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To The
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On Universal Service
CC Docket 96-45

<u>Panel 1</u>

<u>En Banc Hearing on USF Support in Areas Served by Rural Carriers and the Definition of a "Rural Telephone Company"</u>

Gaylord Opryland Resort
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Panel 1

Support in Areas Served by Rural Carriers and the Definition of a "Rural Telephone Company"

I. The Application Of The Existing Modified Embedded Cost Mechanism For Rural Telephone Companies Should Be Retained.

The Joint Board seeks comment on whether it should continue to use the current embedded cost methodology for determining high-cost universal service fund (USF) support for rural carriers. The answer is yes. The current embedded cost methodology is the most appropriate method for determining high-cost universal service support for rural carriers. The Joint Board should therefore recommend that the Commission retain the existing modified embedded cost mechanism for landline rural telephone companies.

Since the early 20th century, AT&T, the Bell Operating Companies and GTE chose not to invest in facilities to provide basic telephone service to nearly 40 percent of the geographic area of the United States. This territory consisted primarily of the most rural, insular, and sparsely populated areas in the Nation. Thin populations and difficult landscapes made these vicinities too costly for large carriers to invest in and the risk of not recovering their investment was too high. Many Americans living in these areas therefore had to invest their own time, labor and money to form small subscriber-owned telephone cooperatives and community-based commercial telephone companies in order to bring service to their homes and communities.

Today, there are over 1,000 landline rural telephone companies serving rural America. These companies were the first and often the only companies willing to bring the latest telecommunications technology to Americans living in the remote areas of our country. This cooperative spirit that brought telephone service to rural America is the same spirit that Congress embraced when it enacted the Act so that all people of the United States, rural and urban, can have access to affordable and comparable telecommunications services.

During the last two decades, rural carriers have continued to invest in rural, high-cost and insular areas in the United States based on a system of rate-of-return regulation, NECA[1] pooling, and universal service support. This existing regulatory structure has allowed the Commission to meet its Congressional mandate to ensure rural consumers access to telecommunications services at prices that are comparable to similar services and prices received by urban consumers. This goal is now threatened by rules that create uncertainty about the stability of the mechanisms used to fund universal service. Rural consumers, meanwhile, continue to demand the high quality of service that they are accustomed to receiving from the carriers that have served them for decades. Rural carriers therefore have a strong interest in ensuring that reforms to the universal service rules provide for cost recovery consistent with their past decisions to invest in networks and incur costs under the then lawful regulatory rules.

Serving a rural telephone company service territory is unmistakably different than serving a non-rural carrier service territory. The average population density for a rural telephone company study area is only 13 persons per square mile compared to 105 persons per square mile in non-rural carrier study areas.[2] Rural carriers, however, serve 93 percent of the Nation's study areas, but only eight percent of the Nation's access lines.[3] When comparing rural carriers among themselves there are also significant differences in study area sizes and customer bases. For example, rural telcos serving the three smallest study area groupings (2,500 lines or less) encompass 48 percent of all study areas, but only five percent of all access lines served by rural

[1] National Exchange Carrier Association (NECA).
[2] *In the Matter of Federal-State Joint Board on Universal Service,* Rural Task Force Recommendation to the Federal-State Joint Board on Universal Service, CC Docket No. 96-45, p. 11 (rel. September 29, 2000) (RTF Recommendation).
[3] *Id.*

carriers.[4] In South Dakota, the rural telephone company members of SDTA serve approximately 75% of the geographic area within South Dakota (appr. 61,000) square miles. The average population density per square mile within these areas is roughly 4 persons per sq. mile and the average number of access lines served per square mile is about 2.5. In total, the rural company members of SDTA serve approximately 150,000 access lines throughout the State. The largest of the rural telephone companies in South Dakota serves approximately 19,200 lines and the smallest serves just over 380 lines.

