

ATTACHMENT

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CAPTS Initial Part VII Filing
(December 21, 2006)

CANADIAN ALLIANCE OF PUBLICLY-OWNED TELECOMMUNICATIONS SYSTEMS

21 December 2006

Ms. Diane Rhéaume
Secretary General
Canadian Radio-television and
Telecommunications Commission
Ottawa, Ontario
K1A 0N2

Dear Ms. Rhéaume:

Subject: Part VII Application to Review and Vary Decision CRTC 2001-756 and
Decision 2006-14

The Canadian Alliance of Publicly-owned Telecommunications Systems (CAPTS) are filing this Part VII Application, requesting the Commission Review and Vary certain parts of Telecom Decision CRTC 2001-756, *Regulatory framework for small incumbent telephone companies* (Decision 2001-756), and Telecom Decision CRTC 2006-14, *Revised regulatory framework for small incumbent local exchange carriers* (Decision 2006-14). In particular, it is the proxy subsidy rates for tax-exempt companies that the CAPTS members submit should be addressed, reviewed and varied by the Commission.

These proxy subsidy rates were first established by the Commission's Decision 2001-756, issued 14 December 2001 as part of the new four-year regulatory framework for small incumbent local exchange carriers (SILECs). During the ensuing 4 years Commission staff was contacted by CAPTS' members attempting to get an understanding of the details of how the proxy subsidy rates for tax-exempt companies were arrived at.

Bruce Telecom

Dryden MTS

Kenora MTS

TBayTel
Corp.

Ontera

City West Telephone

Being unsuccessful in its attempts, CAPTS specifically provided on 29 July 2005 as part of the follow-up review of the SILECs' regulatory regime, a submission that stated that the tax-exempt national weighted-average Phase II Primary Exchange Service (PES) costs used to determine their subsidy requirements be adjusted upward because, in CAPTS view, the impact of income taxes had been overstated in determining the tax-exempt proxy costs. This submission was made based on the information at hand.

Subsequently, on 19 August 2005, the Commission issued Telecom Public Notice 2005-10, *Review of the regulatory framework for the small local exchange carriers* (P.N. 2005-10), that invited comments on establishing a new regulatory framework for the small incumbent local exchange carriers (SILECs) that would go into effect in 2006. The CAPTS submission was made part of the public record.

The Commission denied CAPTS's request for an upward adjustment to the tax-exempt proxy costs set out in Decision 2001-756 on 29 March 2006, by Telecom Decision CRTC 2006-14, *Revised regulatory framework for small incumbent local exchange carriers* (Decision 2006-14).

In Decision 2006-14, the Commission supported its denial by stating that it considered that a Phase II estimate of tax costs is required to appropriately adjust the Phase II proxy residential PES cost estimates contained in the subsidy formula for tax exempt companies and that the proposed accounting-based income tax cost adjustment methodology proposed by CAPTS did not provide an appropriate estimate that is consistent with the Phase II tax cost calculation. There was no discussion by the Commission on the unprovided information.

In subsequent conference calls and meetings with Commission staff, CAPTS was provided with some of the details of the Phase II formula used by the Commission to estimate the effect of taxes on the proxy costs set out in Decision 2001-756.

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A detailed review of the Phase II information that was provided by Commission staff, confirmed that the Commission's formula used to determine the effect of the tax-exempt status on proxy costs is sensitive to the total expenses/total costs ratio. Using capped expense amounts in the tax-exempt proxy cost calculation distorts the expense to total cost relationship causing the income taxes impact to be artificially overstated when the calculation for tax-exempt proxy costs is made.

Accordingly, as a result of this review, it is still CAPTS's respectful view that the Commission's subsidy calculation for tax-exempt companies in Decision 2001-756, and supported by Decision 2006-14, overstates the effect of income tax costs on tax-exempt companies and that the tax-exempt national weighted-average Phase II PES costs used to determine the subsidy requirements of tax-exempt companies should be adjusted upward.

CAPTS's position on this matter is more fully discussed in the attached Review and Vary application.

A machine-readable file copy of this submission is provided to the Commission and interested parties via Internet email.

Yours truly,

Gary Armstrong,
Chair, CAPTS Regulatory Committee

Attachment

c.c.: Parties to Public Notice 2005-10

Bruce Telecom	Dryden MTS	Kenora MTS
TBayTel Corp.	Ontera	City West Telephone

**BEFORE THE CANADIAN RADIO-TELEVISION
AND TELECOMMUNICATIONS COMMISSION**

**IN THE MATTER OF AN APPLICATION BY THE CANADIAN ALLIANCE OF
PUBLICLY-OWNED TELECOMMUNICATIONS SYSTEMS
PURSUANT TO PART VII OF THE *CRTC TELECOMMUNICATIONS
RULES OF PROCEDURE* AND SECTION 62 OF THE *TELECOMMUNICATIONS ACT***

**TO REVIEW AND VARY A PORTION OF *REGULATORY FRAMEWORK FOR SMALL
INCUMBENT TELEPHONE COMPANIES*, DECISION CRTC 2001-756 AND *REVISED
REGULATORY FRAMEWORK FOR SMALL INCUMBENT LOCAL EXCHANGE
CARRIERS*, TELECOM DECISION CRTC 2006-14**

