IN THE COURT OF APPEALS OF IOWA

No. 2-720 / 12-0119
Filed October 31, 2012

KALONA COOPERATIVE TELEPHONE COMPANY,
Petitioner-Appellant,

vs.

IOWA UTILITIES BOARD,
Respondent-Appellee.

Appeal from the Iowa District Court for Polk County, Arthur Gamble, Judge.

Kalona Cooperative Telephone Company appeals the district court's order affirming the Iowa Utilities Board's rejection of Kalona's proposed intrastate access rates. **AFFIRMED.**

Robert F. Holz, Jr. and Steven L. Nelson, of Davis, Brown, Koehn, Shors Roberts, P.C., Des Moines, for appellant.

David J. Lynch and Jennifer L. Smithson, Iowa Utilities Board, for appellee.

Mark R. Schuling and Alice Hyde, Office of Consumer Advocate, for appellee.

Bret A. Dublinske of Gonzalez Saggio & Harlan, LLP, West Des Moines, for intervenor Verizon.

Richard W. Lozier, Jr., of Belin McCormick P.C., Des Moines, for intervenor AT&T.

Heard by Potterfield, P.J., and Danilson and Tabor, JJ.

TABOR, J.

Kalona Cooperative Telephone Company appeals the district court's order affirming the Iowa Utilities Board's rejection of the company's proposed intrastate access rates. Kalona argues the board acted arbitrarily and capriciously by rejecting the company's embedded cost study without giving proper notice, and by discrediting the study in full rather than correcting errors. Kalona also contends the evidence is insufficient to support the board's denial.

Because the utilities board based its denial on pervasive errors and misallocations in Kalona's study and not on a blanket prohibition of embedded cost studies, we do not find its actions were arbitrary or capricious. In addition, the board acted within its authority to reject Kalona's study entirely as fundamentally flawed rather than attempt to recalculate admitted inaccuracies to salvage it. Because the study lacked credibility, the board's rejection of Kalona's rate proposal was supported by substantial evidence.

I. Background Facts and Proceedings

Kalona Cooperative Telephone Company provides local telephone service to customers in and around the city of Kalona, Iowa. The company is a local exchange carrier (LEC) that provides "switched access service" and "special access service" to long-distance telephone companies called interexchange carriers (IXCs). These services involve the origination and termination of long-distance calls to or from Kalona customers.[1] IXCs rely on LEC services because

[1] When a customer makes a long distance call, the customer's LEC provides "originating access service" by carrying the call to an IXC network. The IXC then transfers the call to the dialed party's LEC. The dialed party's LEC in this sense has provided "terminating

an IXC's network does not extend directly to the premises of the end users. The "last mile" network is owned exclusively by the LEC. The rate Kalona charges IXCs to use its services on long-distance calls originating and terminating within Iowa is the subject of the present dispute.

The regulatory authority on access charges depends on the location of the connecting end-users. If the users are from the same state, the IXC is charged an intrastate access charge, which is set by the state regulatory body. If the users reside in different states, the interstate charges incurred by the IXC are regulated by the Federal Communications Commission (FCC).

The Iowa Telecommunications Association (ITA) sets intrastate access tariffs that are often adopted by LECs—including Kalona. In June 2007, ITA filed proposed changes in its access tariff that mirrored changes in the National Exchange Carrier Association (NECA) tariff and, among other things, increased certain intrastate switched access charges. In May 2008, the Iowa Utilities Board issued an order that reduced the local switching rate to mirror NECA's interstate tariff rate, which in turn reduced intrastate access revenues. Because of this decrease, the board encouraged LECs that believed the new ITA rates were insufficient to recover their costs to propose an individual tariff that they believed would provide adequate compensation.

---

access service." This case involves Kalona's rates charged for both originating and terminating access.

In February 2009, rather than continue to concur with the ITA rates, Kalona filed its own proposed tariff changes with the board.[2] IXCs Verizon and AT&T resisted Kalona's proposed changes.[3] The board docketed Kalona's proposed changes for further investigation, allowing Kalona's proposed tariff to become effective, subject to refund, and gave the board an opportunity to assess whether Kalona's revised rates were just, reasonable, and non-discriminatory.

On September 1, 2009, the board heard testimony relating to the proposed rate change, and on September 24, 2010, it issued a final order rejecting Kalona's cost study and proposed tariffs. The board found Kalona's cost study submitted in support of the rate increase did not include specific information regarding the carrier's actual costs of providing intrastate access service, and did not allow the board to adequately review the prudence and reasonableness of the claimed costs. It also found Kalona failed to meet the statutory requirements to provide the board with reliable cost support for Kalona's proposed tariffs.

