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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
Federal Communications Commission
Washington, DC 20554

In the Matter of	)	
	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-54
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Transport Rate Structure and Pricing	)	CC Docket No. 91-213
	)	
End User Common Line Charges	)	CC Docket No. 95-72
	)	

PETITION FOR RECONSIDERATION OF THE RURAL TELEPHONE COMPANIES

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July 17, 1997

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SUMMARY

The Rural Telephone Companies respectfully request the Commission to reconsider the *USF Order* provisions adopting rules for a new universal service fund ("USF") for "rural, insular, and high cost areas" based, in part, on a "forward-looking economic cost" methodology. The Commission has determined that, upon transition to the new methodology the federal USF program will only fund 25 percent of the total USF support necessary for serving rural, high cost and insular areas, leaving the remaining 75 percent to be obtained through state programs or left unfunded. The USF Order makes USF support and the recovery of local switching costs via DEM weighting portable so that a competitive local exchange carrier ("CLEC") can take away not only USF support on a per line basis but also the recovery of local switching investment and other embedded investment associated with that line.

The Commission's decision to rely on the states to fund 75 percent of the total USF when combined with the inability to recover booked costs, will result in an illegal "taking" of the Rural Telephone Companies' property in violation of the Fifth Amendment to the U.S. Constitution. The Commission's decision to also make USF support and the recovery of local switching investment portable to CLECs also violates Section 254(e) of the Act because the Rural Telephone Companies, rather than the CLECs, provide the facilities, the costs of which are being partly recovered by DEM weighting and USF for high cost companies. The Commission's decision is also arbitrary in violation of the Administrative Procedures Act (APA) and inconsistent with the USF principles described in Section 254(b) of the Communications Act, as amended (the "Act").

The *USF Order* also establishes interim high cost support and local switching separations and cost recovery rules for rural incumbent local exchange carries ("ILECs"). The interim rules modify existing jurisdictional separations rules removing current DEM weighting for small ILECs and, on an interim basis, replace that cost recovery mechanism with so-called "local

switching support" paid from a new USF mechanism. The Access Charge Reconsideration Order has also mandated a reduction in the local switching rates charged to interexchange carriers ("IXCs") to reflect this change to the DEM weighting separations rules. The Rural Telephone Companies seek reconsideration of these Orders because, DEM weighting accurately assigns more local switching costs to the interstate jurisdiction to be recovered from access charges billed to IXCs. This is totally appropriate, because small ILECs' local switching costs are driven largely by the needs of IXCs to have equal access, intraLATA toll dialing parity and advanced features such as CCS7 capabilities. While the present DEM weighting separations rules accomplish this, the Commission's interim local switching rules arbitrarily treat DEM weighting as a "subsidy" to be borne by all USF contributors rather than to be recovered in a manner consistent with long standing principles of cost causation.

The interim rules, as adopted in the USF Order and revised in the USF Reconsideration Order, also arbitrarily cap the amount of corporate operations expenses that can be recovered through the high cost loop fund." This cap results in an illegal taking in violation of the Fifth Amendment. Moreover, the Commission has imposed this limitation on cost recovery without of any evidence suggesting that corporate operations expenses were unreasonable or excessive and without considering the impact on small companies. The Commission's action is contrary to Section 254(b) of the Act in arbitrarily limiting the high cost loop support when a rural exchange is acquired and upgraded. Finally, high cost loop support has been arbitrarily limited beginning in the year 2000 by utilization of a national inflation index despite the fact that ILECs with loop costs that have outpaced the national average will be denied assistance by this arbitrary ceiling. For these reasons, discussed in turn below, the Rural Telephone Companies seek reconsideration of the USF Order, the USF Reconsideration Order, and the Access Charge Reform Reconsideration Orders.

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PETITION FOR RECONSIDERATION
OF THE RURAL TELEPHONE COMPANIES

The Rural Telephone Companies, by their attorneys and pursuant to 47 C.F.R. §1.429, respectfully submit this Petition for Reconsideration of the Commission's *Report and Order*,[1] and *Order on Reconsideration*[2] CC Docket No. 96-54 and, further request reconsideration of the Commission's *Order on Reconsideration* in the Access Charge Reform Proceeding.[3]

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[1] 62 Fed. Reg. 32862 (June 17, 1997) (*USF Order*).

[2] Federal-State Joint Board on Universal Service, *Order on Reconsideration*. CC Docket No. 96-45, FCC 97-246, (released July 10, 1997) ("*USF Recon. Order*").

[3] Access Charge Reform, *Order on Reconsideration*, CC Docket 96-262, FCC 97-247 (released July 10, 1997) ("Access Charge Reform Reconsideration Order").

