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SFA**BILL ANALYSIS**

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Senate Bill 1 (Substitute S-1 as passed by the Senate)
Sponsor: Senator Gerald Van Woerkom
Committee: Technology and Energy

Date Completed: 2-6-03

RATIONALE

A consumer's telephone bill contains various charges in addition to the basic monthly fee for local service, such as a local 9-1-1 charge, a Federal universal service fund fee, and a local number portability charge. One of the additional charges is imposed by the Federal Communications Commission (FCC) and is called an end-user common line (EUCL) charge, which covers the cost of completing interstate and international calls. Additionally, Michigan customers pay another EUCL fee that local phone companies charge to recover the cost of completing intrastate long-distance calls on their local networks. This fee also appears on some telephone bills as a subscriber line charge or state access charge. Some people believe that the intrastate EUCL charge should be subject to review and approval by the Michigan Public Service Commission (PSC) to ensure that consumers are assessed a fair rate.

CONTENT

The bill would amend the Michigan Telecommunications Act to require a local telephone service provider to obtain approval from the Michigan Public Service Commission to assess or impose an intrastate end-user common line charge.

Currently, the Act prohibits a provider of basic local exchange service from assessing or imposing on end-users an intrastate subscriber line charge or end-user line charge. (In July 2001, however, the U.S. Court of Appeals for the Sixth Circuit Court issued a preliminary injunction against this prohibition, and the parties recently settled the case.) Under the bill, the prohibition would apply *except* upon a filing and approval of the PSC under Section 304 of the Act. A provider

would be considered in compliance with the bill if its rates and charges had been reviewed and approved by the PSC within three years of the bill's effective date. The filing and approval requirement would not apply to basic local exchange providers with 250,000 or fewer customers in Michigan. (Both the litigation and Section 304 are described in **BACKGROUND**, below.)

The bill also would allow a provider that was assessing or imposing an intrastate subscriber line charge or EUCL charge on the bill's effective date to continue to assess or impose the line charge if, within 210 days of the bill's effective date, the provider submitted a filing pursuant to Section 304 to the PSC; if the line charge were not greater than the amount assessed or imposed on the bill's effective date; and if the provider made any necessary adjustments to the line charge after the PSC issued its decision.

MCL 484.2310

BACKGROUND

Litigation

In *Michigan Bell Telephone Co. v Engler* (257 F.3d 587 [2001]), the United States Court of Appeals for the Sixth Circuit addressed Michigan's prohibition against an intrastate end-user common line charge. This prohibition is contained in Section 310(7) of the Michigan Telecommunications Act (which was enacted in 2000 and will be repealed on December 31, 2005). According to the Court, before Section 310(7) was enacted, local telephone service providers could impose, or increase at any time, the intrastate EUCL charge without prior approval of the PSC or a hearing before the Commission.

The plaintiffs in this case, Michigan Bell Telephone Company (dba Ameritech Michigan) and Verizon North, Inc., sought an injunction against the enforcement of Section 310(7) in the U.S. District Court for the Eastern District of Michigan. After the District Court denied the plaintiff's motion, the Court of Appeals reversed and held that a preliminary injunction was warranted. (This case also involved another section of the Michigan Telecommunications Act requiring a rate freeze.)

The Court of Appeals held that the plaintiffs had demonstrated a substantial likelihood that Section 310(7) violates the Due Process Clause of the Fourteenth Amendment to the U.S. Constitution which, the Court said, "protects utilities from being limited to a charge for their property serving the public which is so "unjust" as to be confiscatory." According to the Court, due process requires a mechanism through which a regulated utility may challenge the imposition of rates that may be confiscatory. Section 310(7), however, "abolishes the EUCL without providing a mechanism to safeguard the right to earn a constitutional rate of return".

In December 2002, the State of Michigan entered into settlements with both Ameritech Michigan (also known as SBC Ameritech Michigan) and Verizon. Ameritech Michigan agreed to reduce its intrastate EUCL rate for residential customers from \$3.28 to \$2.78 per month, and for business customers from 1.21 to \$1.03 per month. Verizon agreed to reduce its monthly EUCL charge from \$3.50 to \$3.25 for residential customers, and from \$1.21 to \$1.03 for business customers. Both parties agreed not to increase those rates through December 31, 2005. The settlement agreements also state that they do not preclude enactment of legislation addressing the subject matter of Section 310(7).