21 DECEMBER 2006

I SUMMARY

1. This Application is made on behalf of the Canadian Alliance of Publicly-owned Telecommunications Systems (CAPTS) pursuant to section 62 of the *Telecommunications Act* and Part VII of the *CRTC Telecommunications Rules of Procedure* to review and vary *Regulatory framework for small incumbent telephone companies*, Decision CRTC 2001-756, dated 14 December 2001 (Decision 2001-756) and *Revised regulatory framework for small incumbent local exchange carriers*, Telecom Decision CRTC 2006-14, dated 29 March 2006 (Decision 2006-14).
2. It is CAPTS's view that without all of the needed information to assess Decisions 2001-756 and 2006-14 there is substantial doubt as to the correctness of the original determinations made by the Commission, and therefore this submission should be considered as a Review and Vary Application and further, for the same reasons, should be considered beyond the six month review and vary.
3. CAPTS requests that the Commission review and vary these Decisions by varying the proxy subsidy rates per NAS for tax-exempt companies contained in these Decisions to reflect the impact of a more accurate calculation of the effect of income tax costs on the total Phase II PES costs of tax-exempt companies.
4. In CAPTS view, an increase in the ratio of total expenses to total costs in the Phase II formula used by the Commission to estimate the effect of income taxes on the proxy costs is needed in order to remove distortions to the formula results caused by Commission imposed expense caps on large Incumbent Local Exchange Carrier (ILEC) PES costs. The ratio of Phase II expenses to total Phase II costs in the Phase II formula should be increased to that value of the ratio which is computed prior to the application of expenses caps, estimated by CAPTS at 35%, in contrast to the value of 23% used by the Commission in its proxy cost calculations for tax-exempt companies.

5. CAPTS submits that this modification is required to develop a realistic Phase II estimate of tax costs for the adjustment of the Phase II proxy residential PES cost estimates contained in the subsidy formula for tax exempt companies.
6. The Phase II formula used by the Commission to calculate the effect of the tax-exempt status on proxy costs is sensitive to the ratio of total expenses to total costs and accordingly the use of the capped expense amounts in the tax exempt proxy cost calculation, distorts this expense to total cost relationship, with the effect that the impact of income taxes is artificially overstated in the tax-exempt proxy costs calculation.
7. CAPTS accordingly submits that there are grounds on which there is substantial doubt as to the correctness of Decision 2001-756, as confirmed by Decision 2006-14, with respect to the calculation of the tax-exempt proxy subsidy. CAPTS contends that the Commission incorrectly calculated the effect of income tax costs under Phase II by failing to consider the fact that the results of the Phase II formula used to quantify the effect of income taxes on total costs are distorted if the Phase II expenses used in the formula incorporate the effect of Commission imposed caps from Decision 2001-238.
8. CAPTS accordingly request that Decisions 2001-756 and 2006-14 be varied to include the following subsidy amounts (changed amount displayed with an overstrike).

Wire centre classification		Tax-paying company	Tax-exempt company
Band E	(0 to 1,500 NAS)	\$16.57	\$10.37 \$8.98
Band F-1	(1,501 to 2,500 NAS)	\$15.93	\$9.81 \$8.46
Band F-2	(2,501 to 4,000 NAS)	\$14.35	\$8.46 \$7.17
Band F-3	(4,001 to 6,000 NAS)	\$12.12	\$6.54 \$5.37
Band F-4	(6,001 to 7,999 NAS)	\$8.31	\$3.26 \$2.27
Band G	(Remote NAS)	\$37.87	\$28.68 \$27.30

9. CAPTS further requests that the above subsidy changes be made effective 1 January 2002, concurrent with the introduction of the new subsidy regime for SILECs, as established by Decision 2001-756.

II BACKGROUND

Decision 2001-756

10. The Commission first established proxy subsidy rates per NAS for both tax-paying and tax-exempt SILECs in Decision 2001-756. The proxy subsidy rates in that Decision were determined on the following basis:

a national weighted-average monthly residential PES cost based on the high-cost serving areas (HCSAs) of the large ILECs for the cost component;

a national weighted-average monthly residential local rate of \$22.75 based on the local rates in HCSAs of the large ILECs;

a mark-up of 15% on the cost component; and

a \$5 per month deemed revenue from other local services.

11. In addition to the above, the Commission made an upward adjustment to the national proxy PES cost component of 7.5%.

12. The Commission calculated proxy subsidy rates per NAS were published in Decision 2001-756 and are detailed in **Table I** below.

Wire centre classification	Tax-paying company	Tax-exempt company
0 to 1,500 NAS (Band E)	\$16.57	\$8.98
1,501 to 2,500 NAS (Band F-1)	\$15.93	\$8.46
2,501 to 4,000 NAS (Band F-2)	\$14.35	\$7.17
4,001 to 6,000 NAS (Band F-3)	\$12.12	\$5.37
6,001 to 7,999 NAS (Band F-4)	\$ 8.31	\$2.27
Remote NAS (Band G)	\$37.87	\$27.30

Table I: Proxy monthly subsidy rates per NAS published in Decision 2001-756

13. In Decision 2001-756, the calculated proxy subsidy rates per NAS reflect separate calculations for each band. For example, for tax-paying companies, the calculation of the proxy subsidy rate for Band E is as follows:

Obtain the national weighted-average monthly residential PES cost based on the high-cost serving areas (HCSAs) of the large ILECs for Band E (as computed by the Commission from the Phase II PES costs of the large ILECs).

\$35.85

Make an upward adjustment of 7.5% of the PES cost component from a. above.

$$\$35.85 \times (1 + 0.075) = \$38.54$$

Add a mark up of 15% to the PES cost on b. above.

$$\$38.54 \times (1 + 0.15) = \$44.32$$

Deduct the marked up PES cost calculated in c. above, from the sum of the national weighted-average monthly residential local rate of \$22.75 and the \$5 per month deemed revenue from other local services.

$$\$44.32 - (\$22.75 + \$5.00) = \$16.57$$

14. For a tax-exempt company, the calculation of the proxy subsidy rate would be identical except that the upward adjusted national weighted-average residential PES cost of step b. is adjusted downward to remove the cost of income taxes. Accordingly for the same Band E,

the calculated PES cost in the third step c. must be \$36.73 in order to obtain a calculated proxy subsidy of \$8.98 per **Table I**.

$$\$8.98 + (\$22.75 + \$5.00) = \$36.73$$

15. In a similar fashion, the upward adjusted and marked up national weighted-average monthly residential PES cost for both tax-paying and tax-exempt companies can be calculated from the subsidies published in Decision 2001-756 and outlined in **Table I** for each band. These amounts are detailed in **Table II** below.