I. Introduction.

The Rural Telephone Companies, listed in Exhibit 1 attached hereto, are a group of incumbent local exchange carriers ("ILECs") operating separately as rate-of-return carriers either based on their own costs or through National Exchange Carrier Association, Inc. ("NECA") developed average schedules.

The companies represented herein serve predominantly rural areas, including small villages and towns, sparsely populated farming communities and/or isolated mountainous areas with difficult terrain. These characteristics tend to increase the Rural Telephone Companies' costs of doing business. Despite these high costs the Rural Telephone Companies have managed to build a telephone network providing state-of-the-art services at affordable rates. This level of service has been made possible, in part through existing universal service support mechanisms, the recovery of local switching investment through interstate access charges paid by interexchange carriers ("IXCs"), and is also due in large measure to the tireless dedication of the Rural Telephone Companies to effectively serve their communities.

II. The "Total Effect" of the New USF Plan Does Not Provide Rural ILECs With A "Just and Reasonable" Rate of Return And Is Confiscatory In Violation of the Takings Clause of the Fifth Amendment to the Constitution.

Under the new USF Rules, high cost support for the Rural Telephone Companies will be based on a forward-looking economic cost model that does not permit them to recover embedded investment. As demonstrated below, the Commission's failure to allow the Rural Telephone Companies to recover embedded costs will result in an impermissible "taking" without just compensation in violation of the Fifth Amendment to the U.S. Constitution.[4] Moreover, the

[4] U.S. Const. amend. V.

Commission's treatment of rural ILECs during the interim period prior to the transition to forward looking costs results in an illegal taking without just compensation.

It is well-settled that ILECs and other public utilities may assert their rights under the Takings Clause of the Fifth Amendment.[5] The Fifth Amendment protects utilities from being regulated in a manner that limits charges for their services to levels "so unjust as to be confiscatory."[6] A rate is considered "confiscatory" if it is not "just and reasonable."[7] In *Hope Natural Gas*, the Supreme Court indicated that to determine whether rates are just and reasonable one must look at the overall impact of the rate order.[8] Thus, the Commission is directed by this precedent to examine the overall framework of interstate access charges and high cost support to ensure that ILECs operating in rural, high cost and insular areas are provided with a reasonable opportunity to recover a fair rate of return on their investment (currently set at 11.25 percent).[9]

Consistent with Commission and Court precedent, in considering whether rates are just and reasonable, the Commission must consider the "overall" rate structure, including revenues for services under the Commission's jurisdiction.[10] In making this "overall" determination, the

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[5] *See Duquesne Light Co. V. Barasch*, 488 U.S. 299, 307 (1989).

[6] *Id.* at 307.

[7] *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944).

[8] *Id.*

[9] Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, *Memorandum Opinion and Order,* 70 RR 2d 26 (1991) (prescribing rate of return on ILEC interstate services of 11.25%).

[10] Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, *First Report and Order*, 11 FCC Rcd 15499, ¶737 (1996) (Local Competition Order) *stayed in part pending judicial review sub nom. Iowa Util. Bd. V. FCC,* 109 F.3d 418 (8th Cir. 1996).

Commission thus is barred from considering ILEC revenues derived from services not under its jurisdiction.[11] Therefore, to assess whether the Commission's USF support scheme for rural, high cost and insular areas is confiscatory, the Commission must consider the revenues from only interstate services and support from only the interstate USF. The FCC has determined that it will only fund 25 percent of the necessary federal USF associated with high cost loop assistance, the recovery of local switching investment via DEM weighting, and the long term support for the NECA carrier common line pool. Any existing or projected implicit or explicit forms of support generated by intrastate rates or support programs must not be considered.[12]

The analysis, attached as Exhibit 2, demonstrates the impact on the rate of return of typical small ILECs comprising the Rural Telephone Companies. To analyze the impact of the rule changes, these companies independently calculated their annual interstate revenue loss due to changes in the DEM weighting allocation rules and changes in existing USF calculations, (including the cap on Corporate Operations Expenses) to obtain their annual interstate rate-of-return reflecting these losses with and without the loss of subscribers due to the introduction of competition. This portion of the analysis demonstrates the immediate impact of the Commission's interim treatment of rural ILECs.

First, Exhibit 2 demonstrates that even without the loss of customers and portable USF, the arbitrary Commission cap on Corporate Operations Expenses will reduce the annual interstate rates-of-return for several Rural Telephone Companies to negative amounts between -0.66% and

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[11] *Id. citing Smith v. Ill. Bell*, 282 U.S. 133 (1930).