Looking at rural carriers throughout this country, each is unique and serves communities and markets that are also unique. These distinct areas include the remote woodlands in Maine and New Hampshire, small farming communities in Kansas, Iowa, Nebraska, communities in remote locations spread across the Northern Plains in South Dakota, North Dakota and Montana and, insular fishing towns in Alaska, and small desert communities in Arizona, New Mexico, Texas, and Nevada. The diversity among these carriers with their varying operating conditions, small and in some cases declining population densities, and their lack of economies of scale, necessitates that rural high-cost universal service support be based on the actual costs of the total facilities needed to provide service.

After two years of careful consideration and deliberation, the Rural Task Force (RTF) recommended, and the Commission and Joint Board agreed, that an embedded cost mechanism should continue to be used for determining the amount of universal service support to rural carriers. The Commission adopted an embedded cost mechanism based in part on the RTF White Papers, which detailed the significant differences between rural carriers and non-rural carriers and the substantial diversity among rural carriers. The RTF convincingly demonstrated that the public would not benefit from the use of a hypothetical forward-looking economic cost

[4] *Id.*

(FLEC) proxy model to determine support for more than 1,000 highly diverse rural carriers. No one has yet made the case that the public will benefit by the use of a forward-looking economic cost proxy model to determine rural telephone company support.[5]

Cost minimization cannot be the primary focus of the Joint Board's review of the modified embedded cost mechanism. The Act's requirement of "sufficiency" and "predictability" make minimization important but only insofar as the goal of efficiency does not interfere with the goals of ensuring that consumers in rural areas receive "quality services" at "just, reasonable, and affordable" rates, and rates and services that are comparable to those provided in urban areas.[6] Goals of increasing efficiency must also be pursued with a recognition of the enhanced service quality often provided by small rural carriers that have a strong local connection to the customers they serve. Rural carriers because of their local presence have shown a greater commitment than many other providers toward providing high quality services and advanced telecommunications services to their customers. Theses additional service benefits generally associated with smaller carriers should not be ignored in the process of trying to improve the efficiency of the high cost mechanism. "Bigger is *not* always better" and any steps taken to make the current high cost mechanism more efficient must not only recognize any increased service value provided by rural carriers, but should also avoid any result that simply penalizes a rural carrier for its smaller size.

Professor Dale Lehman's most recent paper shows that a forward-looking cost standard falls short of the balance that must be considered in choosing a mechanism.[7] That balance includes promoting investment, reducing costs and protecting the principle of comparable rates

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[5] *See,* "False Premises, False Conclusions," Dale Lehman submitted in an analysis report in CC Docket No. 96-45 (August 5, 2004).
[6] Section 254(b).
[7] The Role of Embedded Cost in Universal Service Funding, Dale Lehman, NTCA Initial Comments, CC Docket 96-45, Attachment A, (filed October 15, 2004).

and services. The use of embedded costs to establish rural ILEC high-cost support is a better alternative than a forward-looking cost standard for many reasons. Among them are the following: (1) it would be extremely challenging to validate a forward-looking cost model;[8] (2) forward-looking costs have inherent estimation problems for rural carriers;[9] and (3) the theoretical incentive producing advantages of a forward-looking cost standard are unlikely to materialize in practice.[10] These reasons are explored in detail in Professor Lehman's paper submitted in this proceeding on October 15, 2004. Professor Lehman's analysis demonstrates that a shift to a forward-looking standard is unlikely to achieve the efficiency goals envisioned by proponents who argue that the standard should be applied to rural telephone companies for that reason. The Joint Board should therefore retain the existing mechanism in the interest of preserving a stable environment for investment in high-cost rural areas and the maintenance of universal service in the interim during which fundamental changes in the industry could occur.

II. The Current Rural USF Embedded Cost Methodology Should Continue Beyond The Five-Year RTF Plan

The Joint Board seeks comment on what universal service support mechanism should succeed the Rural Task Force plan. The current rural USF embedded cost methodology should continue beyond the five-year RTF plan for purposes of determining rural ILEC high-cost support.

