Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45
	)	FCC 04J-2

Prepared Testimony of David D. Cole On Behalf of Independent Telephone & Telecommunications Alliance Before the Federal-State Joint Board on Universal Service

I. BACKGROUND AND SUMMARY OF TESTIMONY

My name is David D. Cole. I serve as Senior Vice President, Operations Support for CenturyTel, Inc., a communications services provider based in Monroe, Louisiana, serving rural communities in 22 states. I am testifying today on behalf of the Independent Telephone & Telecommunications Alliance ("ITTA"), an organization of twelve midsize incumbent local exchange carriers ("ILECs"), which collectively operate in more than 40 states and provide local exchange and exchange access service to more than ten million customers. ITTA's member companies are integrated providers offering a broad range of services to their customers, including interexchange, Internet, broadband, video, and wireless services. Most ITTA member companies qualify as rural telephone companies within the meaning of Section 3(37) of the Communications Act of 1934, as amended (the "Act").[1]

ITTA appreciates the opportunity to testify at this hearing. The issues being addressed by this panel are critical to the advancement of universal service. By this testimony, ITTA urges the Joint Board to recommend that the Federal Communications Commission

1 47 U.S.C. §153(37).

("FCC") modify its "Safety Valve" rules so that carriers acquiring rural exchanges are not penalized for investing in rural high-cost areas. ITTA further requests that the Joint Board recommend revisions to the method for calculating support for competitive eligible telecommunications carriers ("CETCs") such that they receive support based on their own costs, not those of the ILEC. These actions are necessary to better target rural high-cost support to areas where it is truly needed, create rational economic incentives for investment (and eliminate disincentives under the current system), achieve greater efficiencies, and better control growth in the universal service fund.

II. SECTION 54.305 AND THE "SAFETY VALVE" SHOULD BE MODIFIED SO INVESTMENT IN RURAL HIGH-COST AREAS IS NOT DISCOURAGED

ITTA members are acutely aware of the hurdles that carriers face immediately following acquisition of rural lines. Within the past five years alone, ITTA members have purchased several million lines from the Bell Operating Companies ("BOCs") (including GTE, now part of Verizon), and many of those lines are in rural areas.[2] These acquisitions routinely have been approved by the FCC and have been found to be in the public interest. ITTA members support the concept of the current "Safety Valve" mechanism, but the present timing and method of calculating support creates disincentives to investment in these acquired exchanges and must be changed.

The "Safety Valve" mechanism set forth in the FCC rules currently provides for up to 50 percent of any positive difference between the purchasing carrier's index year expense

---

[2] *See, e.g., ALLTEL Corporation, Petition for Waiver of Section 61.41*, Memorandum Opinion and Order, 17 FCC Rcd 27,694 (Wir. Comp. Bur. 2002) (ALLTEL Kentucky Acquisition and CenturyTel Alabama and Missouri acquisitions).

adjustment, at the end of its first year of operations, and subsequent year expense adjustments.[3] Thus, rural carriers are ineligible for support for any investments made and expenses incurred in the first year after it acquires lines from another carrier. These rules are not neutral, but penalize buyers and customers in high-cost areas neglected by the operators serving larger study areas.

A. The Current Safety Valve Rule Penalizes Carriers That Make Expenditures in Acquired Markets During the First Year After the Acquisition, and Does Not Adequately Compensate Carriers Thereafter

There is no policy justification to discourage the acquisition of rural exchanges—especially from those operated by the BOCs. Rural customers reap substantial, concrete benefits from such acquisitions because carriers that buy rural exchanges typically make substantial investments and improvements in such exchanges in the first year after acquisition. Not surprisingly, those investments are largely driven by customer demand and, in some cases, by state public service commissions. Carriers acquiring rural exchanges typically perform immediate, extensive maintenance to bring long-neglected telecommunications facilities out of disrepair. This may involve re-working plant that extends from the loop itself all the way into the central office. In most cases when the sale of such access lines are first announced, consumer anticipation is high with the expectation that improvements and new service offerings will be swift in coming. The first year following an acquisition is critical to consumers and the buyer, and support for immediate expenditures should be available in the first year. It is axiomatic that a seller ceases investing in rural exchanges as soon as it decides to sell them – often several years before the sale actually closes. In the first year following an acquisition, the buyer must address the full extent of needed improvements and expenditures, and typically makes long-postponed upgrades to plant and services.