Wire centre classification	Tax-paying company (a)	Tax-exempt company (b)	Reduction (a) - (b) (c)
0 to 1,500 NAS (Band E)	\$44.32	\$36.73	\$7.59
1,501 to 2,500 NAS (Band F-1)	\$43.68	\$36.21	\$7.47
2,501 to 4,000 NAS (Band F-2)	\$42.10	\$34.92	\$7.18
4,001 to 6,000 NAS (Band F-3)	\$39.87	\$33.12	\$6.75
6,001 to 7,999 NAS (Band F-4)	\$36.06	\$30.02	\$6.04
Remote NAS (Band G)	\$65.62	\$55.05	\$10.57

Table II: National weighted-average monthly residential PES cost with upward adjustment and mark up for each band.

16. **Table II** details the reduction in the marked up monthly residential PES costs used to calculate the subsidies for tax-exempt companies. For example, the tax adjustment calculated by the Commission in Decision 2001-756 for Band E is based upon a reduction in the marked up proxy PES cost of \$ 7.59.

17. The reductions in the PES costs for tax-exempt companies outlined in **Table II** must be adjusted in order to quantify the reduction in terms of the Phase II costs without mark up because under Phase II, the mark up on Phase II causal costs does not attract income tax costs. As discussed earlier, the tax-paying company PES costs of **Table II** include a mark up of 15%.

18. This adjustment and calculation is detailed in **Table III** below.

Wire centre classification	Tax-paying company PES cost with mark up from Table II (a)	Tax-paying company PES cost without mark up $\frac{(a)}{(1-0.15)}$ (b)	Tax-exempt company PES cost with mark up from Table II (c)	Tax-exempt company PES cost without mark up $\frac{(c)}{(1-0.15)}$ (d)	Percent reduction in Phase II PES costs for tax-exempt companies. $\frac{(b)-(d)}{(b)}$ (e)
Band E	\$44.32	\$38.54	\$36.73	\$31.94	17.1%
Band F-1	\$43.68	\$37.98	\$36.21	\$31.49	17.1%
Band F-2	\$42.10	\$36.61	\$34.92	\$30.37	17.0%
Band F-3	\$39.87	\$34.67	\$33.12	\$28.80	16.9%
Band F-4	\$36.06	\$31.36	\$30.02	\$26.10	16.8%
Band G	\$65.62	\$57.06	\$55.05	\$47.87	16.1%

Table III: Reduction in the upward adjusted national weighted-average monthly residential PES Phase II cost without mark up, for tax-exempt companies.

19. As detailed in **Table III**, Decision 2001-756 reduced total Phase II costs, without mark up, between tax-paying and tax-exempt companies by approximately 17 %, with some variation between bands.

Decision 2006-14

20. On 19 August 2005, the Commission issued Telecom Public Notice 2005-10, *Review of the regulatory framework for the small local exchange carriers* (P.N. 2005-10), inviting comments on establishing a new regulatory framework for the small incumbent local exchange carriers (SILECs) that would go into effect in 2006.

21. As part of the process initiated by P.N. 2005-10, CAPTS submitted that the tax-exempt national weighted-average Phase II PES costs used to determine their subsidy requirements be adjusted upward because, in CAPTS view, the impact of income taxes had been overstated in determining the tax-exempt proxy costs.¹

¹ See Attachment 2 to the CITC-JTF submission associated with P.N. 2005-10, dated 29 July 2005.

22. As part of the same proceeding, CAPTS was asked an interrogatory by the Commission (Interrogatory 700) on the specific issue of the calculation of the tax-exempt proxy costs under Phase II.² The CAPTS response and related arguments did not sway the Commission, as the CAPTS request for an upward adjustment to the tax-exempt proxy costs was denied in the follow up decision to the proceeding, Decision 2006-14.

23. In Decision 2006-14, the Commission stated that it considered that a Phase II estimate of tax costs is required to appropriately adjust the Phase II proxy residential PES cost estimates contained in the subsidy formula for tax exempt companies and that the accounting-based income tax cost adjustment methodology proposed by CAPTS did not provide an appropriate estimate that is consistent with the Phase II tax cost calculation. As stated by the Commission:

“77. The Commission notes that the definition and calculation of taxes payable used to determine the causal incremental Phase II costs are very different from the accounting-based income tax expense definition and calculation used to develop a company's annual financial statement. The Commission also notes that the SILECs' Phase II proxy costs are based on the Phase II costs of the large ILECs in similar bands.

78. The Commission considers that a Phase II estimate of tax costs is required to appropriately adjust the Phase II proxy residential PES cost estimates contained in the subsidy formula. The Commission, therefore, considers that, contrary to CAPTS's submission, the proposed accounting-based income tax cost adjustment methodology will not provide an appropriate estimate that is consistent with the Phase II tax cost calculation.”

² See Interrogatory P.N. 2005-10, The Canadian CITC Joint Task Force (CRTC)19Sept05-700 and the associated response provided by CAPTS.

III DISCUSSION

Introduction

24. Following Decision 2006-14, CAPTS requested and was granted an opportunity to obtain additional information on the specifics of the formula used by the Commission to calculate the tax-exempt proxy costs under Phase II. Prior to information requested by the Commission during the P.N. 2005-10 proceeding, specifically Interrogatory 700, CAPTS was not aware that a Phase II formula had been used by the Commission to calculate the tax effect on the proxy subsidies.

25. CAPTS was subsequently provided with the details of the Phase II formula in a series of follow up meetings and conference calls with Commission staff. As part of these discussions, it became apparent to CAPTS that the formula used by the Commission to calculate the tax-exempt proxy costs under Phase II was the same formula contained in the Commission's Interrogatory 700. However the formula in itself was insufficient to assess the reasonableness of the Commission's calculations of the tax effect without the related details on the input parameters used by the Commission.