Congress is expected to consider a Communications Act rewrite, which may provide the FCC with clear direction on how to regulate the universal service support mechanisms in the future. Congress may very well require the Commission to apply the current embedded cost

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[8] *Id.*. at 9.
[9] *Id.*,at 10-17.
[10] *Id.*, at 17-20.

methodology to rural ILECs. If the Commission changes the methodology before Congress acts, the Commission may be required to reverse itself in the near future. The decision on a mechanism for the future funding of support for rural telephone companies is also part of a wider set of issues, including reform of intercarrier compensation and the President's pronouncement that broadband should be made available to all Americans by 2007. It is counter-productive to engage huge resources in a debate over embedded cost versus forward-looking economic costs during a time when other changes may make this debate a moot issue. The Joint Board should therefore recommend that the Commission refrain from changing the current rural ILEC high-cost USF methodology at this time.

The current high-cost universal service rules permit rural carriers to recover their investment in the total network facilities needed to provide comparable rates and services to customers living in rural and high-cost areas. High-cost support reflects the legitimate costs of rural carriers serving their <u>entire</u> rural study areas, an obligation that is imposed on these companies as carriers of last resort. Without support for the entire cost of the network, many consumers living in rural high-cost regions of the United States would not have access to affordable and comparable telecommunications services. To avoid such an outcome, the Joint Board should recommend that the Commission retain the current rural methodology for determining high-cost support for rural ILECs beyond the five-year RTF plan.

III. The Current Definition Of A "Rural Telephone Company" Should Be Retained

The Joint Board seeks comment on whether the Commission should continue to use the statutory definition of a "rural telephone company" to determine which carriers are rural carriers for purposes of high-cost universal service support. The answer is yes.

Congress clearly distinguished rural telephone companies from non-rural telephone companies in Section 153(37) of the Act. Congress took into consideration key differences between rural and non-rural carriers namely, small customer bases and higher costs, when it established the definition of a rural telephone company. This definition was clearly developed with rural high-cost universal service in mind. Section 214(e) establishes the terms and conditions for which universal service support will be available to rural ILECs and their competitors. This section requires that before designating a competing eligible telecommunications carrier (CETC) in an area served by a rural telephone company, a state must find that the designation is in the public interest. This public interest determination is not required for non-rural telephone companies. Congress therefore believed that all carriers that fall under the current statutory definition of a rural telephone company should have a specific public interest determination before any competing carriers are granted CETC status for purposes of receiving high-cost universal service support. The Joint Board therefore should not seek to substitute its own definition of a rural carrier for Congress' definition of a rural telephone company.

The Joint Board should instead recommend that the Commission apply the statutory definition of a "rural telephone company" to CETCs, such as regional and national wireless carriers, and prohibit the distribution of rural high-cost support to all non-rural CETCs under the guise of the current identical support rule. Non-rural wireless carriers are not rural carriers under the definition of a rural telephone company and as such should not be eligible to receive rural high-cost universal service support based on rural ILEC costs. The Joint Board should therefore recommend that the Commission eliminate the identical support rule and require all CETCs to base their support on their own costs.

The Commission's "identical support rule" provides that CETCs receive the same per line support as ILECs, based on the ILEC's costs.[11] Section 254(e) requires that support be used "only for the provision, maintenance, and upgrading of the facilities and services for which the support is intended" and "[a]ny such support should be explicit and sufficient to achieve the purposes of this section."[12] Congress thus contemplated restrictions on both the use and level of support. The United States Court of Appeals for the 5th Circuit has already warned: "excessive funding may itself violate the sufficiency requirement of the Act."[13] By failing to establish a relationship between a CETC's costs and the support the CETC receives, the existing rule distorts and ignores the requirement of "sufficiency." The rule further advantages classes of carriers, in particular wireless CETCs, by allowing them to receive support unrelated to their costs. The rule is also not competitively neutral because wireless CETCs are held to a lower service standard than rural ILECs. The rule has undeniably become the basis for unfair competition in high-cost rural service areas and is the critical instrument used by wireless CETCs for gaming universal service support dollars that have no relationship to their cost of providing service.