Kalona filed an application for rehearing or reconsideration and requested a stay of the Board's final order in the interim. Verizon and AT&T again resisted, this time joined by the Office of the Consumer Advocate. On November 12, 2010, the board denied Kalona's request for rehearing and order to stay. Kalona

---

[2] Kalona's proposed changes included increases in both intrastate switched access rates as well as special access rates.

[3] MCImetro Access Transmission Services, LLC, d/b/a Verizon Access Transmission Services, and MCI Communications Services, Inc. d/b/a Verizon Business Services; and AT&T Communications of the Midwest, Inc. and TCG Omaha, will be referred to as Verizon and AT&T, respectively.

filed a petition for judicial review of the board's decision. On December 16, 2011, the district court affirmed the board's final decision.

II. Scope and Standard of Review

Judicial review of administrative agency decisions is governed by Iowa Code section 17A.19(10) (2011). *NextEra Energy Res. LLC v. Iowa Utils. Bd.*, 815 N.W.2d 30, 36 (Iowa 2012). We apply the standards set forth therein to determine whether we reach the same conclusions as the district court. *Westling v. Hormel Foods Corp.*, 810 N.W.2d 247, 251 (Iowa 2012). If our conclusions are the same, we affirm, but if they are different, we reverse. *Id.*

We will reverse an agency's decision if it is not supported by substantial evidence. *Kohlhaas v. Hog Slat, Inc.*, 777 N.W.2d 387, 391 (Iowa 2009). "Substantial evidence" means the quantity and quality of evidence that would be deemed sufficient by a neutral, detached, and reasonable person, to establish the fact at issue when the consequences resulting from the establishment of that fact are understood to be serious and of great importance." Iowa Code § 17A.19(10)(f)(1). We make this determination by reviewing "the record as a whole." Iowa Code § 17A.19(1)(f). Our focus is not on whether the evidence presented would support an alternative finding than that made by the agency, but whether the evidence supports the findings made. *Broadlawns Med. Ctr. v. Sanders*, 792 N.W.2d 302, 306 (Iowa 2010).

We may also reverse an agency action if it is unreasonable, arbitrary, capricious, "or characterized by an abuse of discretion or a clearly unwarranted exercise of discretion." *Equal Access Corp. v. Utils. Bd., Utils. Div. Iowa Dep't of*

Commerce, 510 N.W.2d 147, 151–52 (Iowa 1993). We consider an agency action to be arbitrary or capricious when its decision was made with no regard to the law or facts. *Doe v. Iowa Bd. of Med. Exam'rs*, 799 N.W.2d 705, 707 (Iowa 2007).

We grant considerable deference to an agency's expertise, especially when its decision involves "the highly technical area of public utility regulation." *Office of Consumer Advocate v. Iowa Utils. Bd.*, 663 N.W.2d 873, 876 (Iowa 2003). Because of its highly technical subject matter, we typically defer to the board's informed decision so long as it falls within a "zone of reasonableness." *Equal Access Corp.*, 510 N.W.2d at 151–52. Therefore, "the majority of disputes are won or lost at the agency level." *S.E. Iowa Coop. Elec. v. Iowa Utils. Bd.*, 633 N.W.2d 814, 818 (Iowa 2001) (internal quotations omitted).

III. Analysis

Before reaching the merits, we first address the IXCs' claims that at least a portion of the present appeal is moot. In November 2011, the FCC issued an order superseding the traditional access charge regime and phasing out regulated per-minute intercarrier compensation charges. *See Connect America Fund*, Report and Order and Further Notice of Proposed Rulemaking, 26 FCC Rcd. 17663. The order replaces the "outdated" access charge system with a "bill-and-keep" methodology, meaning LECs like Kalona will bill their own customers rather than recover costs from IXCs for the charges at issue in this dispute.

Both Verizon and AT&T argue the FCC order renders moot at least a portion of this appeal. AT&T also argues Kalona's proposed rates were conditional and ultimately rejected, and because Iowa law does not permit retroactive ratemaking, Kalona cannot reclaim those previous rates.

Kalona contends the FCC order applies only to terminating switched access rates, and not originating access rates. It argues because the intrastate rates in dispute on appeal will be used to calculate Kalona's access charges through July 1, 2013, all issues are still alive on appeal. Kalona contends because its proposed conditional rates remain in place, overturning the agency's decision would not result in retroactive rate-making.

