*, 133 Ill. App. 3d at 442-43. As the court in *City of Chicago* stated, "[t]his premise is directly contrary to the overwhelming weight of authority and would place an impossible burden on the utility of anticipating the basis of every intervenor's objection." *Id.* at 442.

Verizon Wireless claims in its BOE that the Petitioners did not meet their burden of proof because their initial round of testimony was based on HAI Inputs and estimates from the small, rural telephone companies' IUSF case in 2001 and the fact that the Commission indicated in that case that HAI had shortcomings when applied to small, rural carriers. Despite its shortcomings,

the Commission utilized HAI in the IUSF case to satisfy the requirement to demonstrate economic costs. Verizon Wireless ignores all the current cost data provided by the Petitioners in their second round of testimony in this case that shows support for the Petitioners' proposed reciprocal compensation rates.

Despite the fact that it accepts the use of HAI in other portions of its BOE, Verizon Wireless asserts that HAI still has important shortcomings. Verizon Wireless argues that HAI overstates forward looking costs. Interestingly, Staff makes the exact opposite argument about HAI in this case when they assert that HAI produces rates that on average are more than 50% below their best estimate of forward looking costs. Verizon Wireless cites the example of the minutes of use Input discussed above, and claims that there has been a dramatic increase in minutes of use between the mid-1990 and the present. Verizon Wireless makes these assertions despite the fact that its expert witness admitted that he had never modeled reciprocal compensation rates for carriers as small as the Petitioners and that he had never even set foot in any of the Petitioners' service areas. Verizon Wireless' reliance on this example is suspect at best given that the ALJ found in the PAD that minutes of use is in flux for the various companies at this time based on the fact that dial up internet service appears to be on the decline, even in rural areas, and customers increasingly rely on wireless minutes in place of wireline minutes.

Next, Verizon criticized HAI because it does not model fiber rings in the manner that Verizon Wireless asserts is the most efficient. Nevertheless the suggested alternate language proposed by Verizon Wireless indicates that Verizon has agreed to the use of HAI and that the resulting rates can be approved as a reasonable approximation of forward-looking costs. While Verizon Wireless identifies two areas where it believes that HAI may overestimate costs, Verizon Wireless completely ignores Petitioners' evidence that there are just as many areas

where appropriate Input adjustments would likely increase the estimated forward looking costs. Petitioners' expert witness identified two such areas; (1) remote-to-host and host-to-remote fraction, and (2) Interoffice Trunks Common with Feeder Fraction. As stated by Mr. Hendricks "one could spend years refining the model and its inputs only to find that the net effect is a wash," and "the primary cost drivers are the open issues in this proceeding."

The PAD's conclusions with respect to burden of proof should not be changed.

C. Exception 7. SS7 Network Costs

The ALJ in the PAD concluded that the fact that SS7 provision does not generate per-call charges to the LEC does not mean that rural carriers do not incur any SS7 costs related to the termination of wireless calls; that Petitioners have established that they incur forward-looking costs of trunking related to SS7 capabilities; and that therefore it is appropriate to include the ISUP cost in the reciprocal compensation rate. Verizon Wireless takes exception to these conclusions and argues that where no additional costs are incurred there is nothing to pay within reciprocal compensation rates. Again, Verizon Wireless wants to use the Petitioners' network and facilities for **free**.

The Petitioners have shown however that they must invest in, and incur expenses related to, terminating SS7 trunks. These trunks are sized in relation to the volume of traffic Petitioners receive. Petitioners Ex. 2, lines 643-44. If these terminating SS7 trunks were not in place, the Petitioners would not be able to receive calls from originating wireless carriers through use of SS7. Thus, they meet the definition of incremental costs discussed in the FCC rules.

In its BOE, Verizon Wireless seems to be challenging the amount of the SS7 costs that are included in reciprocal compensation because it gets its signaling from a different carrier. SS7 Network costs are estimated by the HAI model, but Verizon did not propose any Input

adjustments to HAI in an attempt to reduce the estimated SS7 signaling costs. The Verizon Wireless proposal would result in the Petitioners receiving **no compensation** for their forward-looking SS7 Network costs.