Based on USAC[14] quarterly projections, in fourth quarter 2004 $25.3 million in rural high-cost universal service support will be distributed to CETCs that do not fall under the definition of a rural telephone company.[15] This accounts for 24 percent of $105.6 million in projected rural high-cost universal service support earmarked for CETCs in fourth quarter 2004. This demonstrates that non-rural carriers are able to receive rural ILEC high-cost support, using

[11] 47 C.F.R. § 54.307.
[12] 47 U.S.C. § 254(e).
[13] *Texas Office of Public Utility Counsel v. FCC,* 183 F.3d at 412 (U.S.C.A. 5th Cir. 1999)
[14] Universal Service Administrative Company (USAC).
[15] Universal Service Administrative Company, *Federal Universal Service Fund Size Projections fro the Fourth Quarter 2004* (August 2, 2004), Appendices HC01 and HC18.

the identical support rule, with no demonstration of their own costs, no accounting for their own economies of scale and scope, and no showing that their costs exceed a national benchmark average that would either qualify or disqualify them to be even eligible for support. This is clearly not what Congress intended when it established the definition of a rural telephone company and a special public interest determination for carriers seeking CETC designation in rural ILEC service areas. Limited high-cost universal service support is being distributed inappropriately to non-rural CETCs.

The identical support rule has provided an irresistible temptation for CETCs. Even if the management of a CETC knows that their costs are low enough to compete effectively without the additional support, they are compelled by their fiduciary duty to seek CETC designation so as to maximize profits and avoid lost opportunities to obtain support. The Joint Board and Commission has become increasingly concerned about the impact on the USF due to the rapid growth in high-cost support distributed to CETCs. As the chart below based on annualized USAC quarterly fund size projections demonstrates, universal service support to CETCs based on the identical support rule is the driving force behind existing and future growth in the high-cost universal service fund.

	ANNUALIZED ($Millions)			
	2nd Quarter 2003 Support	**3rd Quarter 2003 Support**	**4th Quarter 2003 Support**	**-- Change -- 2Q 2003-3Q 2004**
CETC HC Support				
Non-Rural	$ 43.0	$ 54.4	$ 104.8	144%
Rural	$ 104.4	$ 197.4	$ 432.1	314%
Total	$ 147.4	$ 251.7	$ 536.9	264%
ILEC HC Support				
Non-Rural	$ 741.9	$ 743.8	$ 723.4	-2%
Rural	$ 2,409.0	$ 2,436.1	$ 2,525.2	5%
Total	$ 3,150.9	$ 3,179.9	$ 3,248.6	3%
All Companies				
Non-Rural	$ 784.9	$ 798.1	$ 828.2	6%
Rural	$ 2,513.4	$ 2,633.5	$ 2,957.3	18%
Total	$ 3,298.3	$ 3,431.6	$ 3,785.5	15%

SOURCE: USAC Quarterly Fund Size Projections

Moreover, wireless CETCs are exempt from rate and state entry regulation; this allows them to avoid the substantial costs associated with carrier-of-last-resort obligations, service quality requirements, cost-studies, rate cases, accounting obligations, separations requirements, audit reviews, and other state and federal regulatory mandates.[16] As Commissioner Abernathy identifies:

> Requiring incumbent LECs, but no one else, to comply with costly regulations and to open their books to competitors raises obvious questions of competitive neutrality.[17]

This regulatory disparity, coupled with application of the identical support rule, provides for an artificial inducement for competition that unjustifiably favors wireless CETCs.