While AT&T correctly asserts utility regulators may not retroactively set a rate, *Archer Daniels Midland Co. v. State, Dep't of Commerce Utils. Div.*, 485 N.W.2d 465, 467 (Iowa 1992), this axiom does not contemplate affirming or denying a conditional rate charged, which is the situation here. At oral argument, the board asserted though the FCC order would override future intrastate rates, the question regarding the rates imposed before the FCC order's effective date still must be resolved. We agree with the board and therefore address the merits of the appeal.

Iowa Code sections 476.3 and 476.11 govern LEC intrastate access rates. Section 476.3 directs public utilities to furnish "reasonably adequate service at rates and charges in accordance with tariffs filed with the board." Section 476.11 grants the board authority to determine whether connection rates are reasonable between two or more telephone companies. *AT&T Commc'ns of the Midwest,*

Inc. v. Iowa Utils. Bd., 687 N.W.2d 554, 559 (Iowa 2004) (referring to authority as "broad, general and comprehensive for telephone companies in Iowa"). Because AT&T and Verizon objected to Kalona's access rates, the board acquired jurisdiction to consider whether the access rates were "just, reasonable, and nondiscriminatory." Iowa Code § 476.11.

Kalona's main appellate arguments can be distilled into whether the board acted arbitrarily and capriciously in rejecting Kalona's proposal, and whether substantial evidence supports the board's decision. We address each challenge.

A. Did the Board Act Arbitrarily and Capriciously?

1. Did the Board Generally Reject Embedded Cost Studies?

Kalona used an embedded cost study rather than a forward-looking economic cost (FLEC) study to support its proposed rate. The company argues the board's rejection of its embedded cost study demonstrates a change in the board's established procedures for evaluating cost studies without providing proper notice or rulemaking. Kalona concludes the manner in which the board arbitrarily "changed the rules of the game" also violates Kalona's due process rights.

The board asserts its final order was not a rejection of all embedded cost studies as a means to set intrastate access rates. The agency notes previous board decisions have cautioned utilities that embedded cost studies in similar proceedings may be less appropriate than other means of justifying rates, and Kalona admitted it was aware of the board's concerns with using historical costs. The three intervenors concur, asserting the board clearly explained its rejection

of Kalona's cost study was based on the pervasive inaccuracies within that particular study rather than the format itself.

Our administrative code governs the manner in which a telephone utility may file for modified tariffs. Iowa Admin. Code r. 199-22.14(2)(a). It requires tariffs providing for intrastate access services to be filed with the board, "based only on Iowa intrastate costs." *Id.* But as acknowledged by Kalona and the board, the rules remain silent as to whether an embedded cost or FLEC study is an appropriate methodology to support a proposed access rate.

Embedded cost studies rely on the historical costs an LEC previously incurred by providing a service, and then project future rates for the same services based on that historical data. *Verizon Commc'ns, Inc. v. FCC.*, 535 U.S. 467, 511–12 (2002). AT&T points to three drawbacks to embedded cost studies. First, there is no guarantee that a carrier will incur the same costs in the future as it had in the past. Second, the formula does not account for the inefficiencies in the LEC's past cost, and passes the inefficiencies to rate-payers. *See id.* Third, embedded cost studies can encourage LECs to "overstate book costs" to ensure a higher tariff rate. *See id.* AT&T explains a FLEC study attempts to establish the economic cost an LEC will incur in providing its service during the period of time the rates would be in effect. *See id.* at 495–96.

The board has previously cautioned parties of its concerns with the embedded cost methodology in the wake of the 1995 shift in our state's

regulatory regime.[4] The agency warned that using an embedded cost study tends toward improper subsidization. Our legislature specifically directs the board to remove subsidies in LEC price structures. *See* Iowa Code § 476.95(3) ("In order to encourage competition for all telecommunications services, the board should address issues relating to the movement of prices toward cost and the removal of subsidies in the existing price structure of the incumbent local exchange carrier.").

The board cites to one of its previous 2008 final orders involving a cooperative telephone company, in which the board found reliance on cost studies based on embedded cost calculations could result in improper subsidization. In the hearing, Kalona's consultant-expert acknowledged the company was aware of the 2008 order and knew presenting the board with an embedded cost study posed a risk.[5] The board argues these previous cautions were meant to bring to light the potential problems with such studies so subsequent parties relying on them would be prepared to address the board's concerns.