[12] *Id.*

-28.84%. If a Rural Telephone Company loses just 25% of its customers the annual rate-of-return for interstate access service will, in many cases, fall to between -2.33% and -47.37%.

Exhibit 2 also demonstrates the projected impact of the new USF regime (*i.e.*, applying a forward looking economic cost methodology and funding only 25% of the necessary support). The analysis estimates forward looking costs on the basis of available information including Part 51 cost proxies and the Commission's estimated per-line nationwide revenue benchmark of $31 for residential lines and $51 for single-line businesses.[13] The sample rate of return data demonstrates that use of a forward-looking economic cost methodology in combination with the new support system for rural, high cost and insular areas, funded at only 25 percent of the total necessary amount, will not enable the Rural Telephone Companies to recover a fair return on their investment and will have a significant impact on the financial integrity of the Rural Telephone Companies. As shown in Exhibit 2, under the new USF methodology, the Rural Telephone Companies will experience a negative interstate rate of return between -12.3% and -61.89% even if no customers are lost to competitors. As indicated, these interstate rates-of-return were calculated using the default proxies for forward-looking costs already adopted in Section 51.511 of the Commission's rules and Commission estimated revenue benchmarks. However, even using the Benchmark Cost Proxy Model ("BCPM") for estimating forward looking costs causes a negative rate-of-return on the interstate rate base for Rural Telephone Companies. *See* Exhibit 2-FLCM.

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[13] *USF Order* at ¶ 267. Use of these forward-looking cost estimates and the estimated revenue benchmarks is for demonstration purposes only and does not constitute an endorsement of this method of determining USF assistance by the Rural Telephone Companies.

Average schedule companies will also be adversely impacted by treating the DEM weighting separations rules at a portable subsidy and requiring a forward-looking cost methodology. The impact on average schedule companies will be similar to the impact on cost companies as Section 69.606 of the Commission's rules will require NECA to revise the central office average schedule formula to reflect the elimination of DEM weighting. Exhibit 3 provides separate data demonstrating the impact upon typical average schedule companies. The average schedule companies listed in Exhibit 3 calculated their 1996 revenues from the average schedule formulas which, for ILECs with less than 10,000 access lines, provide a weighting factor - - "Access Line Factor" which provides settlements analogous to DEM weighting.[14] To assess the impact of forward-looking cost models, individual average schedule companies among the Rural Telephone Companies used available data (*i.e.*, FCC estimated benchmarks and Section 51.511 forward-looking cost proxies) to determine first, whether they would qualify for USF under the new regime (forward-looking costs minus national revenue benchmark). In each example set forth in Exhibit 3, the average schedule companies would not qualify for USF or DEM weighting. Finally to demonstrate the total impact on these companies, Exhibit 3 shows that the loss of USF and DEM weighting will cause a loss of interstate average schedule settlements of as much as $482.26 per access line or a loss of between 8.24 % and 38.26 % of total annual interstate average schedule settlements. With the current average schedule formulas developed to ensure that average schedule companies earn a fair return on their interstate investment of at least 11.25%, the substantial losses in settlements that will be caused by the USF Order will deny

[14] The Rural Telephone Companies understand that the central office average schedules formula itself also incorporates a DEM weighting factor. This factor cannot be "backed out" of the formula. Thus, the impact of losing DEM weighting is likely to be more significant than what is set forth in Exhibit 3.

average schedule Rural Telephone Companies an opportunity to earn a just and reasonable interstate rate-of-return in violation of the Fifth Amendment to the U.S. Constitution.

The Commission's new rules making USF support and the recovery of local switching costs via DEM weighting portable, *in lieu* of being used to continue to recover booked investment, has immediate and adverse consequences for the Rural Telephone Companies. The interim high cost loop support and local switching cost recovery mechanisms available to the Rural Telephone Companies until at least January 1, 2001, permit recovery of some embedded investment. However, because USF support becomes immediately transitory, CLECs can take per-line USF support away from the Rural Telephone Companies, thereby taking the per-line share of their support including the embedded investment associated with that line. Moreover, the level of support that the Commission will allow the CLEC to take is based in part on the embedded investment of the ILEC. Beginning January 1, 1998, the USF Order permits CLECs to take away a Rural Telephone Company's recovery of local switching investment now accomplished by the DEM weighting separations rules. The USF Order unlawfully penalizes the Rural Telephone Companies for making past investment in reliance on their ability to gain a fair return, by transferring the cost recovery and USF support based on that investment to the Rural Telephone Companies' competitors.