26. Commission staff subsequently provided some information on the input parameters used in by the Commission in its calculation. It became apparent that these parameters were also identical to those contained in the scenario posited by the Commission in Interrogatory 700 with one exception. That exception being that Interrogatory 700 posited a scenario where total Phase II expenses were assumed to be zero, when in fact a non-zero level of expenses was assumed in the Decision 2001-756 Phase II formula calculation.

The Phase II Formula Used by the Commission

27. In Decision 2001-756, the Commission calculated the proxy subsidy rate for tax-exempt companies by making a downward adjustment to the national weighted-average residential PES costs of tax-paying companies in order to remove the cost of income taxes. The steps associated with this calculation were previously outlined in Section II of this submission.

28. The Phase II formula used to undertake this calculation is detailed in **Table V** below. As noted earlier, the formula is identical to that contained Commission Interrogatory 700. Commission staff also confirmed its use as part of the Commission’s tax-exempt subsidy calculations during the follow-up discussions.

29. Commission staff also confirmed the parameters used in the formula to calculate the tax effect on the total Phase II costs (PWAC) in Decision 2001-756. These are detailed in **Table IV** below.

Income Tax rate: 40%
Debt Ratio: 45%
Effective annual cost of debt: 8%
Effective annual cost of capital: 10%
CCA rate: 5%
Discount rate used for the calculation of the Present Worth: 10%
Life estimate (years): 20
Salvage value: 0
End Of Study values (EOS): zero

Table IV: Phase II formula input parameters

$$PWAC = FC \times (a - (b \times S)) + PWExpenses$$

where,

PWAC is the Present Worth of Annual Costs.

PW Expenses is the Present Worth of Expenses.

FC is a capital expenditure at time 0.

S is the Salvage value.

LE is the life of the plant.

t is the tax rate.

i is the effective annual cost of capital.

C is the CCA rate

j is the nominal annual cost of capital rate = $\ln(1+i)$ = natural Logarithm of (1+i)

P/A is the Present Worth of a continuous annuity factor.

jd is the nominal cost of debt

R is the debt ratio

and

$$a = \left(\left(1 + O - \frac{C}{C+i} \times \frac{i}{j} \times O_A \times \left(\frac{1+.5i}{1+i} \right) + \frac{P/A}{LE} \times (O_A - O) \right) \right)$$

and

$$O = \left(\frac{t}{1-t} \right) \left(1 - \frac{Rjd}{j} \right) \quad O_A = \left(\frac{t}{1-t} \right) \left(1 - \frac{trjd}{t} \right) = t(1+O)$$

and

$$b = \frac{1}{1+i} \times \frac{LE}{LE} \left[\left(\frac{1+O \times t \times i}{j(1+i)} \right) \left(\frac{i \times (1-.5C)}{(C+i)} \right) + 1 \right]$$

Table V: Phase II formula used to calculate the effect of taxes on the proxy Phase II PES costs.

30. The matter of the value of the input parameters used in the Commission's calculations in Decision 2001-756 is an important one. In accordance with that decision, the proxy costs for tax-paying companies were calculated on the basis of the national weighted-average PES costs of the large ILECs. Accordingly, one would expect that the calculation for tax-exempt companies relied upon equivalent national weighted-average input parameters to the Phase II formula. However it is readily apparent that this may not have been the case, since some of the input parameters are clearly different than those used in the large ILECs PES studies. For example, the large ILEC Phase II PES studies were based upon 5-year study periods, while the equivalent parameter for the tax-exempt calculation in **Table IV** is 20 years.³ With the exception of a brief discussion on the matter of the length of the study period, Commission staff was not able to shed light on this matter, as they indicated that the staff person responsible for the calculation was not available and that accordingly the related source data could not be readily located.
31. On the matter of the length of the study period, Commission staff indicated that it was their view that the use of a 20-year study period with no asset salvage or terminal value was equivalent to using the large ILEC standard study period of 5 years with asset salvage and terminal value. CAPTS is not in a position to question this assertion since it has not been provided with any of the weighted-average input data related to asset salvage and terminal values used by the Commission in its Decision 2001-756 calculation. CAPTS would however request that the Commission locate the source data in an effort to ensure that the input data contained in **Table IV** is representative of the national weighted-average data of the large ILECs.
32. Under the assumption that the input parameters of **Table IV** are appropriate, the formula from **Table V** may be reduced to the formula outlined in **Table VI** below, once the data is input into the formula. The formula in **Table VI** is identical to that formula provided by CAPTS in its response to Commission Interrogatory 700.

³ See Decision 2001-238, paragraph 158, where the Commission approves the assumptions for large ILEC PES cost studies, including for example a study period of 5 years.

$$PWAC = 1.2827 \times FC + PWExpenses$$

where,

PWAC is the Present Worth of Annual Costs.

PW Expenses is the Present Worth of Expenses.

FC is a capital expenditure at time 0.

1.2827 is the calculated amount for at an income tax rate of 40% and the other input parameters of **Table IV**.

Table VI: Phase II PWAC formula with input parameters per Table IV.

33. The formula of **Table VI** is further reduced when the income tax rate is set at zero, the case of a tax-exempt company. Under the tax-exempt assumption, the formula reduces to that detailed in **Table VII** below.

$$PWAC = FC + PWExpenses$$

where,

PWAC is the Present Worth of Annual Costs.

PW Expenses is the Present Worth of Expenses.

FC is a capital expenditure at time 0.

Table VII: Phase II PWAC formula for an income tax rate of 0%.