3 47 C.F.R. § 54.305.

The months immediately preceding and following the acquisition is also the period of time that the buyer is most at risk to competitors picking off the most attractive customers – the buyer cannot afford to delay these much-needed improvements. Yet the Safety Valve currently rewards only those buyers who wait a year before making expenditures, by comparing expenditures in the first year to expenditures for subsequent years. As experience repeatedly demonstrates, however, essential first-year expenditures are necessary to rehabilitate neglected rural infrastructure and carriers should be given every incentive to make those expenditures.

In addition to National Telecommunications Cooperative Association ("NTCA"), ITTA and other rural interests, an independent analyst (Legg Mason) has pointed out these shortcomings of the Safety Valve mechanism. In its study examining the phenomenon of BOC sales of exchanges to independent, often rural, carriers,[4] Legg Mason found that BOC exchanges being sold were among the most depreciated among all BOC exchanges.[5] These properties need substantial infusions of cash – Legg Mason estimates an average of $400 per line – to fund investment in new and improved plant and equipment in order to provide high-quality services to

---

[4] Legg Mason, *Reshaping Rural Telephone Markets: Financing Perspectives on Integrating Acquired Access Lines*, at 21 (Fall 2001) ("2001 Legg Mason Report") ("In recent years, we believe that RBOC managements have directed resources to urban areas, where long-term strategic positioning is key and higher return on investment can be generated. As a result, it appears that rural investments have been minimal and, when the companies are pressed to upgrade non-urban properties, divestiture becomes a more logical outcome.").

[5] *See, e.g., id.* at 107, 156 ("[O]n the subject of infrastructure, the data are stunning about the distressed nature of the RBOC rural plant. Depreciation is 60%-75% of total telecommunications plant in service for the most part, many of the exchanges have remote switches, and the divested properties are often 'orphaned remotes,' which means that the buyer must then rearchitect the plant or install new host switches."; "[V]irtually every acquirer of RBOC lines has reported difficulties with cabling and serving electronics.").

rural America.[6] The experience of mid-size companies confirms Legg Mason's findings. As Valor Telecommunications of Texas, L.P. ("Valor") documented in its 2003 petition to the FCC for waiver of the Safety Valve rules, the lines that it bought from GTE in Texas were 70 percent depreciated, compared to the lines retained by GTE that were only 48 percent depreciated.[7] In less than three years of operation, Valor invested over $100 million in the Texas lines acquired from GTE, and still had over two years remaining in its five-year facilities investment plan.[8]

Furthermore, state commissions, which are aware of past infrastructure neglect by larger selling carriers, have requested or required companies buying those properties to make needed investments and maintenance expenditures—often as a condition of approval of sale. For instance, the Wisconsin state commission required CenturyTel to replace the seller's highly outdated switches as one of the conditions on its approval of CenturyTel's acquisition of lines in that state. In Missouri and Alabama, the state commissions required CenturyTel to freeze local rates for two years notwithstanding the need to update switches and other telecommunications infrastructure.

It borders on unconscionable that the current Safety Valve rule, due to timing triggers, actually works to dissuade carriers from making needed improvements to newly acquired exchanges and to delay by a year or more access by affected rural consumers to the basic level of services that such investment would provide. Section 54.305 is by no means an incentive to "gold plate" a rural network – carriers are motivated to invest to improve service quality, though they may recover only a fraction of the added expenditures they make in the

---

6 *Id.* at 107.

7 Valor Telecommunications of Texas, L.P., Petition for Waiver of Section 54.305 of the Commission's Rules, CC Docket No. 96-45, at 9 (filed Apr. 30, 2003).

8 *Id.*

acquired exchanges. Therefore, carriers have no economic incentive to invest monies that are not necessary for the provision of basic services. Further guarding against abuse, rural ILECs make all investments in advance and are subject to rigorous accounting requirements to justify their receipt of support. Carriers should be given a reasonable incentive to improve telecommunications services in the exchanges they acquire without unnecessary delay.