The Commission's decision making USF support and the recovery of local switching investment portable is also inconsistent with Section 254(e) of the Act because, although a CLEC may purchase unbundled network elements to serve a particular customer, the Rural Telephone Companies are still providing the facilities for which USF is used. Section 254(e) mandates that

USF support be used "only for provision, maintenance and upgrading facilities and services."[15] As with the Commission's Open Network Architecture ("ONA") rules, just because parts of a Rural Telephone Company's network are made available on an unbundled basis does not render the elements of the Rural Telephone Company's network any less the property of the Rural Telephone Company.[16]

It is inappropriate for the Commission to treat costs legitimately allocated to the interstate jurisdiction via DEM weighting as a portable subsidy. The DEM weighting separations rules recognize that small ILECs experience higher switching costs and is unrelated to the costs associated with CLEC operations. A large portion of the cost of a rural ILEC's switch relates to central processing hardware and software which varies little with the number of access lines. The processing and software features of the switch are necessary for network functions required by IXCs such as equal access, intraLATA toll dialing parity, toll screening, toll blocking, Signaling System 7 ("SS7"), expanded Carrier Identification Codes (CICs) and 800 number portability. Therefore, these costs are appropriately recovered through access charges.

Under the standard for determining whether a rate is reasonable, as annunciated by the Court in *Hope Natural Gas,* "the regulatory body must balance the interests of both the investor and consumer."[17] "From the investor or company point of view, it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business..." From the consumers point of view the return on equity should be "commensurate with returns on

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[15] 47 U.S.C. § 254(e).

[16] *See gen.* Filing and Review of Open Network Plans, *Memorandum Opinion and Order*, CC Docket No. 88-2, Phase I, 4 FCC Rcd 1 (1988); recon., 5 FCC Rcd 3084 (1990); *Memorandum Opinion and Order*, 5 FCC Rcd 3103 (1990).

[17] *Hope Natural Gas*, at 602.

investments in other enterprises having corresponding risks."[18] Due to the significant reduction in the rate of return that will be caused by the USF Order, the Rural Telephone Companies will not have sufficient revenues to cover operating expenses as well as the capital costs of their businesses. Therefore, under the standard discussed in *Hope Natural Gas,* the Commission's rules are "confiscatory" in violation of the Fifth Amendment takings clause. Accordingly, the Rural Telephone Companies seek reconsideration of the Commission's funding decision and USF portability rules.

III. It is Arbitrary and Capricious To Fund Only 25 Percent of the High Cost Fund Without Any Evidence That the States Will Fund the Remaining 75 Percent.

The Commission's decision to fund only 25 percent of the federal USF associated with the recovery of local switching investment via DEM weighting, high cost loop support and the long term support for NECA's carrier common line pool violates Sections 254(b)(1)and (3) of the Act because the Commission has failed to ensure that the support level it will fund is sufficient to preserve and advance universal service. To the contrary, the Commission's decision to fund only 25 percent of what was formerly fully supported by the federal USF will place upward pressure on local rates in a manner that will jeopardize rate affordability. The record contains no evidence that the states have mechanisms in place to fund the remaining 75 percent needed for federal USF..[19] Given the great disparity among the several states, the Commission has created a patchwork of unfunded and underfunded high cost areas completely at odds with Section 254(b)(3) which requires the Commission to ensure access to universal service "in all

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[18] *Id.*

[19] *USF Order* at ¶ 268.

regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas."[20]

Without a secure definite source of full support, the Commission cannot ensure that telecommunications rates will continue to be affordable to consumers in high cost, rural and insular areas. If only 25 percent of the necessary high cost funding is available in a particular area, ILECs will experience pressure to make up the short fall through higher local rates. Thus, to the extent state regulations will permit, consumers may be faced with local rate increases in obvious contradiction of Section 254(b)(1) which requires that universal service be available at "just, reasonable and affordable rates."[21]

The Commission's decision is also contrary to Section 254(b)(5) which requires "specific, predictable and sufficient" USF mechanisms. By its own admission, the Commission does not have the information before it to determine whether its funding decision is consistent with this Congressional mandate.[22] Because the Commission has not made any attempt to determine the level of support that will be provided by the states, it has no way of knowing that funding will be "sufficient" or "predictable" and is not in a position to ensure just, reasonable and affordable rates as required by Section 254(b). Therefore, the Commission has failed in its obligation to adopt USF rules that comport with the plain language of Section 254(b) of the Act.[23]

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[20] 47 U.S.C. §254(b)(3).

[21] 47 U.S.C. §254(b)(1).

[22] *USF Order* at ¶ 268.