34. As can be seen from the formulas contained in **Table VI** and **Table VII** above, the increase in the total Phase II costs (PWAC) due to income tax is attributable to the factor of 1.2827 applied to the Phase II capital costs (FC). Further the formulas illustrate the fact that any calculation of the percent reduction in total Phase II costs due to a company's tax-exempt status must also consider the value of the Present Worth of expenses since that element of the formula, although unaffected by income taxes, directly impacts the value of the total Phase II costs.

The impact of the ratio of expenses to total Phase II expenses on the income tax effect

35. The difference in total Phase II costs between a tax-paying and a tax-exempt company can be expressed in terms of the ratio of the total Phase II expenses (PW Expenses) to the total Phase II costs (PWAC) of the tax-paying company. The relationship between total Phase II expenses and total Phase II costs is important since under Phase II expenses do not attract income tax costs and accordingly mitigate the effect of taxes on total costs.
36. The mathematical formula describing the ratio of the total Phase II costs of a tax-exempt company to the total Phase II cost of a tax-paying company, using the input parameters set at the values used by the Commission in its subsidy calculations of Decision 2001-756, is derived and detailed in **Table VIII** below.
37. A table chart of the results obtained from the formula in Table VIII for different values of the parameter y (the ratio of total Phase II expenses to total Phase II costs of a tax-paying company) is provided in **Table IX** below.
38. As illustrated in **Table IX**, as the ratio of total Phase II expenses to the total Phase II costs of a tax-paying company increases in column (a), the reduction in total Phase II costs of the tax-exempt company decreases in column (c). For example, once the ratio of expenses to total costs of column (a) increases to 95%, the decrease in total costs of column (c) is only 1.1%.
39. As noted earlier, Commission Interrogatory 700 posited a scenario where total Phase II expenses were assumed to be zero, when in fact a non-zero level of expenses was assumed in the Decision 2001-756 Phase II formula calculation. The Interrogatory 700 assumption, as can be seen from the discussion above, was misleading and not a fair assessment of concerns, since the ratio of total Phase II expenses to total Phase II costs does have a direct impact on the percent difference in total Phase II Costs (PWAC) as between tax-paying and tax-exempt companies.

From Table VI

Equation (1): Total Phase II Costs tax-paying: $PWAC_{tax} = 1.2827 \times FC + PW_{Expenses}$

From Table VII

Equation (2): Total Phase II Costs, tax-exempt: $PWAC_{notax} = FC + PW_{Expenses}$

If the parameter *PW Expenses* is expressed as a percentage *y* of the total *PWAC tax costs*, Equations (1) and (2) become,

Equation (3): $PWAC_{tax} = 1.2827 \times FC + (y \times PWAC_{tax})$

Equation (4): $PWAC_{notax} = FC + (y \times PWAC_{tax})$

If both sides of Equation (4) are multiplied by the factor 1.2827,

Equation (5): $1.2827 \times PWAC_{notax} = 1.2827 \times FC + (y \times PWAC_{tax})$

If Equation (3) is subtracted from Equation (5):

Equation (6): $1.2827 \times PWAC_{notax} - PWAC_{tax} = 0.2827 \times (y \times PWAC_{tax})$

Equation (6) reduces to:

Equation (7) : $1.2827 \times PWAC_{notax} = PWAC_{tax} \times (1 + 0.2827 y)$

Therefore,

$PWAC_{notax}/PWAC_{tax} = (1 + 0.2827 y)/1.2827$

Where *y* is ratio of the *PW expenses* to total *PWACtax*

Table VIII: The mathematical formula of the ratio of total Phase II costs of tax-exempt companies to the total Phase II costs of tax-paying companies, using the Commission Phase II formula and related input parameters of Decision 2001-756.

Ratio of Phase II expenses to Phase II costs of the tax-paying company, y (a)	Ratio of the Phase II costs of tax-exempt SILEC to Phase II costs of tax-paying SILEC $PWAC_{notax}/PWAC_{tax} = (1 + 0.2827y)/1.2827$ (b)	Percent that Phase II cost of the tax-exempt SILEC is lower than that of tax-paying SILEC: (a) – (b) (c)
1%	78.18%	21.82%
5%	79.06%	20.94%
10%	80.16%	19.84%
15%	81.27%	18.73%
20%	82.37%	17.63%
23%	83.03%	16.97%
25%	83.47%	16.53%
30%	84.57%	15.43%
35%	85.67%	14.33%
40%	86.78%	13.22%
50%	88.98%	11.02%
75%	94.49%	5.51%
95%	98.90%	1.10%

Table IX: Percent reduction in Phase II costs for tax-exempt SILEC as a function of the ratio of Phase II expenses to total Phase II costs of the tax-paying SILEC

Why the reduction of Phase II costs applied by the Commission for tax-exempt status in Decision 2001-756 is too high

40. As outlined earlier in **Table III**, the Commission applied a 17% reduction to the total Phase II costs of tax-exempt companies in Decision 2001-756. In order for the Commission to have calculated a 17% reduction in Phase II costs for tax-exempt companies, and consistent with the input parameters used in the Phase II formula, the ratio of total Phase II expenses to total Phase II cost of the tax-paying companies would have needed to equal approximately 23%. This percentage is calculated using the formula detailed in **Table VIII** and is consistent with the results outlined in **Table IX**.

