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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	
Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers;	CC Docket No. 00-256
Federal-State Joint Board on Universal Service;	CC Docket No. 96-45
Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation;	CC Docket No. 98-77
Prescribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers	CC Docket No. 98-166

REPLY COMMENTS OF INNOVATIVE TELEPHONE

Innovative Telephone ("Innovative," formerly known as Virgin Islands Telephone Corporation),[1] by its attorneys, hereby offers these reply comments in the FCC's proceeding to consider the Multi-Association Group ("MAG") plan for reform of access charges for rural and insular non-price cap carriers.[2] In its comments, Innovative voiced its support in principal for the adoption of the MAG plan as filed. At the same time, Innovative recognized that there are some areas, such as disaster recovery, where the plan as currently constituted falls short.

Innovative notes that a large number of commenters agree that the MAG plan is a step in the right direction, and urge its adoption with relatively minor modifications. However, some parties seek wholesale changes to the

[1] The Virgin Islands Telephone Corporation is doing business under the trade name "Innovative Telephone."

[2] *In the Matter of Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers*, CC Docket No. 00-256, Notice of Proposed Rulemaking, FCC 00-448 (rel. January 5, 2001).

plan. Many of these changes would strike at the very heart of the MAG plan, and cripple its effectiveness. For example, retention of the Low End Adjustment factor is critical to allow smaller rural and insular carriers to attract capital, because these carriers face very high costs of providing service and some tend to have service areas that are prone to natural disasters. The commenters who suggest reducing the number of options available to non-price cap carriers fail to recognize both the size of the carriers affected and the diversity of circumstances that these carriers face. Reducing the number of options available would seriously hamper the flexibility, which is currently the plan's greatest asset. Those parties who argue that the Commission should adopt a productivity or "X" factor also fail to take into account the diversity of the non-price cap carriers, which would make the selection of a rational X factor impossible. Finally, there is no reason to develop a rate of return prescription in this proceeding.

The Commission should move forward with the adoption of the MAG plan without making large-scale changes to the plan. Nevertheless, the Commission should add a modest change to ensure that carriers are able to recover their reasonable expenses in the event of a natural disaster.

I. CONTRARY TO THE SUGGESTIONS OF SOME COMMENTERS, THE LOW END ADJUSTMENT MUST BE RETAINED.

In the initial comment round, some parties argued that the Low End Adjustment factor ("LEAF") should be reduced or eliminated.[3] However, the unique nature of the circumstances faced by smaller rural and insular carriers means that a mechanism to adjust rates for revenue shortfalls is necessary for carriers to be able to attract capital. If the Commission does reduce or eliminate the LEAF, it must make sure to provide some means to recover reasonable expenses associated with catastrophic loss.

[3] *See, e.g.*, Comments of AT&T at 17 ("AT&T"); Comments of ASCENT at 4.

A. The LEAF Is Necessary Given The Challenges Faced By Rural Carriers.

As Innovative and a number of other commenters pointed out in the initial round, smaller rural and insular carriers face a number of unique challenges in providing telecommunications service.[4] Because of their smaller size, these carriers cannot take advantage of the economies of scale that larger, price cap carriers enjoy. As a result, it is often more difficult for these companies to attract capital. Providing a structure such as the LEAF, which allows carriers to rebalance their rates in the event of an unexpected shortfall, is necessary to address this problem. Indeed, just as the low end adjustment in the price cap context was intended to protect against unconstitutional takings, the LEAF is a necessary backstop feature for rural and insular companies.

B. If The Commission Eliminates Or Reduces The LEAF, It Must Ensure That There Is Some Method For Recovering Catastrophic Loss.

A structure like the LEAF is particularly important to those carriers situated in areas where weather or other natural catastrophes can destroy large amounts of infrastructure quickly and unpredictably. As Innovative explained in its initial comments, the LEAF as currently structured does not go far enough in addressing these concerns, and in fact ensures that carriers in disaster prone areas will be unable to fully recover their reasonable expenses in recovering from a calamity, because the adjustment is at least 50 basis points below 11.25%.[5] Reduction or elimination of the LEAF would make incentive regulation even less feasible for carriers in areas subject to frequent weather and other natural catastrophes by further exacerbating these carriers' inability to fully recover their reasonable expenses.

The FCC must address the problem of disaster recovery in any plan that it adopts. As Innovative has suggested, a simple modification of the currently proposed LEAF structure to allow recovery up to the nominal 11.25% level in the event of a natural disaster or other calamity would be one effective method for doing so. In

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[4] Comments of Innovative at 5-9 ("Innovative"); Comments of Alaska Rural Coalition at 2-3; Comments of Alabama Rural LECs at 2.

[5] Innovative at 10.

addition, if the Commission decides that the LEAF should be reduced or eliminated entirely, it should ensure that the plan that it eventually implements contains some method for recovery of reasonable expenses in recovering from a catastrophic destruction of infrastructure.