[23] 47 U.S.C. §254(b); *See also, Griffin v. Oceanic Contractors, Inc.*,447 U.S. 102, 100 S.Ct. 2051 (1980)(Discussing the "familiar canon of statutory construction that the starting point for interpreting a statute is the language of the statute itself. Absent a clearly expressed legislative

The Commission's funding decision forces the states to make up the short fall or face the consequences of local universal service set-backs. In effect, the decision creates a mandate to the state public service commissions to fund the remaining 75 percent of the federal USF recognized by the Commission as necessary to properly advance and preserve universal service in a manner consistent with Section 254 of the Act. This funding decision gives states little choice -- if states wish to maintain total USF support to carriers operating in their jurisdiction at current levels, they are compelled to act. The Commission states (at ¶¶ 268 & 271) that "[it] has every belief" that states will fund USF programs. By so compelling the state governments to fund a federal regulatory program, the Commission runs afoul of recognized principles of state sovereignty in violation of the Tenth Amendment to the U.S. Constitution.[24]

In addition, the Commission's action is inconsistent with the limitations on the Commission's own jurisdiction found in Section 2(b)(1) of the Act.[25] The U.S. Court of Appeals for the Eighth Circuit recently vacated a similar attempt by the Commission to exercise jurisdiction over the recovery of access charges for intrastate calls.[26] The *Comptel* case involved, *inter alia*, the Commission's decision to "allow states to preserve certain intrastate universal support mechanisms based on access charges" on an interim basis until the Commission

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intention to the contrary, that language must ordinarily be regarded as conclusive."

[24] *New York v. United States*, 505 U.S. 144, 188 (1992)(the Federal Government may not compel the states to enact or administer a federal regulatory program); *see also Printz v. United States*, __ U.S. __, 1997 WL 351180(1997)(Federal Government may neither issue directives requiring the States to address particular problems, nor command the States' officers, or those of their political subdivisions, to administer or enforce a federal regulatory program. Such commands are fundamentally incompatible with our constitutional system of dual sovereignty).

[25] 47 U.S.C. § 152(b)(1).

[26] *Competitive Telecommunications Assoc. v. Federal Communications Commission*, No. 96-3604, (Filed June 27, 1997, U.S. Ct. App. 8th Circuit)(*Comptel*).

completed proceedings on Access Charge Reform and USF.[27] The Eighth Circuit vacated the FCC's decision stating, "[w]hile we recognize the FCC is merely 'allowing' the state commissions to continue to allow the LECs to collect access charges on intrastate calls, we believe that such an assertion of regulatory power is beyond the scope of the FCC's jurisdiction."[28] In *Comptel,* the Commission overstepped the limits of its authority in suggesting how to fund USF with access charges. In the instant case the Commission's action represents a significant and permanent invasion of the states' authority and thus should also be considered outside its jurisdiction.

Accordingly, the Rural Telephone Companies request that the Commission vacate its funding decision and adopt support levels and funding methods that ensure cost recovery and a fair rate of return on investment for ILECs based on 100 percent of the current regulated rate base.

IV. It Is Arbitrary and Capricious To Treat The DEM Weighting Separations Rules As A Per-Line "Subsidy" Borne By All USF Contributors, Rather than IXCs, When the Most Expensive Features of A Digital Switch Are Required By the IXC Network and Involve Usage Sensitive Charges.

Under Section 706 of the Administrative Procedure Act, Commission actions, findings and conclusions are unlawful if found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[29] The Commission, in adopting new USF rules, has arbitrarily labeled the DEM weighting separations rules as an implicit "subsidy"[30] when in fact it

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[27] *Local Competition Order* at ¶ 732.

[28] *Comptel*, fn. 5.

[29] 5 U.S.C. § 706(2)(A).

[30] *USF Order*, at ¶ 212.

is an important cost recovery mechanism that properly assigns small ILEC local switching costs to the interstate jurisdiction for recovery from interexchange carriers, the entities that cause small ILECs to incur the lion's share of their switching costs. By first changing the existing DEM weighting rules, to an interim approach funded by all USF contributors, and eventually eliminating DEM weighting entirely, the Commission has created a subsidy program for IXCs by shifting costs away from them and onto the backs of all USF contributors. In doing so, the Commission has, without explanation, abandoned its oft espoused principle of requiring costs of telecommunications services to be recovered from the cost causer, which in the case of the majority of local switching costs is the IXC.[31]

The DEM weighting separations rules are targeted to the smallest carriers (*i.e.*, those with less than 50,000 access lines) typically operating in sparsely populated rural areas. However, switching costs for these companies, such as those that rely on common channel signaling, are significant in their own right, and particularly significant relative to the smaller number of end-users served. Despite the fact that the Rural Telephone Companies have smaller service areas and typically serve fewer customers, their switching costs are closer to those of the larger LECs, and much higher on a per minute basis. As demonstrated in Exhibit 4, Rural Telephone Companies ranging in size from about 800 access lines to about 5,200 access lines have spent between $87,575 and $367,515 just to upgrade their digital switches for equal access, SS7 and