41. CAPTS submits that the use by the Commission of the referenced 23 % ratio of total Phase II expenses to total Phase II total costs for tax-paying companies was too low and does not reflect the reality of actual Phase II costs in large ILEC PES studies.
42. CAPTS has reviewed the public record associated with Decision CRTC 2001-238, *Restructured bands, revised loop rates and related issues*, dated 27 April 2001 (Decision 2001-238). In Decision 2001-238-2, a follow up correction to Decision 2001-238, the Commission published the residential PES costs per month for the large ILECs in Attachment 2 to that decision. CAPTS notes that the approved Phase II PES costs of the large ILECs incorporate Commission imposed caps on filed Phase II expenses. These related to caps on maintenance expenses and functional operating expenses (FOE). Maintenance expenses were capped at 10% of Phase II capital costs and FOE expenses were capped at \$2.50 per month per NAS.⁴
43. The public record of the related proceeding (Public Notice 2000-27) also provided information on the level of Phase II expenses to total Phase II costs for some of the large ILECs. In the case of Bell Canada, the public record indicates that the ratio of total Phase II expenses to total Phase II costs in the case of the company's unbundled loop study was decreased from 29% to 23% as a result of Commission determinations in Decision 2001-238, notably the effect of the expenses caps.⁵
44. CAPTS would also submit that the referenced 29% expense to total cost ratio of the Bell unbundled loop study is likely higher in the case of a PES study, since one would expect PES expenses to be higher as a ratio of total PES costs. For example, in Decision 2001-238, at paragraph 160, the Commission determined that additional FOE activities and expenses for the retail PES service as compared to the unbundled loop service would result in increased

⁴ See paragraphs 158 to 160 of Decision 2001-238 as well as Decision 2001-238-1, a correction to paragraph 158 of the 2001-238 Decision.

⁵ See the response to Bell(TELUS)30July01-4 PN 2000-27, Table 2, page 3. In Table 2, expenses are estimated at 23% of total Phase II costs of the unbundled loop service and capital at 77%, once the Decision 2001-238 adjustments had been made. Prior to the adjustments, the table indicates that expenses were 29% of total Phase II costs. The use of Bell Canada results is considered appropriate in consideration of the likely importance (due to its size) of the Bell Canada results in the calculation of the national weighted-average proxy results used by the Commission for the SILECs.

FOE expenses per NAS per month from \$1.95 per NAS for unbundled loop service to \$2.50 per month per NAS for PES service. An increase of 28%.

45. CAPTS does not have any direct knowledge of the actual percentage used by the Commission in the calculation of the tax exempt subsidy and is relying upon a logical analysis of the subsidy results published in Decision 2001-756. CAPTS acknowledges the Commission determination in Decision in 2006-14 that a Phase II estimate of tax costs is required to appropriately adjust the Phase II proxy residential PES cost estimates contained in the subsidy formula for tax-exempt companies. However CAPTS submits that such an adjustment must be based upon the actual Phase II costs of the large ILECs, not those Phase II costs with artificial expense caps included. Otherwise the adjustment for a company's tax-exempt status is unrealistic even under Phase II. In CAPTS's view, the Commission imposed expense caps distorted the relationship between Phase II expenses and total Phase II costs of the national weighted-average Phase II PES costs of the large ILECs, thereby materially overstating the income tax effect under Phase II on the total Phase II PES costs of tax-exempt companies.
46. In terms of the amount of subsidy calculated for tax-paying companies, it is CAPTS view that the use of the referenced approved weighted average costs of the large ILECs is entirely appropriate since all SILECs are treated equally. However, in the case of the subsidy calculation for the tax-exempt SILECs, the use of the amounts containing expense caps causes material distortion to the calculation of the effect of income taxes and accordingly penalizes tax-exempt SILECs as compared to their tax-paying peers.
47. Indications of the ratio of the large ILEC Phase II costs attributable to expenses prior to the imposed expense caps are documented on the public record. As noted earlier, and as detailed in Table 2 of the previously referenced Bell response to a TELUS interrogatory as part of P.N. 2000-27, Bell indicated that its ratio of expenses to total Phase II for its unbundled loop study was 29%, prior to the implementation of Commission determinations of Decision 2001-238. This ratio of expense to total costs is likely a very conservative indicator of what that level would be for PES service, since one would expect, as noted earlier, that the equivalent expense level for PES to be somewhat higher than in the case of unbundled loops.

48. CAPTS further notes that there is some information on the public record that directly addresses the ratio of expenses to total costs for PES studies. In its 1997 Prospective Annualised Revenue Cost (PARC) study, and as part of its discussion of the study results, Bell Canada indicated that a 13.8% decrease in Phase II expenses resulted in an overall decrease in total costs of 4.9%. On that basis, expenses would have had to total approximately 35% of the total Phase II costs in order to obtain that result.⁶ The calculation of the referenced 35% ratio is detailed in **Table X** below.

$$\text{Equation (1) : } PWAC = PWCapital + PWExpenses$$

$$\text{Equation (2) : } (1 - .049) \times PWAC = PWCapital + (1 - .138) \times PWExpenses$$

If we subtract Equation (2) from Equation (1)

$$0.049 \times PWAC = 0.138 \times PWExpenses$$

Therefore,

$$PWExpenses = 35.5\% PWAC$$

Table X: Estimate of Bell ratio of PES expenses to total PES costs

49. CAPTS was also able to locate information on the public record with respect to the equivalent ratio of cost for TELUS, the second largest of the large ILECs used in the proxy calculation. In a submission made by TELUS in a follow-up proceeding to Decision 2001-238, TELUS estimated that its mark up on Phase II for fixed common costs would have increased from 32% to 47% if the maintenance and FOE expenses in its Phase II PES studies had not been capped.⁷ On the basis that the TELUS expenses represented an amount equal to approximately 23% of total Phase II costs once the determinations of Decision 2001-238 caps were applied, as was the case for Bell, in order for TELUS to reach that conclusion, total Phase II expenses would have needed to be in the order of 38 % of total Phase II costs. This calculation of the referenced 38% ratio is detailed in **Table XI** below.

⁶ See Bell(CRTC)1May97-709-PCII Attachment2, Abridged, page 21. In this PARC study, both FOE and maintenance expenses are included under the category of Functional Operating Expenses.