---

[4] In 1995, our state enacted legislation shifting away from the monopolistic market and encouraging the development of competition in our telecommunications markets. *See* Iowa Code § 476.95. In 1996, Congress also did away with the local monopoly outlook on LECs and opened the market for competition. *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 11 FCC Rec. 15499 (August 8, 1996).

[5] In consultant-expert Schoonmaker's testimony, he admitted he reviewed the order including the caution against embedded cost studies, but explained "we felt like this was a reasonable approach to take in regards to presenting costs to you." When a board member asked, "So surely you knew there was a risk to it?" Schoonmaker replied, "Yes, we knew there was a risk to it."

The board's final order explained its rejection of Kalona's study was not meant as an absolute bar to all embedded cost studies, and that an LEC may use either kind of study to support its access rate, so long as it is reliable. As the board stated: "If an embedded cost study is to be used for setting rates, then there must be a review of those costs to ensure they were reasonable and prudent." The order subsequently noted that if done properly, a FLEC model can be a useful alternative as well. The board concluded:

> This rejection of Kalona's embedded cost study does not mean that such studies can never be considered in the context of setting intrastate access rates for [LECs], but a party relying on embedded costs should make a persuasive case that the resulting rates will be representative of the prudent and reasonable cost of providing services during the time the proposed rates will be collected.

It is evident from this analysis that the board did not "change[] the rules of the game without notice;" therefore Kalona's due process rights were not violated. Kalona was well aware of previous board action warning LECs of the board's skepticism about embedded cost studies and suggesting how to overcome concerns. Kalona did not prove its embedded cost study included measures to surmount the inherent inaccuracies in that formula, and, in fact, Kalona's study was replete with errors and misallocations.

2. Did the Board Err in Rejecting Kalona's Entire Cost Study?

Kalona asserts the board improperly rejected its "cost study and rate request *in toto*." Kalona cites previous cases in which the board determined the economic impact of various deficiencies in a study and adjusted the proposed rates, but that in the present dispute, the board wholly rejected Kalona's survey without parsing out the errors. Kalona believes the board is required to

determine the impact of each deficiency on the proposed rates and make the proper adjustments.

AT&T distinguishes the utilities case cited by Kalona, asserting "the study itself was not so fundamentally and pervasively erroneous as to prevent the Board from making the necessary corrections, [and that] the board's actions in specific cases involving specific cost studies do not bind the Board to make adjustments to all cost studies in all future cases." Both IXCs argue the board is not obliged to correct Kalona's errors, and in fact it is Kalona's burden to prove the reasonableness and prudency of the costs identified in the study even if the intervenors did not specifically object to a particular item. The Office of Consumer Advocate adds because Kalona's cases relate to pre-1995 LEC access rates, they do not apply to today's partially competitive market.[6]

The board contends it rejected Kalona's study "in part because of the sheer number of admitted errors and misallocations, the additional number of disputed errors, and Kalona's acknowledged failure to update the cost study for significant cost changes." The board reasons because the study contained so many errors, the report as a whole lacked credibility and could not support Kalona's proposed rates.

The board reviews proposed access tariff changes to determine whether the revisions are "just, reasonable, and non-discriminatory." Iowa Code § 476.3(1). When a written complaint is filed by a carrier, the board then determines whether the utility "has failed to provide just, reasonable, and

---

[6] The Consumer Advocate also argues the 2010 case Kalona cites relating to electric rates has no relevance on a telecommunications wholesale access charge application.

nondiscriminatory arrangements for interconnection of its telecommunications services with another telecommunications provider." Iowa Code § 476.11. Any IXC filing a resistance holds a burden to support its resistance with appropriate evidence or argument, but "the ultimate burden to show the tariff is reasonable and in the public interest" remains on the LEC. Iowa Admin. Code r. 119-22.14(5); Iowa State Commerce Commission Docket No. RMU-85-19, "Order Adopting Rules" (February 7, 1986). Therefore the burden rests on Kalona to provide proper evidence to support its rate increase.

In the board's final order, it identified misallocations specific to Kalona's own analysis that substantially undermine the company's conclusion:

> For example, Kalona's non-regulated activities accounted for more than 45 percent of Kalona's 2007 revenues, but the company assigned less than 2 percent of executive and Board of Director expenses to deregulated services. Allegations were also made that Kalona improperly reported its general manager's time, Board of Directors' expenses, billing systems and support, advertising expenses, building and central office expenses, vehicles, and consulting and accounting expenses to regulated services. Kalona admitted some of these misallocations.