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[31] *Access Charge Reform Order* at ¶ 75. The APA requires that all decisions "shall include a statement of — findings and conclusion, and the reasons and bases therefor, on all material issues of fact, law or discretion presented on the record." 5 U.S.C. § 557(c)(3); *see also See v. Washington Metro. Area Transit Auth.* 36 F.3d 375, 384-86 (4th Cir. 1994); The absence of the APA-required explanation is fatal to the validity of an administrative decision. *Garret v. FCC*, 513 F.2d 1056, 1060(D.C. Cir 1975); *Anglo-Canadian Shipping Co. v. FMC*, 310 F.2d 606, 617 (9th Cir. 1962)(citing *Saginaw Broadcasting Co. v. FCC*, 96 F.2d 554, 563 (D.C. Cir. 1938).

other network functions. Such upgrades are necessary for both large and small ILECs primarily to facilitate the provision of advanced features and functions required by IXCs but has a greater cost impact on smaller ILECs, on a per-minute basis.

Unlike larger ILECs that have economies of scale permitting the spread of investment over a larger number of exchanges, small ILEC operations cannot take advantage of such economies.[32] Larger ILECs also benefit from economies of scale that afford them discounts from manufacturers to purchase switching equipment.

Current DEM weighting separations rules properly assign a greater share of the local switching costs to access charges to be recovered from IXCs because, as demonstrated above, but for the IXCs, much of a small ILEC's local switching costs could be avoided. The Commission has not only arbitrarily created a subsidy program for IXCs by shifting costs away from them and to all USF contributors, but by making the recovery of such costs portable and capped by the level of forward looking costs, the Commission has deprived the Rural Telephone Companies of any opportunity to recover a fair return on their local switching investments, whether from IXCs or other USF contributors.

The Commission's decision adversely impacts both cost companies and "average schedule" ILECs. Average schedule companies' interstate settlements are based on a NECA-derived formula designed to simulate payments to cost companies of similar size and therefore include a weighted DEM component which must be identified and shifted to the new USF.[33]

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[32] *USF Order*, at ¶ 294 (stating that, "compared to large ILECs, rural carriers generally serve fewer subscribers, serve more sparsely populated areas, and do not generally benefit as much from economies of scale and scope").

[33] 47 C.F.R. § 69.606(a). NECA, the entity responsible for recalculating the average schedule formulas as well as, on an interim basis, administering the new USF fund, has several important

Furthermore, many states have prescribed intrastate access rates that mirror NECA's interstate access rates. If these states reduce their traffic sensitive access charges to reflect changes NECA must make as a result of the elimination of the DEM weighting, but do not develop an intrastate USF funding mechanism to account for the change, the Rural Telephone Companies will also experience immediate and substantial intrastate revenue reductions. The attached Exhibits 2 and 3 show the impact on several Rural Telephone Companies of making these drastic changes to the interstate DEM weighting separations rules. In many states, there will even greater negative impacts on intrastate revenues.

V. The Commission's New USF Rules Discourage Investment In "Advanced" Services and "New Technologies and Services" In Violation of Sections 7 and 254(b)(2) of the Act.

The Commission's new USF rules contradict the Congressional mandates embodied in Sections 7 and 254(b)(2) of the Act because they do not "encourage the provision of new technologies and services to the public" and ensure "access to advanced telecommunications and information services."[34] The new USF rules replace DEM weighting and existing high cost support with a system that does not allow the Rural Telephone Companies to recover booked investment. Under the new rules, the Rural Telephone Companies may continue to receive support based on

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implementation tasks. The new rules will require the recalculation of the average schedule formulas to account for changes in the DEM weighting separations rules. Thus, the Commission's Rules raise an additional concern for average schedule companies, whose compensation is subject to NECA's discretion. Given NECA's past difficulties, some average schedule companies do not have a great deal of confidence in NECA's abilities to fairly administer these changes and will be forced to expend scarce resources to closely monitor NECA's implementation. *See Florida Public Service Commission Request for Interpretation of the Applicability of the Limit on Change in Interstate Allocation*, Section 36.154(f) of the Commission's Rules, AAD-95-77, FCC 97-83 Order, released March 12, 1997.