In addition, Ameritech Michigan and Verizon agreed that, in response to any legal challenge, they will support the constitutionality of broadband and right-of-way statutes enacted in 2002. Ameritech Michigan also agreed that it will not claim property tax credits based upon payment of the maintenance fee that telecommunications providers must pay under that legislation.

The U.S. District Court accepted the

settlement agreements and dismissed the case.

Section 304 of the Act

Section 304 states that the rates for basic local exchange service must be "just and reasonable", and allows a provider to apply for a rate alteration by filing one of the following with the PSC:

- Notice of a decrease, discount, or other rate reduction in a basic local exchange rate. A rate decrease becomes effective without PSC review or approval.
- Notice of an increase in a basic local exchange rate that does not exceed 1% less than the consumer price index. If the PSC approves the rate increase, the provider must notify customers before the effective date of the rate alteration. Unless the PSC determines that the alteration exceeds the allowed increase, the increase will take effect 90 days after the notice is provided to customers.
- An application to increase a basic local exchange rate in an amount greater than the amount allowed above. The application must be accompanied by sufficient documentation that the rate increase is just and reasonable. Within 90 days, the PSC must determine either that the rate increase is just and reasonable, or that a filing under Section 203 is needed. Upon review of a filing under Section 203, the PSC may approve, modify, or reject the proposed rate alteration. (Section 203 allows the PSC to conduct an investigation, hold hearings, and issue its findings and orders under the contested case provisions of the Administrative Procedures Act. A PSC order under Section 203 may be appealed to the Michigan Court of Appeals.)

In reviewing an application for a provider seeking to raise its rates under the third option, the PSC must consider only one or more of the following factors:

- Total service long-run incremental cost of basic local exchange service.
- Comparison of the proposed rate to the rates charged by other providers in this State for the same service.
- Whether a new function, feature, or capability is being offered as a component of basic local exchange service.
- Whether there has been an increase in the

costs to provide basic local exchange service in the geographic area of the proposed rate.

- Whether the provider's further investment in the network infrastructure of the geographic area of the proposed rate is economically justifiable without the proposed rate.

A provider is allowed only one rate increase under Section 304 for each class or type of service per year.

The PSC must exempt from the provisions of Section 304 any provider that: provides basic local exchange service or basic local exchange and toll service to fewer than 250,000 end-users in this State; offers single-party local exchange service, tone dialing, toll access service, including EUCL services and dialing parity at a total price of no higher than the amount charged as of May 1, 2000; and provides dialing parity access to operator, telecommunication relay, and emergency services to all basic local exchange end-users.

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

In addition to the basic monthly rate for local telephone service, there are various other charges on consumers' telephone bills. With all the different line items, the bills can be confusing and consumers believe they are being overcharged because their phone bills are higher than they anticipated. The American Association of Retired Persons (AARP) reports that the organization has received thousands of calls, letters, and e-mails from seniors concerned about the EUCL. According to an AARP representative, the average family spends up to 6% of its income on utilities, and seniors and others living on a fixed income often spend as much as 23%. While the savings may be small, the EUCL is just one of many added charges that pad consumers' phone bills every month. The PSC should have the authority to review the intrastate EUCL charge to ensure that consumers are not subjected to an unfair rate.

Supporting Argument

Michigan is the only state in which local phone

providers charge a EUCL. Since consumers already pay a Federal EUCL fee, they are being charged twice for the same service. The PSC should examine the intrastate charge closely to determine whether it is really necessary.

Response: Providers in other states recoup their costs in other ways. While they might not have a separate item called a EUCL charge on their bills, they might use a different term or simply incorporate the charge into higher basic monthly rates. Illinois, for example, collects the fee by imposing a direct per-call charge for local calling. Furthermore, the EUCL is not a double charge. The Federal EUCL charge covers the cost of interstate and international calling, while the local EUCL charged covers the cost of intrastate calling. Local phone providers charge long-distance providers a fee for the use of the local network to complete a long-distance call, which the long-distance providers pass on to consumers. It makes more sense for the local providers to charge customers directly.

Opposing Argument

The bill would be counterproductive because SBC and Verizon already have spent months negotiating their EUCL charges with the PSC and, as a result of the settlements with the State, will begin assessing lower EUCL rates on February 15, 2003. The settlement agreements ended a long, costly legal battle that potentially could have dragged on for years. The bill would invite more litigation in which providers and the State would have to use scant resources in the courtroom, and ultimately pass the cost on to taxpayers and customers.