⁷ See Comments of TELUS Communications Inc, Decision 2001-238 Follow-up Proceeding, Mark up, January 11 2002, Appendix A Abridged revised, An Analysis to Determine Mark-Ups for the Purpose of Pricing Essential Facilities, paragraph 52.

$$\text{Equation (1) : } 1.32 \times PWAC = PW\text{Capital} + 0.23 \times PWAC$$

$$\text{Equation (2) : } 1.47 \times PWAC = PW\text{Capital} + y \times PWAC$$

If we subtract Equation (1) from Equation (2)

$$0.15 \times PWAC = (y - 0.23) \times PWAC$$

Therefore,

$$y = 38\% PWAC$$

Table XI: Estimate of TELUS ratio of expenses to total PES costs

50. CAPTS therefore submits that a fair estimate of the tax effect on the Phase II PES costs of tax-exempt SILECs should have been based upon a total Phase II expenses to total Phase II cost ratio of approximately 35%, not the estimated 23% used in Decision 2001-756.

51. The effect of this determination would be to reduce the Phase II costs of tax-exempt SILECs as compared to tax-paying SILECs by an estimated 14% in contrast to the 17% reduction calculated by the Commission in Decision 2001-756.

What is the impact on the subsidy for tax-exempt SILECs , if the appropriate Phase II expense levels are used

52. The reduction of tax-exempt SILEC total Phase II costs by 14%, instead of 17%, has a material impact on the level of the tax-exempt company subsidy. The related calculations are detailed in Table XII, Table XIII and Table XIV below.

Wire centre classification	Tax-paying company PES cost without mark up from Table III	Tax-exempt company PES cost based upon 35% expenses to total costs ratio for tax-paying companies. $(a) \times (1 - 0.14)$
	(a)	(b)
0 to 1,500 NAS (Band E)	\$38.54	\$33.14
1,501 to 2,500 NAS (Band F-1)	\$37.98	\$32.67
2,501 to 4,000 NAS (Band F-2)	\$36.61	\$31.48
4,001 to 6,000 NAS (Band F-3)	\$34.67	\$29.82
6,001 to 7,999 NAS (Band F-4)	\$31.36	\$26.97
Remote NAS (Band G)	\$57.06	\$49.07

Table XII: CAPTS calculated national weighted-average PES costs for tax-exempt companies based upon a 35% ratio of total Phase II expenses to total Phase II cost of the tax-paying companies.

Wire centre classification	Tax-paying company PES costs with mark up from Table II	Tax-exempt company PES cost from Table XII	Tax-exempt company PES costs with mark up $(b) \times (1 + 0.15)$	Imputed Revenues	Subsidy $(c) - (d)$
	(a)	(b)	(c)	(d)	(e)
Band E	\$44.32	\$33.14	\$38.12	\$27.75	\$10.37
Band F-1	\$43.68	\$32.67	\$37.56	\$27.75	\$9.81
Band F-2	\$42.10	\$31.48	\$36.21	\$27.75	\$8.46
Band F-3	\$39.87	\$29.82	\$34.29	\$27.75	\$6.54
Band F-4	\$36.06	\$26.97	\$31.01	\$27.75	\$3.26
Band G	\$65.62	\$49.07	\$56.43	\$27.75	\$28.68

Table XIII: CAPTS subsidy calculation for tax-exempt companies based upon a 35% ratio of total Phase II expenses to total Phase II cost of the tax-paying companies.

Wire centre classification	Tax-exempt company subsidy per Decision 756 (a)	Tax-exempt company per Table XIII (b)	Difference <i>(b) – (a)</i> (c)
0 to 1,500 NAS (Band E)	\$8.98	\$10.37	\$1.39
1,501 to 2,500 NAS (Band F-1)	\$8.46	\$9.81	\$1.35
2,501 to 4,000 NAS (Band F-2)	\$7.17	\$8.46	\$1.29
4,001 to 6,000 NAS (Band F-3)	\$5.37	\$6.54	\$1.17
6,001 to 7,999 NAS (Band F-4)	\$2.27	\$3.26	\$0.99
Remote NAS (Band G)	\$27.30	\$28.68	\$1.38

Table XIV: Requested change in subsidy for tax-exempt companies

IV COMMISSION'S TEST AND CRITERIA FOR APPLICATIONS TO REVIEW AND VARY

53. In Guidelines for Review and Vary Applications, Telecom Public Notice CRTC 98-6, dated 20 March 1998 (Public Notice 98-6), the Commission prescribed guidelines to govern its consideration and determination of review and vary applications made under section 62 of the *Act*. The Public Notice 98-6 guidelines encompass both the criteria to be used to determine whether an application should be treated by the Commission as a new application or an application to review and vary, as well as the criteria to be applied by the Commission to determine whether to exercise its power to review and vary its telecommunications decisions.

New Application or Review and Vary Application

54. In determining whether an application should be treated as a new application or as an application to review and vary a decision, the Commission commented in Public Notice 98-6 that:

"Where an application raises substantial doubt as to the correctness of the original decision at the time it was made, the Commission will generally consider the

application to be a review and vary application. However, where the application essentially relates to the continuing correctness of a decision rather than its original correctness, the application will generally be treated as a new application."

55. CAPTS submits that there is substantial doubt as to the correctness of the original determinations made by the Commission in Decision 2001-756 and Decision 2006-14. Accordingly, having regard to Public Notice 98-6, CAPTS submits that this Application ought to be considered by the Commission as a review and vary application and not as a new application.

Timeframe for a Review and Variance of a Decision

56. In Public Notice 98-6, the Commission indicated that, given the public interest in regulatory certainty, applications made pursuant to section 62 of the *Act* should generally be filed within six months of the Commission's original decision; however, the Commission also indicated that review and vary applications made after that time would also be considered in exceptional circumstances and where the Commission is satisfied that there are good reasons for the delay.