II. OPTIONALITY IS ESSENTIAL TO THE SUCCESS OF THE MAG PLAN.

The suggestions by some commenters that the number of options in the MAG plan should be reduced, or that carriers should not be allowed to select a regulatory path for themselves from a range of reasonable options, are misguided. The existence of a reasonable degree of optionality is central to the MAG plan's success, and the options presented to carriers by the MAG plan are no different or more complex than those adopted by the Commission in the past.

A. The Current Range of Options in the MAG Plan Must Be Retained.

Several commenters contend that the MAG plan affords non-price cap carriers too many options, and thus creates an opportunity to "game the system."[6] However, these commenters offer no alternative method for addressing the wide range of differing circumstances faced by non-price cap carriers. Instead, these commenters treat the large and diverse group of non-price cap carriers as if it is a single, monolithic bloc of entities with similar or identical concerns.

In its initial comments, Innovative explored the tremendous diversity of the group of non-price cap carriers, including the unique problems faced by insular carriers.[7] The options contained in the MAG plan are not designed to allow carriers to "game the system." Instead, they provide the flexibility necessary to allow a single regulatory scheme to accommodate 1300 different carriers operating in a variety of different circumstances. Any decrease in the MAG plan's optionality would reduce this flexibility, and inevitably compromise the plan's effectiveness.

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[6] Comments of Sprint at 13; *see also* Comments of Competitive Universal Service Coalition at 12 ("CUSC").

[7] Innovative at 5-10.

B. Options In MAG Plan Are Completely In Line With Those Adopted By the Commission in Other Proceedings.

In its comments, the CUSC argues that the Commission should not allow carriers to select a regulatory structure from a range of reasonable alternatives.[8] Instead, the CUSC suggests that the FCC should determine which carriers fit into which categories.[9] CUSC provides little support for the need to have the agency make this determination.[10]

The Commission should reject CUSC's argument. The carrier selected options contained in the MAG plan are no different from similar plan elements that the FCC has adopted in the past. Indeed, the original price cap plan contained options for even the largest carriers, depending upon their own perceptions of their individual circumstances.[11] The FCC has made price caps itself an option for every carrier other than the very largest carriers. Innovative agrees with the California Public Service Commission that "[i]t does not appear that the two-path scheme [in the MAG plan] would have practical or administrative consequences that are more complex than those imposed by the implementation of the CALLS proposal."[12] There is no reason for the FCC to apply a different standard on the availability of options in the MAG proceeding than it did in the price cap plan.

III. THE COMMISSION MUST PRESERVE CARRIERS' CHOICE OF TIMING TO MOVE TO INCENTIVE REGULATION.

Carriers require flexibility to time their move to incentive regulation. Non-price cap carriers face irregular investment patterns and difficulty in making accurate predictions in an uncertain market. Concerns about carriers abusing their flexibility are purely speculative, and unlikely to occur in an increasingly competitive market.

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[8] CUSC at 13.

[9] *Id.*

[10] *Id.*

[11] *Access Charge Reform*, Sixth Report and Order in CC Docket No. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962 at 57 (2000).

[12] Comments of People of the State of California and California PUC at 11.

Non-price cap carriers' investment schedules require flexibility in timing their adoption of incentive regulation. Factors such as limited facilities, or recurrent severe storms, lead to sporadic facilities investment schedules. Forcing carriers to immediately move to incentive regulation, or providing only periodic opportunities to do so, is inconsistent with carriers' uncertain investment schedules. Permitting carriers the flexibility to decide when to move to incentive regulation avoids penalizing carriers for past investment patterns that were in many ways beyond their control, while encouraging earlier selection of incentive regulation by eliminating the need to wait until a particular adoption date.

Carriers also require adequate time to evaluate the merits of the various regulatory alternatives as ultimately adopted, similarly necessitating flexibility in the timing of each carrier's decision regarding incentive regulation. Under the MAG plan, the decision to move from rate-of-return regulation to new incentive regulation is permanent. Consequently, carriers must carefully evaluate factors such as the expected growth or reduction in their access lines, anticipated trends in the volume and types of network usage and necessary future maintenance and facilities upgrades. Carriers will have to make these predictions in the context of a changing marketplace due to increased competition from wireline, wireless, satellite and Internet telephony competitors, and growth in broadband and other advanced services. To remain competitive, and to allow consumers the full benefits of a market-oriented environment, carriers need the ability to switch to incentive regulation based on the level of marketplace competition, rather than arbitrary dates or deadlines.

Concerns raised by some commenters that non-price cap LECs would use the transition period to game the system are purely speculative.[13] To take advantage of the flexibility offered by the MAG plan, carriers must assume a commensurate level of risk. If, as some commenters hypothesize, carriers were to "gold-plate their networks and raise rates" prior to electing Path A regulation,[14] those carriers would make themselves an attractive target for competitive entry. Without a rate of return mechanism under Path A, these carriers then would only be forced to readjust their rates to meet competition. Further, carriers that do not elect incentive regulation within the transition

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[13] *E.g.*, AT&T at 13-14.

period must obtain a Commission waiver to do so in the future. Any attempted "gaming" of the system by such carriers would appropriately be addressed based on actual facts presented in the waiver request, rather than mere speculation. At base, commenters' theoretical concerns should not overcome carriers' legitimate need for flexibility to determine the time within the transition period when they will move to incentive regulation.