B. ITTA Supports Modifications to the Safety Valve Mechanism

Section 54.305 of the FCC's rules ensures transactions will not occur purely to increase the amount of support to a particular exchange. However, the FCC modified this rule because the rule did not provide adequate support for substantial investments made in acquired exchanges, which penalized both acquiring carriers and their customers.[9] Unfortunately, as well-intentioned as the Safety Valve concept was, the FCC did not go far enough in adopting the Safety Valve as currently structured, because it does not provide any cost recovery for additional expenditures in the critical first year following the purchase of rural exchanges.

Additional support is needed, as has been widely recognized, requiring modifications to the Safety Valve mechanism. In a petition for reconsideration of the *RTF Order*, NTCA asked the Commission to amend Section 54.305 to allow acquiring carriers to receive Safety Valve support for first year investments in newly acquired exchanges.[10] ITTA supports this petition, which has been pending before the FCC for more than 3 years. In

---

[9] The Joint Board explained, "In its *Rural Task Force Order*, the Commission modified [Section 54.305 of its rules] to permit an acquiring rural carrier to receive additional high-cost loop support (i.e., "Safety Valve" support) for substantial investments it made in acquired exchanges." *Federal-State Joint Board on Universal Service Seeks Comment on Certain of the Commission's Rules Related to High-Cost Universal Service Support*, Public Notice, FCC 04J-2 at ¶ 48 (rel. Aug. 16, 2004) (citing *Rural Task Force Order* at ¶ 91-119).

[10] NTCA Petition for Reconsideration and Clarification, CC Docket 96-45, (filed July 5, 2001).

addition, the recently filed ICF plan for Intercarrier Compensation and Universal Service Reform Plan (the "ICF Plan"), drafted by a diverse cross-section of the industry that includes interexchange carriers, BOCs and competitive local exchange carriers,[11] supports a "neutral" policy toward sales of rural exchanges, and supports modifying the Safety Valve so rural high-cost loop support is available in the first year, and so additional support (for non-loop expenditures) is available as well.[12]

The ICF Plan proposes the following modifications. *First*, the acquiring carrier should be eligible for support immediately following the acquisition of rural exchanges based on a showing of actual investment in the acquired properties.[13] *Second*, the Commission should measure the baseline cost-per-loop in an acquired exchange on the costs of the *seller* at the time of the acquisition. Measuring the baseline by the seller's costs will best demonstrate the increased costs incurred by the buyer subsequent to the acquisition, and will provide an immediate basis for support. *Third*, the acquiring carrier should receive 75 percent of the difference between its average loop cost and its baseline loop cost during the first year after acquisition, and 50 percent in subsequent years as under the current rule. The ICF Plan also proposes a second, comparable, Safety Valve mechanism that would provide support to the acquiring carrier for non-loop expenditures.[14]

Under the ICF Plan, the additional support that is advocated still would compensate carriers only for a fraction of their additional expenditures in acquired exchanges, but would remove the current disincentives to acquisition of, and investment in, high-cost rural

---

11

12 ICF Plan, CC Docket No. 01-92 (filed Oct. 5, 2004).

13 *Id.* at Exhibit A, pp. 80-81.

14 *Id.* at 23-24.

exchanges. ITTA therefore supports the ICF proposed changes to the Safety Valve mechanism and requests that the Joint Board recommend these modifications to the FCC.

III. CETCS SHOULD RECEIVE SUPPORT BASED ON THEIR OWN COSTS, NOT THOSE OF THE ILEC

At a time when universal service funding is under attack on multiple fronts, the FCC and Joint Board must not lose sight of the statutory purposes of the high-cost fund – providing specific, predictable and sufficient support to ensure comparable services are available at comparable prices in rural and urban areas.[15] ITTA understands concerns that have been raised about growth in the universal service fund. However, rural ILECs are not the major cause of increases in the overall high-cost fund. The high-cost loop fund is capped and the national average cost-per-loop is frozen. ILEC high-cost loop support will actually decline in 2005, for the first time, due to line loss, while total available support remains capped for ILECs (despite the steady increase in actual average per-line costs).