[34]47 C.F.R. §§ 7 and 254(b)(2).

some embedded costs, assuming no portability, until they convert to the new USF system based on forward-looking economic costs, currently scheduled to take place January 1, 2001. However, even allowing for the interim period, the new rules discourage investment in violation of Sections 7 and 254(b)(2) because such investment made during the interim period will be depreciated over a useful life that goes well beyond January 1, 2001. Thus, much of the "big ticket" switching or infrastructure upgrades will be left largely underdepreciated on January 1, 2001 leaving the Rural Telephone Companies' investment stranded and unrecoverable.

This change comes at a particularly critical time for the Rural Telephone Companies because the Commission's new USF rules will require them to make significant new investments to upgrade switches and infrastructure, in some instances prior to January 1, 1998, in order to be recognized as an "eligible telecommunications carrier" by their state commissions.[35] In addition, new programs for rural health care, schools and libraries will require considerable upgrades to infrastructure that are not supported by the new USF programs for these entities.

To be considered "eligible" for USF, ILECs must, *inter alia*, provide "single party service" and "voice grade access to the public switched network."[36] ILECs' existing plant is designed to operate between 300 Hz and 3300 Hz. Mandating 3.5 KHz bandwidth between 500 Hz and 4000 Hz will require the Rural Telephone Companies to redesign their networks and will severely burden them at a time when the Commission is restricting the recovery of such investment.

While acknowledging that the successful roll-out of these programs will require significant investment in network infrastructure, particularly on the part of rural ILECs who serve many of the

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[35] *See* 47 C.F.R. §54.201(a)(1).

[36] 47 C.F.R. § § 54.101(a)(1) and (a)(4).

geographic areas targeted for support, the Commission's forward looking cost methodology will preclude ILECs from recovering the costs of these necessary investments.[37] The Commission's action is unfair to the Rural Telephone Companies who are burdened with mandatory switch and network upgrades without the ability to fully recover the cost of that investment and, therefore, discourages investment in violation of Sections 7 and 254(b)(2) of the Act. Accordingly, the Rural Telephone Companies request the Commission to vacate its decision to limit their recovery of investment in infrastructure and switching to forward looking costs, particularly at a time when the Commission mandates new investment.

VI. The Commission's Use of the DEM Separations Factor Results In Underpriced Local Switching Access Rates in Violation of the FCC's Own Policies Which Require Costs to Be Recovered From the Cost Causer.

The Commission's interim Part 36 separations and Part 54 Universal Service rules for calculating interstate access charges to recover local switching costs utilize the DEM weighting factor frozen at 1996 levels.[38] In adopting this method, the Commission failed to correct inaccuracies caused by the DEM which underprice the local switching rate paid by IXCs in violation of the Commission's own policies requiring costs to be recovered from the cost causer.[39]

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[37] *USF Order* at ¶ 635(The Commission has also declined, at this time, to authorize support for infrastructure development and upgrades to provide high bandwidth services to rural health care providers).

[38] *See* 47 C.F.R. §§36.125 and 54.301

[39] *See e.g.*, 47 C.F.R. 36.2(a)(1) stating the "[f]undamental" principle-- "Separations are intended to apportion costs among categories or jurisdictions by actual use or by direct assignment."

The DEM factor double counts local exchange intra-office minutes.[40] This anomaly is a product of local switching architecture in years past that utilized separate facilities for originating and terminating minutes. Because today's digital switches handle both originating and terminating traffic, the allocation factor employed should be accordingly updated. Without this change in the separations rules, the double counting of intra-office minutes understates the interstate DEM thereby reducing interstate access rates in violation of the Commission's policies requiring costs to be recovered from the cost causer and prohibiting implicit subsidies for IXCs.

In addition, to the extent that the states adopt USF rules that mirror the Commission's Rules, use of the DEM overstates the amount of local switching minutes that are attributable to the state jurisdiction which could artificially increase the amount of state universal service support available to carriers. In sum, the Commission's decision to continue using the DEM without modification, is arbitrary and capricious because: (1) it continues an implicit subsidy for IXCs by understating interstate local switching rates in violation of Section 254(e) requiring "explicit" USF support; and (2) it violates the Commission's policies requiring costs to be recovered in rates paid by the cost causer.[41]

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[40] *See* 47 C.F.R. §36.125(b). The DEM is "the minutes of holding time of the originating and terminating local switching equipment..." Thus, for an intraoffice call the local minutes of use are counted twice, once for originating and once for terminating.

[41] Agency action is arbitrary and capricious if it does not further the Commission's stated goals. *See Bechtel v. FCC*, 10 F3d 875, 885-886 (D.C. Cir 1993).