Furthermore, it is a massive and complicated undertaking for one provider to file a rate case with the PSC, and for the PSC to conduct its review. One case alone takes six to seven months, requires the services of two or three full-time staff in addition to an Assistant Attorney General, involves thousands of documents and numerous witnesses, and costs close to \$200,000. Using valuable resources in this manner would be both wasteful and unnecessary.

Response: While both SBC and Verizon have agreed to reduce their EUCL charges, there is no guarantee that the lower rates will remain in place past December 31, 2005, when the Act is set to expire.

Opposing Argument

The intrastate EUCL charge is already capped; it may not rise above the Federal EUCL charge. Therefore, regulation of the intrastate charge would be redundant and unnecessary.

Response: The FCC sets the Federal EUCL charge through a deliberate process. Local providers can increase the intrastate EUCL charge whenever the Federal EUCL charge is increased, without regard to necessity or fairness. This mechanism creates a rate increase that is arbitrary rather than cost-based. The Federal EUCL charge has risen since its implementation in 1985 from \$1 to \$6.50, and another increase to \$7 is expected to take place on July 1, 2003. The intrastate EUCL charge should not rise automatically whenever the Federal charge rises.

Opposing Argument

As a public body, the PSC could face enormous pressure to lower rates from consumers who do not understand the cost that goes into providing phone service. An accurate determination of the EUCL charge should be based on necessity and fairness to all parties involved, not just a desire to appease the public.

Response: The bill is designed to provide oversight of the EUCL charge, not eliminate it or jeopardize providers' profits. The PSC has recognized the EUCL charge as legitimate in the past, so it is unlikely to order a company to collect a EUCL charge so low that the company could not recover its costs, or eliminate the charge completely.

Opposing Argument

The EUCL charge is a critical part of cost recovery for local phone service providers. Its elimination or significant reduction could cause irreparable financial damage to the provider or result in skyrocketing rates for customers. If a local provider could not cover its justified costs, the obvious outcome would be a lower quality of service and decreased investment in infrastructure maintenance and improvement. The reduction or elimination of the EUCL charge also would result in the loss of millions of dollars in property, use, and sales tax revenue, which would be particularly disastrous given the State's current budget shortfall. The telecommunications industry already is struggling and has had to cut jobs. The *Detroit News* recently published a article reporting that SBC's sales have declined for

six straight quarters due to competition from wireless providers and the loss of millions of lines to its competitors (1-28-03). According to testimony given by a representative of SBC, the elimination of the EUCL charge would cost the City of Detroit alone \$1 million and could lead to the loss of 1,100 more Michigan jobs.

Response: The same *Detroit News* article also reported that, despite the loss of so many lines to competitors, SBC experienced a 40% profit increase in the fourth quarter of 2002. The claim that the reduction or elimination of the EUCL charge would result in significant financial harm to large companies is questionable when they are reaping such huge profits. A reduction in the EUCL charge would mean more money in consumers' pockets that they could spend on other taxable goods. While State and local governments could lose revenue from phone service, they would recover it in other areas.

Opposing Argument

The EUCL charge is one small component of the overall rate structure. It would be unwise to amend the Act in a piecemeal fashion because the entire statute will be examined before the end of 2005, when it is scheduled to sunset. A more productive course of action might be to form a task force that would look at the Act in its entirety and make recommendations to the Legislature. Meanwhile, if the bill were enacted, it is likely that the EUCL would be reduced by only a few cents. Such a small reduction would do little to address consumers' larger concerns about high phone rates.

Response: Consumers have been demanding examination of the EUCL charge since the Act was passed in 2000, and should not have to wait until 2005 to have their concerns addressed. Any potential reduction in phone service rates is desirable.

Opposing Argument

There is no need for the additional PSC regulation because Michigan has a competitive market for local phone service. The stated purpose of the Act includes enhancing competition and ensuring affordable service. It has been successful on both fronts and Michigan now is the second most competitive state for telecommunications services. Now, customers can place their trust in the market to give them the most value for the lowest price. SBC has seen a 20% reduction in the lines it may use and has cut its prices by

approximately \$30 million annually, and both SBC and Verizon will lower their EUCL rates on February 15, 2003. Also, the PSC determined recently that there is sufficient competition in Michigan to allow SBC to offer long-distance service, pending FCC approval. Rates already are going down because competition is forcing providers to offer enhanced services, such as bundled service packages and increased numbers of calls a customer may make without being charged extra. Michigan customers have some of the lowest telephone rates in the nation. These facts are proof that Michigan is competitive and that the system is working. Moreover, due to the legal challenge, this dramatic increase in competition occurred without a rate freeze or the elimination of the EUCL charge. This bill goes against the current trend of deregulation in the telecommunications industry.