The report also relied on an outdated 2007 cost study, which included the cost of obsolete equipment Kalona no longer uses. In noting that the cost separation rules Kalona used were "not specifically designed to capture the intrastate costs of providing exchange service," the board cited Kalona's acknowledgement that the cost separation rules weighed "certain data in certain ways so as to create implicit subsidies." Kalona's admission implicates the board's statutory obligation to do away with subsidies. *See* Iowa Code § 476.95(3).

The board also found other allocations appeared to have "biased the results toward higher proposed intrastate switched access rates." It concluded the nature of the embedded cost study "significantly hampered" the board's ability to review the prudency, accuracy, and efficiency of the allocated costs, and that the study "therefore cannot support its true cost of providing intrastate switched access service."

We find no authority obligating the board to correct applicant errors. Moreover, the misallocations within Kalona's study reach far beyond previous decisions in which the board altered an applicant's calculations. As the board explains in its order denying reconsideration, the board denied Kalona's cost study "because the sheer number of admitted errors and misallocations, the additional number of disputed errors, and the acknowledged failure to updated the cost study for significant cost changes all combine to render the entire study unreliable." The board concluded because of the number of inaccuracies, regardless of their individual size, correcting discrete errors would not salvage the study; the study was unreliable based on the pervasiveness of the mistakes.

Because the board's final order identified the discrepancies that lead to its rejection of Kalona's study in full, we reject Kalona's claim the agency acted arbitrarily and capriciously. *See Office of Consumer Advocate v. Iowa State Commerce Comm'n*, 432 N.W.2d 148, 154 (Iowa 1988) (requiring agency decisions be made with regard to law and facts of case). The order explained (1) the board's rejection of Kalona's study was not a complete bar to embedded cost studies; (2) embedded cost studies are less convincing as to the proper rates in a

partially-competitive marketplace; and (3) it rejected the study, not as an alternative to correcting the errors, but because the pervasiveness of inaccuracies and misallocations rendered the study unreliable. These determinations are within the board's expertise. *Id.* at 156. Because the board's decision to reject Kalona's proposed rates falls within the "zone of reasonableness," we will not disturb it on appeal. *See S.E. Iowa Coop. Elec*., 633 N.W.2d at 818 (recognizing as a consequence, "the majority of disputes are won or lost at the agency level").

B. Did Substantial Evidence Support the Board's Decision?

Kalona also argues the board acted arbitrarily and capriciously by not granting Kalona's rate increase, given the agency record. Kalona's challenge is better characterized as whether substantial evidence exists to support the board's rejection of Kalona's proposed rates. Kalona contends any misallocations do not obscure the overall findings of the study, and the embedded costs show the true costs of providing services.

The board's factual findings are binding so long as substantial evidence supports them. *Meyer v. IBP, Inc.*, 710 N.W.2d 213, 218 (Iowa 2006). As discussed previously, the board offered several findings as to why Kalona's evidence did support its proposed rates. *See* Iowa Admin. Code r. 199-22.14. On appeal, Kalona points to specific allocations, testimony, and other evidence to show why the board arrived at an incorrect conclusion. The intervenors contend Kalona is attempting to relitigate the factual findings committed to the discretion of the board.

The Administrative Procedure Act leaves fact finding largely up to the agency. Iowa Code § 17A.19(7). Determinations as to the weight and credibility of evidence are within the scope of the agency's authority and not for us to decide on appeal. *Arndt v. City of LeClaire*, 728 N.W.2d 389, 394 (Iowa 2007). This division of labor is especially sharp in cases involving the highly technical area of public utility regulation, where we afford even further deference to the board's expertise. *S.E. Iowa Coop. Elec. Ass'n*, 633 N.W.2d at 818. Because the board, exercising its expertise in proper cost methodologies, found Kalona's study to lack credibility, substantial evidence supported its decision to deny Kalona's proposed rate.[7]

AFFIRMED.

[7] Kalona also contends because no party resisted its proposed special access rates, the board should have approved those rates regardless of denying its intrastate rates. Because the IXC's filings challenged Kalona's entire cost study as fundamentally unreliable, and did not limit the scope as to the specific rates that were unjust, Kalona again held the burden to prove the propriety of the rates. Iowa Admin. Code r. 119-22.14(5). Because the board discredited Kalona's embedded cost study—the only evidence supporting its special access rates—Kalona did not meet its burden. Accordingly the board properly rejected Kalona's special access rates as well.