VII. The FCC Decision To Cap the Amount of Corporate Operations Expenses That Can Be Recovered From High Cost Loop Support Is Arbitrary In Violation of the APA Because There is No Evidence That the Current Overhead Needed to Serve High Costs Areas Is Excessive.

The new USF Rules limit recovery of corporate operations expenses through the high cost loop fund to a Commission-determined so-called "range of reasonableness."[42] The Commission arbitrarily arrived at its "reasonable range" without first determining that corporate operations expenses for ILECs serving high cost areas are unreasonable or excessive. The Commission adopted the new restriction in an effort to limit carriers' "facility investment and maintenance consistent with their obligations under section 254(k)" of the Act.[43] Section 254(k) of the Act, authorizes the states and the Commission to establish "any necessary cost allocation rules, accounting safeguards and guidelines to ensure that **services included in the definition of universal service** bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."[44]

The cap sets a specific per-line amount of permissible Corporate Operations Expenses that may be included for calculating loop costs. To set the cap, the Commission appears to have utilized a Commission staff-prepared analysis of NECA cost data developed prior to passage of the Act. This data does not properly reflect increases in the Rural Telephone Companies' corporate operations expenses incurred and likely to be incurred as a result of the Commission's implementation of the Act and, therefore, cannot be relied upon to set per-line expense amounts.

Corporate Operations Expenses are recorded in Part 32 Accounts 6710 and 6720 and include expenses for legal, accounting and finance, executive and planning, procurement, research and

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[42] USF Order, at ¶ 283.

[43] *USF Order* at ¶ 283.

[44] 47 U.S.C. § 254(k)(emphasis added).

development, information management, and other general and administrative expenses.[45] The Rural Telephone Companies have already experienced expense increases as they scramble to comply with the requirements of the new USF regime as well as analyze the provision of services based on forward-looking costs.[46] Given the complexities of the new regulatory environment, the Rural Telephone Companies are forced to incur additional Corporate Operations Expenses to conduct research, develop plans and procure necessary equipment and consulting services to, for example, ensure compliance with USF eligibility rules or conduct cost studies to determine forward-looking costs.

Thus, because of the new and substantial Corporate Operations Expenses that the Rural Telephone Companies are now incurring in furtherance of the new Commission-defined universal service and changes to its access charge rules, the Commission must reconsider its decision. The data used by the Commission could not possibly determine whether current levels of Corporate Operations Expenses are excessive or unreasonable and inconsistent with Section 254(k) of the Act. Moreover, use of this flawed data should not be used to set "reasonable" expense levels, particularly at this time when the Commission is requiring increases in these expenses.

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[45] 47 C.F.R. §§32.6710 and 32.6720; *See also* In the Matter of Bell Atlantic Telephone Companies, Transmittal Nos. 741 and 786, Revisions to Tariff F.C.C. No. 10, Rates, Terms, and Conditions for Video Dialtone Service in Dover Township, New Jersey, *Order* Designating Issues for Investigation, 11 FCC Rcd. 2024, fn.53. (1995).

[46] *See gen.* Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, *First Report and Order*, 11 FCC Rcd 15499 (1996) *(Local Competition Order) stayed in part pending judicial review sub nom. Iowa Utils. Bd. V. FCC*, 109 F.3rd 418 (8th Cir. 1996).

VIII. It Is Contrary to Statutory USF Goals to Limit the High Cost Loop Recovery When a Rural Exchange Is Acquired and Upgraded.

The Commission's decision (at ¶ 308) to limit the high loop cost recovery of ILECs acquiring new exchange property is inconsistent with Section 254(b) universal service principles and contrary to Section 7 of the Act. The decision discourages investment in switching and network upgrades in portions of rural America most in need of such investment. Rural ILECs have an exemplary record of quality service to rural America. Today, many rural communities, particularly in western portions of the U.S., benefit from modern quality services taken for granted by suburban and urban subscribers (e.g., single party services), only because rural ILECs have had incentives to acquire and upgrade neglected exchanges. Thus, limiting the recovery of costs by ILECs acquiring new exchanges does not advance and preserve universal service goals.

The Commission's justification for limiting high loop cost recovery, i.e., to discourage carriers from placing "unreasonable reliance upon potential universal service support in deciding whether to purchase exchanges", is unfounded. First, the Commission has already limited potential universal service support through continuation of its indexed cap on USF and modifications to USF support mechanisms for high cost areas. Second, exchange acquisitions must still be approved by the Commission through the study area waiver process to determine whether USF support for upgrading such acquired exchanges serves the public interest. Rather than rely on a blanket prohibition, the Commission should use existing procedures to evaluate transactions on a case-by-case basis providing a more tailored approach to addressing the Commission's concerns and the public interest.