Furthermore, the FCC's cost allocation rules should be extended to CETCs seeking universal service support. Not all rural ILEC costs are included in the calculation of universal service support. If it is determined that the same cost allocation rules cannot be used for CETCs, any rule changes should at minimum provide for a proper allocation of CETC costs by means of estimates or proxy-like mechanisms. This could ensure that support is not excessive and used for the purposes intended as required by Section 254(e). Section 254(k) further requires the Commission, with respect to interstate services, and the States, with respect to intrastate services, to "establish cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than their reasonable share of the

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[16] Wireless CETCs neither provide the same quality of local service or interstate access services to consumers. They do not use the same type of facilities to provide the services or incur the same costs for providing the services as rural ILECs. Wireless CETCs do not have high-cost loops and do not provide ubiquitous local service. They also do not have the interstate access costs relevant to the Interstate Common Line Support (ICLS) mechanism because they have no wireline local loops on which the ICLS mechanism is based. And, unlike rural ILECs, wireless CETCs do not offer equal access to all long distance carriers and hence wireless CETC costs for providing access to a single long distance carrier are likely substantially lower than the rural ILEC's costs.

[17] Separate Statement of Commission Kathleen Q. Abernathy, Report and Order in CC Docket Nos. 00-199, 97-212, and 80-286, Further Notice of Proposed Rulemaking in CC Docket Nos. 00-199, 99-301, and 80-286, FCC 01-305, In the Matter of 2000 Biennial Regulatory Review – Comprehensive Review of Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2, Amendments to the Uniform System of Accounts for Interconnection, Jurisdictional Separations Reform and Referral to the Federal-State Joint Board, Local Competition and Broadband Reporting, p. 2 (rel. November 5, 2001).

joint and common costs of facilities used to provide those services." Applying similar cost allocation rules to wireless CETC costs will ensure that wireless CETCs cannot use USF support to cross-subsidize services and unfairly compete in the communications services marketplace.

The current rules have created an insidious incentive for wireless carriers to seek CETC status in all rural high-cost areas regardless of whether universal service support is actually necessary to make their wireless services universally available. Wireless carriers have every incentive to seek CETC status because they can obtain high-cost support for existing ILEC subscribers without ever demonstrating their costs and determining whether wireless costs are high enough to warrant high-cost support. When a wireless CETC receives universal service support under these circumstances it is obvious that windfalls will result in direct violation of Section 254(e). The Joint Board therefore should recommend to the Commission that it eliminate the identical support rule and require all CETCs to base their support on their own costs before the burden on the universal service fund becomes too great.

IV. Rural ILEC Support Should Be Based On The Carrier's Study Area Average Costs

The Joint Board seeks comment on whether the Commission should calculate high-cost universal service support for rural carriers based on the individual carrier's study area average costs or statewide average costs The Joint Board should recommend the continued use of study area average costs for rural ILECs.

The current use of study area average costs in the high-cost universal service rules have allowed rural carriers to recover their investment in the total network facilities needed to provide comparable rates and services to customers living in rural and high-cost areas. Basing support on some other basis, such as the non-rural statewide average costs, will neither ensure that rural carriers receive sufficient support nor that rural consumers receive comparable rates and services as compared to urban consumers.

Most rural carriers serve a single study area in a state and these study areas are generally the highest cost areas in the state. Rural carriers do not have the benefit of averaging the cost of serving these areas with lower costs in another part of the state. Statewide averaging in these cases would most likely result in insufficient support. The use of statewide average costs in the non-rural universal service mechanisms has resulted in distortions, which are likely to carry over if applied in the rural context. As a result of statewide averaging of non-rural support, only eight states receive non-rural high-cost support. This has led Qwest to seek legislative relief in states where it is not receiving non-rural high-cost support and this issue will likely be part of any rewrite of the Act. Without rural carrier support based on study area average costs, many consumers living in rural high-cost regions of the United States may not have access to affordable and comparable telecommunications services. To avoid such an outcome, the Joint Board should recommend that the Commission continue to use study area average costs in the current rural methodology for determining high-cost support for rural ILECs.