ITTA members are troubled by the tone of recent releases by the Joint Board that propose to rein in “uncontrolled” growth in the universal service high-cost fund by cutting funding to rural ILECs, the carriers-of-last-resort in many rural communities.[16] Such proposals are not rooted in the realities of providing service to rural communities and are contrary to Section 254 of the Act. Section 254 of the Act makes clear that universal service must be the goal of the universal service fund.

---

[15] 47 U.S.C. §§ 254(b)(3), (5).

[16] *See generally Federal-State Joint Board on Universal Service*, Recommended Decision, FCC 04J-1 (rel. Feb. 27, 2004) (“Recommended Decision”); Public Notice.

CETC support is currently at about seven percent of the high-cost fund, over half a billion dollars annually,[17] and it is the fastest growing category of federal support.[18] It is also the only form of federal support that is not capped based on relative costs. As explained in a recent Legg Mason report, "*the size of the universal service fund . . . would not be a major concern if it were not for the dramatic growth in CETC payments over the last two years and the potential expansion in the next few years*."[19]

That is why it is critical to look at CETC requests for funding as part of the responsible management of the fund. An important part of checking growth in the universal service high-cost fund, while continuing to promote universal service in rural areas, is to require CETCs to justify support based on their own costs, not the costs of the ILEC. While more and more CETCs are getting support at the same level as the ILEC, they still are not required to demonstrate that the support is being used to provide a service that is comparable to the service the ILEC provides. This is a fundamental measure of consumer-focused accountability that should be recommended by the Joint Board. ILEC costs, investment and related recovery are there for all to see. CETCs should also be required to demonstrate their costs justify funding, and what amount of funding would be "sufficient" under the Act. Recent pressures and

---

[17] Legg Mason Wood Walker, Inc., Universal Service Financial Analysis, at 11-12 (June 25, 2004) (estimating approximately $44.74 million of funding per month to CETCs) ("2004 Legg Mason Report").

[18] Comments of the National Association of State Utility Consumer Advocates on the Recommended Decision of the Federal-State Joint Board on Universal Service, CC Docket No. 96-45, at 8-9 (filed Aug. 6, 2004) ("These numbers show that CETCs and especially wireless ETCs are consuming an ever-growing amount of high-cost funds. Wireless ETC support is the fastest growing portion of the high-cost fund. In fact, 66% of the growth of the fund over the last four quarters can be attributed to CETCs.").

[19] 2004 Legg Mason Report at 5 (emphasis in original).

controversies surrounding the administration of universal service funds dictate that center piece of any pending reforms should be strict oversight of rapidly increasing CETC disbursements.

Accountability measures under the current rules are not sufficient to ensure that CETC support is directly related to costs they incur in providing service to high cost areas. Given current standards in use to designate CETCs, it is not possible to determine what costs CETCs incur serving rural areas or how those costs relate to incumbents' costs. While, for example, it is certain that wireless CETCs have lower legal and regulatory costs than their wireline counterparts, existing accountability measures provide no basis for accurately assessing CETCs' actual costs of providing service.

In addition, there is what has been termed by some the "customer list" problem.[20] That is, as soon as a wireless carrier receives its CETC designation, the new CETC receives support for its entire existing customer list equal to the per-line support of the ILEC, without any effective accountability for those lists or without any requirement to expend the newly acquired resources in serving those lines. Given that current standards in many states for CETC designation are quite liberal, CETCs are effectively compelled to seek universal service support to maximize profits, even though they may not require such support to continue to compete.[21]

In some instances, CETCs are receiving more universal service support than the incumbent because multiple CETCs in the market are submitting substantially more lines for

---

[20] Remarks of Commissioner Kevin J. Martin, Federal Communications Commission, to the Santa Fe Conference of the Center for Public Utilities Advisory Counsel, Santa Fe, New Mexico, at 6 (March 18, 2003); McLean & Brown, *Issue Update, Special Edition, USF Portability – Getting it Right*, at 2 (June 25, 2002).