57. In the current case, CAPTS notes that following the rendering of Decision 2001-756, CAPTS attempted, on several occasions, to obtain more detailed information on the Commission calculations associated with the tax-exempt subsidy amounts published in that decision, however such information was not forthcoming. CAPTS further notes that the currently available set of information needed to assess the reasonableness of the Commission calculations related to tax-exempt proxy subsidy was only made available to CAPTS following the rendering of Decision 2006-14. In this regard, CAPTS notes that in consideration of the complexity of the matter and CAPTS lack of experience with Phase II, it took some time after the rendering of Decision 2006-14, for CAPTS to obtain the necessary resources to assess the information provided by Commission staff and to fully understand the impact of this information on the Commission determinations made in Decision 2001-756 and Decision 2006-14 on the matter of the tax-exempt proxy subsidy. CAPTS also notes that

even today, and as discussed earlier in this submission, some input information to the Phase II formula used by the Commission to calculate the tax-exempt subsidy remains unavailable to CAPTS.

58. CAPTS submits that it is entirely reasonable to allow CAPTS to obtain needed information to fully assess the reasonableness of a decision before bringing forward an application to review and vary. Also, to the extent that the decision under review contains material errors, the simple passage of time does nothing to alter the inherent correctness of the decision.

59. For the above reasons, CAPTS submits that this is an appropriate case for the Commission to review its decision beyond its six-month guideline for review associated with Decision 2001-756 and Decision 2006-14.

Criteria to Determine Whether to Review and Vary a Decision

60. In determining whether to exercise its power to review and vary its telecommunications decisions, the Commission stated in Public Notice 98-6 that it will require applicants to demonstrate that there is substantial doubt as to the correctness of the original decision. In Public Notice 98-6, the Commission identified four examples of circumstances in which there may be substantial doubt as to the correctness of a decision:

"Accordingly in order for the Commission to exercise its discretion pursuant to section 62 of the Act, applicants must demonstrate that there is substantial doubt as to the correctness of the original decision, for example due to:

- i) an error in law or in fact;
- ii) a fundamental change in circumstances or facts since the decision;
- iii) a failure to consider a basic principle which had been raised in the original proceeding; or
- iv) a new principle which has arisen as a result of the decision."

Grounds for substantial doubt

61. CAPTS submits that there are grounds on which there is substantial doubt as to the correctness of Decision 2001-756, as confirmed by Decision 2006-14, with respect to the calculation of the tax-exempt proxy subsidy.
62. As was discussed earlier in this submission, the Commission incorrectly calculated the effect of income tax costs under Phase II by failing to consider the fact that the results of the Phase II formula used to quantify the effect of income taxes on total costs are distorted if the Phase II expenses used in the formula incorporate the effect of Commission imposed caps from Decision 2001-238.
63. CAPTS submits that the Commission failed to consider this fact in that the Commission used the artificially low and capped Phase II expenses of the large ILECs as an input to the Phase II formula, in contrast to the filed expenses amounts, thereby distorting the relationship between actual Phase II expenses and Phase II total costs which then led to an overstatement of the impact of income taxes on Phase II total costs and a consequential reduction in the subsidy amounts calculated for tax-exempt companies.

V CONCLUSION AND ORDER SOUGHT

64. For all of the reasons set out in this Application, CAPTS respectfully requests that the Commission review and vary Decision 2001-756, as follows:

“99. Therefore, the Commission approves four sub-bands in the 1,501-7,999 NAS band. Taking into consideration all the components of the subsidy proxy and the adjustment to the proposed PES cost approved by the Commission, the following per NAS proxy rates are to be used to determine the small ILECs' subsidy requirements:

Wire centre classification	Tax-paying company	Tax-exempt company
Band E (0 to 1,500 NAS)	\$16.57	\$10.37
Band F-1 (1,501 to 2,500 NAS)	\$15.93	\$9.81
Band F-2 (2,501 to 4,000 NAS)	\$14.35	\$8.46
Band F-3 (4,001 to 6,000 NAS)	\$12.12	\$6.54
Band F-4 (6,001 to 7,999 NAS)	\$8.31	\$3.26
Band G (Remote NAS)	\$37.87	\$28.68

65. CAPTS also respectfully requests that the Commission review and vary Decision 2006-14, as follows:

“115. When a CLEC starts to operate in a specific SILEC territory, the Commission will establish the final subsidy per residential NAS amounts in its next revenue-percent charge decision. As an interim measure, the CFA should make subsidy payments based upon the subsidy per residential NAS amounts that would be paid if the residential local service rates were \$22.75, which are as follows:

Wire centre classification	Tax-paying company	Tax-exempt company
Band E (0 to 1,500 NAS)	\$16.57	\$10.37
Band F-1 (1,501 to 2,500 NAS)	\$15.93	\$9.81
Band F-2 (2,501 to 4,000 NAS)	\$14.35	\$8.46
Band F-3 (4,001 to 6,000 NAS)	\$12.12	\$6.54
Band F-4 (6,001 to 7,999 NAS)	\$8.31	\$3.26
Band G (Remote NAS)	\$37.87	\$28.68

NOTICE

This application is made by the Canadian Alliance of Publicly-owned Telecommunications Systems (CAPTS) on behalf of its following members: TBayTel, Bruce Telecom, Dryden Municipal Telephone System, Kenora Municipal Telephone System and Ontera.

TAKE NOTICE THAT pursuant to sections 57(2)(c) and 59 of the *CRTC Telecommunications Rules of Procedure*, interested parties are required to mail or deliver their Answers to this Application to the Secretary General of the Canadian Radio-television and Telecommunications Commission, Central Building, 1 Promenade du Portage, Gatineau, Québec, J8X 4B1, and to serve a copy of their Answer on the Applicant by 22 January 2007.

Service of the copy of the Answer on the applicants may be effected by personal delivery, by electronic mail, or by ordinary mail. In the case of service by personal delivery, it may be effected at the addresses set out below:

Mr. Gary Armstrong

Chair, CAPTS Regulatory Committee

C/O

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If an interested party does not file its Answer within the time limit prescribed, the Application may be disposed of without further notice to it.

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