The Joint Board should also recommend to the Commission that it retain the corporate operations expense adjustment in its current form. The corporate operations expense adjustment is critical for rural telephone companies and should remain as part of the rural high-cost loop support mechanism. Corporate operations expenses are not trivial, and cannot be overlooked or ignored. For small, rural carriers particularly, such expenses can provide a substantial obstacle to being able to provide service to their customers. In a recent white paper on the universal service needs of rural service providers,[18] Dale Lehman, finds that while corporate operating

[18] Dale Lehman, "False Premises, False Conclusions: A Response to an Attack on Universal Service," August, 2004. Available online at NTCA's website: www.ntca.org.

expenses are highly variable, this variability is primarily a function of company size. When examining several years of cost data (to minimize the effect of such infrequent but significant events as rate cases) and analyzing the data by aggregating at the holding company, rather than the study area level, Lehman finds that only 12% of the variability in corporate operations expenses is not explained by company size.[19] This casts significant doubt upon previous claims that small company inefficiencies were a significant cause of variability in corporate operating expenses.[20] Since such support provides small carriers with an important and predictable means of recouping these necessary costs, it should be retained as part of the rural ILEC high-cost loop support mechanism.

The Joint Board should further recommend that there is a continued need to provide the local switching support (LSS) to rural ILECs serving 50,000 or fewer lines. According to data submitted last year, the weighted mean per loop switching investment in 2002 for rural companies with less than 500 loops was more than triple that of those rural companies with between 50,000 and 100,000 loops.[21] Similarly, rural companies with between 500 and 1,000 loops faced per loop switching costs that were 2⅓ times greater than those rural companies with between 50,000 and 100,000 loops. LSS helps offset the harmful impact of higher local switching costs on small rural providers. In the interest of the upholding the goals of universal service, it is crucial that LSS continue to be made available to eligible carriers.

V. The Time Is Ripe To Expand The Base Of USF Contributors To Ensure Equitable And Nondiscriminatory USF Contributions

The South Dakota Telecommunications Association (SDTA) believes that the time is ripe for the Commission to expand the list of contributors to include both facilities-based and non-

[19] *Id.* at 14.
[20] See, "Lost in Translation: How Rate of Return Regulation Transformed the Universal Service Fund for Customers into Corporate Welfare for the RLECs," Economics and Technology, Inc., February 2004.
[21] NECA 2003 USF data submission. Analysis of 2002 cost data by line size groupings.

facilities-based voice over Internet protocol (VoIP) and IP-enabled service providers and all cable, wireless and satellite providers of broadband Internet access and other providers that connect to or benefit from connection to the public switched telephone network, regardless of the classification of the service as an information service, telecommunications service or private carriage service. The Commission has the authority to expand the number and types of contributors to the fund to ensure "sufficient" support to achieve the goals of the Act. The universe of "telecommunications carriers" and providers of telecommunications and the share of new providers' markets have expanded far beyond the boundaries that existed when the Commission first identified contributors to universal service. It is time for the Joint Board to recommend to the Commission that it expand the base of contributors to ensure contributions on an equitable and nondiscriminatory basis pursuant to Section 254(d).

VI. Summary

Based on the above reasons, SDTA urges the Joint Board to recommend to the Commission the following:

(1) refrain from applying a forward looking economic cost model for determining high-cost universal service support for rural ILECs;

(2) allow the current rural ILEC USF embedded cost methodology to continue beyond the five-year RTF plan for purposes of determining rural ILEC high-cost support;

(3) retain the current definition of a "rural telephone company" for purposes of receiving rural high-cost universal service support;

(4) eliminate the identical support rule and require CETC support to be based on their own costs, not the ILEC's costs;

(5) apply similar cost allocation rules to wireless CETCs;

(6) continue to calculate rural ILEC support based on the individual carrier's study area average costs;

(7) retain the current corporate operations expense adjustment for rural ILECs;

(8) continue to provide local switching support to rural telephone companies; and

(9) expand the base of USF contributors to include all cable, wireless and satellite providers of broadband Internet access and facilities-based and non-facilities-based VoIP and IP-enabled service providers.

Thank you for the opportunity to participate on this panel and discuss issues concerning the future of rural carrier high-cost universal service support.

Dated this 10th day of November, 2004.

Respectfully submitted:

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