Furthermore, the bill provides no standard by which the PSC would have to judge whether a provider's EUCL rate was reasonable, meaning that not all providers would be judged equally. In the absence of a specified standard, disagreements would surely end up in court. In court proceedings, providers would likely be held to a rate-of-return standard, which was stricken from the original version of the bill because it is an inappropriate standard to use in a competitive market.

Although the bill does not specify a "reasonable" EUCL charge, it represents government price-fixing in that the PSC would have the authority to set the rate. If that rate were above what providers would charge in a competitive market, the bill would fail to reduce prices. On the other hand, a rate set below the market price would constitute rate-of-return regulation, a system the telecommunications industry in Michigan and other states rejected in 1991. Price-fixing does not provide consumers with lower rates or more value because it removes competitive pressures to be efficient and innovative. Consumers are far better off if providers compete with each other in the market than if they fight one-on-one with the PSC.

Response: It is not altogether certain that the local phone service market in Michigan really is competitive. According to a recent *Detroit News* article (1-23-03), SBC has been assessed more than \$1 billion in fines and penalties over the last six years for anticompetitive behavior, including 23

consecutive fines by Federal regulators. With approximately 99% of the market in its service territory, Verizon faces virtually no competition. The small amount of competition in SBC's service territory exists because of Federal orders requiring SBC to open its lines to competitors. In the same *Detroit News* article, the chief executive of Qwest acknowledged the existence of an agreement between the former Bell companies not to infringe on each other's service territories. In other words, the few companies that actually are capable of competing against each other have chosen not to, thereby perpetuating the existence of regional monopolies. If the market really were competitive, people would see the difference on their monthly phone bills. That, however, does not seem to be happening. Several representatives of the AARP presented testimony comparing Michigan phone bills to phone bills from other states. In those cases, consumers were paying significantly less elsewhere for similar services. In a competitive market, costs are recovered through product sales, not the imposition of extra, potentially arbitrary fees. If the market were truly competitive in Michigan, providers would not collect a EUCL charge at all. The fact that providers still impose this fee is evidence that competition has not developed sufficiently in Michigan to eliminate the necessity of PSC oversight.

Legislative Analyst: Julie Koval

FISCAL IMPACT

The bill would have an indeterminate, although likely negative, impact on State revenues. Any impact would affect both General Fund/General Purpose and School Aid Fund revenues.

The bill essentially would require Public Service Commission approval of any end user line charges or subscriber charges on telephone bills. The fiscal impact of the bill would depend upon the decisions made by the PSC regarding the charges. If the PSC were to approve such charges at current levels, the bill would have no fiscal impact. At one extreme, the PSC could prohibit such charges, which would reduce use tax revenues by approximately \$9.1 million to \$9.2 million, assuming that the 2002 agreements with Ameritech and Verizon to lower the end user line charges are implemented. However, the

PSC could disallow the line charges and instead allow providers to increase rates to offset the loss of revenue, in which case revenues would be unaffected. At another extreme, if telecommunications providers successfully argued that the current line charges are insufficient, the providers would receive increases in the charges and/or rates, in which case use tax revenues would increase.

School Aid Fund revenues would experience one-third of any fiscal impact on use tax revenues, while the remaining fiscal impact would affect General Fund/General Purpose revenues.

General Fund revenues also could be reduced because a portion of the assessments the largest telecommunications providers face under the telephone and telegraph property tax is based upon a taxpayer's income. If elimination of end user line charges or subscriber charges were to result in a net reduction in taxpayer income, then the assessments could be lower also. The magnitude of any assessment reduction that would result from the bill is unknown and depends upon a wide variety of factors. Based on available information, under the bill assessments could decline approximately 3%, which would result in a \$4.2 million reduction in General Fund revenues under the telephone and telegraph property tax.

Similarly, if the bill resulted in lower business income or altered gross receipts, General Fund revenues under the Single Business Tax (SBT) Act could fall. Whether the charges are included in the SBT base depends upon the filing method a taxpayer chooses. If the line charges were eliminated and the tax base were reduced, and taxpayers filed under a method in which business income is included in the tax base, then SBT revenues could be reduced by approximately \$3.0 million.

This estimate is preliminary and will be revised as new information becomes available.

Fiscal Analyst: David Zin

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.