[21] Comments of the Rural Telecommunications Associations, CC Docket No. 96-45, at 7 (filed Aug. 6, 2004) ("Even if the management of a competitive carrier knows that their costs are low enough to compete effectively without additional support, they are compelled by their fiduciary duty to seek ETC designation so as to maximize profits and avoid lost opportunities to obtain support.").

support than there are households (or, in some cases, even people) in the study area. The National Exchange Carrier Association recently provided the example of universal service fund abuse in Iowa, where, in the Batavia study area, wireless carriers sought support for 927 customers, *nearly twice the population of the study area*.[22] NECA further commented that federal support is apparently being provided for "two mobile phones for every man, woman and child in Batavia."[23] Similarly, SBC has noted that Western Wireless sought support for over 30,000 working loops on the Pine Ridge Reservation in South Dakota in the first quarter 2003 despite the fact that the Reservation had fewer than 15,000 residents and fewer than 4,000 housing units.[24]

CenturyTel also has first-hand experience with this phenomenon. CenturyTel's only study area in Arizona has 1,933 wireline loops, but Smith Bagley, a wireless CETC, submits 2,730 loops for funding and receives 41 percent more support than CenturyTel in CenturyTel's Arizona study area.[25] Considering the concerns of the Joint Board regarding the size of the universal service fund, it is hard to imagine that the public interest is served by the absence of the reasonable accountability measures for CETCs. This issue is exacerbated by the fact that wireless CETCs commonly file petitions to redefine ILEC service areas so that the

---

[22] Comments of the National Exchange Carrier Association, Inc., CC Docket No. 96-45, at 14 (filed Aug. 6, 2004).

[23] *Id*.

[24] Comments of SBC, CC Docket No. 96-45, at 10-11 (filed May 5, 2003) (citing Comments of South Dakota Telecommunications Association, WT Docket No. 02-381 (filed Feb. 3, 2003)).

[25] Universal Service Administrative Company, Fourth Quarter Appendices (HC18), available at http://www.universalservice.org/overview/filings/2004/Q4/default.asp (visited Sep. 21, 2004).

CETC can receive the same support per-line as the ILEC, without having the obligation to serve the entire ILEC study area.

In addition, ITTA previously has recommended that, like ILECs, CETCs should submit actual cost data to justify the amount of support they receive. The Joint Board recently recognized the impropriety of basing CETC support on ILEC's costs in a recommended decision submitted to the Commission in this proceeding.[26] Specifically, the Joint Board stated:

> For areas served by rural carriers, we are concerned that funding a competitive ETC based on the incumbent LEC's embedded costs *may not be the most economically rational method for calculating support*. . . . We agree that universal service payments should not distort the development of nascent competitive markets. Universal service support should neither incent nor discourage competitive entry.[27]

CETCs should be required to adopt reasonable standardized accounting methods to submit their costs in a uniform manner to the Universal Service Administrative Corporation ("USAC"). Most CETCs are established carriers, and as such they should not find it burdensome to track their costs or disclose their financial records related to these areas – this is likely something they already do, for the benefit of their investors. But even if some effort is required by the CETC to provide documentation of costs, it seems to be a small concession in order to protect the integrity of the universal service fund. ITTA does not advocate that *all* competitive carriers submit cost data; but competitive carriers that seek to obtain universal service support should demonstrate that they are using the support for its intended purposes.[28]

---

[26] Recommended Decision at ¶ 96.

[27] *Id*. (emphasis added).

[28] *See* 47 U.S.C. § 254(e).

IV. CONCLUSION

ITTA urges the Joint Board to pursue policies that give priority to the welfare of the nation's most rural communities. For the reasons discussed above, the Joint Board should recommend modifications to the Safety Valve support mechanism as proposed herein, in order to appropriately compensate carriers for the high expenses and substantial investments incurred to rehabilitate acquired exchanges. ITTA also requests that the Joint Board recommend that CETCs should receive universal service support based on their own costs, and not the costs of the ILEC and that reasonable accountability measures be instituted to ensure that funds are distributed appropriately. Adoption of these proposals is critical to promoting telecommunications services in rural America and protecting the viability of the universal service high-cost fund.

Prepared this 9th day of November, 2004.

/s/

David D. Cole
Senior Vice President, Operations Support
CENTURYTEL, INC.

On Behalf of

INDEPENDENT TELEPHONE AND TELECOMMUNICATIONS ALLIANCE
1300 Connecticut Avenue, N.W., Suite 600
Washington, D.C. 20036
(202) 775-8116