D. Exception 8. ICC Authority to Set Proxy Rates

The ALJ in the PAD concludes that the Commission can set proxy rates and has wide latitude in doing so. Section 252(d)(2) of the Federal Act vests state commissions with the power to set reciprocal compensation rates that are just and reasonable, subject only to the requirement that the recovery of costs be mutual and reciprocal and that the rate be a reasonable approximation of the additional costs of terminating traffic. The analysis in the PAD discusses the 8th Circuit Court of Appeals' decision in *Iowa Utils. Bd. v. FCC*, 219 F.3d 744, 756-57 (8th Cir. 2000), *aff'd in part and rev'd in part* sub nom. *Verizon Communications v. FCC*, 535 U.S. 467 (2002) and provides the following quote:

The FCC "has jurisdiction to design a pricing methodology." *AT&T Corp.*, 525 U.S. at 385, 119 S. Ct. 712. However, the FCC does not have jurisdiction to set the actual prices for the state commissions to use. Setting specific prices goes beyond the FCC's authority to design a pricing methodology and intrudes on the states' right to set the actual rate pursuant to § 252(c)(2). Following the Supreme Court's opinion, we now agree with the FCC that its role is to resolve "general methodological issues," and it is the **state commission's role to exercise its discretion in establishing rates**. Br. for Federal Pet'rs at 26-27, *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 119 S. Ct. 721 (1999).

Iowa Utils. Bd., 219 F.3d at 757 (Emphasis Added).

Verizon Wireless takes exception to this analysis and conclusion and argues that the Commission does not have the authority to set proxy rates. Verizon Wireless claims that the FCC rule that authorizes state commissions to set proxy rates was vacated by the Court. This is not true. The Court specifically identified the FCC rules being vacated as 47 C.F.R. §§ 51.513, 51.611 and 51.707. *Id.* The Court did not vacate Section 51.705(a)(2), which establishes the

authority of state commissions to set rates on the basis of default proxies. Verizon Wireless asserts that proxy rates are no longer authorized because Section 51.705(a)(2) refers to the proxies in vacated rule 51.707. Verizon Wireless' interpretation is not reasonable and should be rejected in light of the specific language used by the Court in vacating 51.707, but not 51.705(a)(2). The Court said, "it is the state commission's role to exercise its discretion in establishing rates." Following the 8th Circuit's opinion in *Iowa Utils. Bd.*, the only reasonable interpretation of Section 51.705(a)(2) is that state commissions have the authority to establish default proxy rates within their discretion, rather than based on the minimum and maximum proxies that the FCC had previously purported to set.

This conclusion in the PAD is both correct and important if the Commission ultimately decides to adopt a modified form of Staff's recommendation to use the Petitioners' interstate access rates as a proxy for forward-looking costs. If the Staff's proxy is corrected either by reflecting the NECA pool payments to the four average schedule Petitioners or by averaging the interstate access rates of all seven Petitioners, Staff has developed a wholly adequate means of establishing a "reasonable approximation" of Petitioners' forward-looking costs. If the Commission does not accept Petitioners' position on Input 13 so that Petitioners can recover a portion of their switching costs from Verizon Wireless' use of the switch, then the Commission should accept Staff's proposal to use the Petitioners' interstate access rates (with one or the other of the Petitioners' adjustments) as the reciprocal compensation rates for the Petitioners.

IV. Conclusion

This is a case of first impression for this Commission. Petitioners seek to establish a means by which they and other small rural carriers can reasonably negotiate reciprocal compensation rates that approximate their costs of transport and termination consistent with the

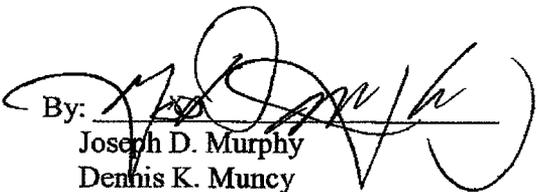
Federal Act. Petitioners have demonstrated a means for the Commission to do this through the use of the HAI. Staff supports this outcome, albeit through its proposed proxy rates. Verizon Wireless seeks to box Petitioners in to a minimal and non-compensatory rate. Verizon Wireless further hopes to render the Commission's arbitration decision here useless to other small carriers by forcing them (through its proposed a declaratory ruling requiring evidence current local minutes of use) to expend substantial amounts to measure local minutes before establishing their own rates. The Commission should respond to Petitioners and Staff by establishing a rate and a means to set a rate that will support real and fair negotiations between small rural carriers and wireless companies.

Although the record evidence in this docket provides the Commission with a number of available bases (as set forth in the Appendix to Petitioners' Brief on Exceptions) for setting either forward-looking or proxy rates, with very little change, the most straight forward way to establish a rate consistent with Staff's and Petitioners' best approximation of Petitioners' costs of both transport *and termination* is to correct the PAD, simply by adopting Petitioners' Input 13 to allow a reasonable rate for the demonstrated usage-sensitive costs of termination. Without this correction to the PAD, the arbitration decision will establish reciprocal compensation rates that demonstrably do not approximate the forward-looking costs of Petitioners. With the approach

advocated by Verizon Wireless, an arbitration decision would, for all intents and purposes, bar small rural carriers from the benefits and procedures of the Federal Act.

DATED this 13th day of January, 2006.

Respectfully submitted,

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