IV. A PRODUCTIVITY FACTOR IS UNWORKABLE FOR NON-PRICE CAP CARRIERS.

Several commenters urge the Commission to incorporate a productivity factor (or "X factor") into any incentive regulation plan that it eventually enacts.[15] Each of these commenters bases their arguments on the FCC's use of an X factor in the price cap context. However, in applying the mandatory price cap structure only to the largest eight carriers in the country,[16] the Commission has already recognized the substantial differences between the large, price cap and smaller, non-price cap carriers. The commenters fail to address two key distinctions that make the application of an X factor to the rural and insular non-price cap carriers unworkable.

First, there is no indication that non-price cap carriers could achieve the same kind of efficiency gains that larger carriers have been able to do. As noted above, larger carriers have substantial economies of scale that are simply not present in smaller, non-price cap LECs. Moreover, each of these larger carriers can count on a steady increase in its number of lines, and can build future plans around this expansion. Smaller, rural and insular LECs often do not have this luxury. Thus, it is an open question whether all or even the majority of non-price cap LECs can be expected to have productivity growth that outpaces that of the economy in general. Without solid evidence that such productivity gains are possible, the imposition of an X factor would be arbitrary.

Second, the great diversity of the non rural price cap carriers would make selection of a single X factor impossible. Selecting an X factor for the eight price cap carriers, which were all large companies facing similar

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[14] AT&T at 14.

[15] AT&T at 15; Comments of GCI at 5; Comments of Worldcom at 6.

[16] These eight carriers were the seven RBOCs and GTE, and are now SBC, Qwest, Verizon, and BellSouth.

circumstances, proved very difficult. Indeed, in order to accommodate the differences between just those eight carriers, the Commission initially gave these companies the choice between two X factors, and later three.[17]

In contrast, the non-price cap carriers consist of approximately 1,300 companies, with a vast range in nearly every important characteristic, from size to geography of service areas to composition of their customer bases. As Innovative's comments demonstrated, the only solid commonality between non-price cap LECs is that they each face unique challenges.[18] Assuming for the sake of argument that all non-price cap carriers can be expected to have productivity gains that outstrip those of the rest of the economy, it is impossible to imagine that those gains would be the same or even similar for a medium sized carrier serving islands in the Atlantic Ocean, such as Innovative, a rural carrier serving customers in the Alaska Bush, or a carrier in the desert Southwest. In order to be certain that it was setting the correct X factor, the Commission would have to take substantial evidence on the varying economic circumstances facing this large group of diverse carriers. As a result, any X factor calculation that the Commission set for the non-price cap carriers would be a massively complex exercise, requiring an enormous amount of scarce agency resources, with little chance that the final product would be an accurate reflection of reality.

V. THE FCC SHOULD REJECT REQUESTS TO MODIFY THE RATE OF RETURN PRESCRIPTION.

Some parties also argue that the current authorized rate of return is too high. These parties are flat wrong. The FCC should maintain the current rate of return prescription. The uncertainty associated with newly imposed regulations and market forces, coupled with an increasingly unfavorable market for capital, counsels against any modification to the rate of return prescription. Indeed, the FCC considered such a modification two years ago, but did not adopt any. This remains the appropriate course of action today.

That stale record cannot be used to change the rate of return prescription because the market has changed in the last two years. The emerging competitive marketplace leads to volatility, increasing burdens on non-price cap

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[17] *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786, ¶ 78 (1990); *Price Cap Performance Review For Local Exchange Carriers*, First Report and Order, 10 FCC Rcd 8961 at ¶¶ 214-15 (1995).

[18] Innovative at 5.

carriers' when obtaining new investment. Prior to the Telecommunications Act of 1996, investors knew that smaller rural and insular carriers were incumbent providers with fairly predictable risks and benefits. Now, competitive challenges are emerging from traditional wireline providers, as well as wireless carriers, cable companies, and Internet telephony. Indeed, in the last two years, increased competition has increased risks to carriers, and consequently increased the equity return demanded of investors. Thus, the record in that proceeding is, at a minimum, outdated. Any efforts to prescribe an accurate rate based on this old record would be arbitrary and lead to an erroneous result.

Revisions to the rate regulation of non-price cap carriers itself will produce substantial uncertainty regarding future markets, making it impossible to accurately predict the cost of capital for such a market. At the conclusion of this proceeding, the Commission likely will adopt substantial modifications to the regulation on non-price cap carriers' rates. Consequently, any development of a rate prescription in this proceeding will not eliminate the need to initiate another rate prescription proceeding as soon as the new policies are implemented. The Commission should leave the current rate prescription unchanged, at least until the effects of the current regulatory and competitive upheaval becomes more predictable.

VI. CONCLUSION

As Innovative explained in its initial comments, the FCC should adopt the MAG plan as currently envisioned. The Commission also should add an adequate means for ensuring recovery of costs in the event of catastrophic loss, such as allowing retargeted rates to a full 11.25% in these circumstances.

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March 12, 2001

CERTIFICATE OF SERVICE

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