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March 12, 2001

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

By Messenger
Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: In the Matter of Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers, CC Docket No. 00-256.

Dear Ms. Salas:

Enclosed for filing please find an original and four (4) copies of the Reply Comments filed on behalf of The Interstate Telcom Group in the above-captioned proceeding. Also enclosed are two (2) copies to be filed in each of the following dockets: 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.

As required by the FCC's Public Notice and the Notice that subsequently appeared in the *Federal Register*, properly labeled 3.5-inch diskette copies of the Reply Comments were also delivered on this date to the Competitive Pricing Division and to International Transcription Service, Inc., the FCC commercial contractor.

Please acknowledge receipt of this transmittal by affixing a date-stamped copy of the enclosed duplicate of the Reply Comments marked "RECEIPT".

Respectfully submitted,

Gerard J. Duffy

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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

In the Matter of	)	
	)	
Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange 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

TO: The Commission

REPLY COMMENTS OF THE INTERSTATE TELCOM GROUP

The Interstate Telcom Group (which is comprised of Interstate Telcom Consulting, Inc. and fifty-eight of its rural telephone company clients[1]) hereby submits its reply comments in the captioned proceeding. The Interstate Telcom Group continues to support generally the interstate access proposals in the MAG Plan, and has not changed or reconsidered any of the positions taken in its initial comments. In these reply comments, it will focus upon two issues: (1) that the option for rural telephone companies to remain subject to rate of return regulation (Path B) must be retained, at least for small local exchange carriers serving 50,000 or fewer lines; and (2) that no estimated

[1] These fifty-eight rural telephone companies are located in the states of Minnesota, Wisconsin, Michigan, Iowa, South Dakota and Ohio, and were listed in the Interstate Telcom Group's February 26, 2001 comments in this proceeding.

productivity offset should be included in the Revenue Per Line ("RPL") mechanism for the proposed incentive plan (Path A).

The Commission Must Retain A Separate Rate Of Return Option For Small LECs

In its initial comments, the Interstate Telcom Group showed that incentive regulation was not a "one size fits all" solution for local exchange carriers ("LECs"), and that incentive regulation was particularly unsuitable and harmful for some small LECs. The Commission itself has long recognized that the size, business cycles and investment patterns of small LECs make it far more likely that incentive regulation will disrupt their financial stability and viability, than improve their efficiency. Regulatory Reform for Local Exchange Carriers, CC Docket No. 92-135, 8 FCC Rcd 4545, 4546 (1993). For example, the small size and limited scale of Interstate Telcom Group members (which range from one exchange to nineteen exchanges, and from approximately 40 access lines to approximately 35,000 access lines) make it impossible for them to "smooth" upgrade investments or operating expense increases either over time or over substantial operating bases. Rather, a spike in investment (e.g., to replace a switch or to rebuild outside plant) or in operating expenses (e.g., to repair lines after a major storm) for one or two exchanges of a small LEC can exceed and overwhelm its revenue mechanism under incentive regulation. These fluctuating costs will produce negative cash flows that not only will disrupt the existing operations of small LECs but also will increase the cost and difficulty of their acquisition of the financing necessary for future upgrades. These problems will be exacerbated in rural areas where access lines and the resulting incentive revenues may decrease over time due to the closing or relocation of business customers or to overall declines in the population of some rural areas, without any concomitant decrease in the rural LEC's primarily fixed plant and operating costs. Put simply, the mixing of stable revenue mechanisms under incentive regulation with the fluctuating investment and expense patterns of small LECs is a recipe for financial volatility – one that will constantly threaten both the short-term and the long-term viability and service quality of the small LECs.

The initial comments of the Competitive Universal Service Coalition ("CUSC") propose that the Commission establish "a single regulatory system, modeled on MAG's Path A . . . that would ensure that all [rural LECs] move away from rate of return guarantees and toward an incentive mode of regulation that is more compatible with the advent of competition" (CUSC Comments, p. 12). CUSC opines, among other things: (a) that the MAG Plan does "not provide a significant incentive" for carriers to select Path A rather than Path B (Id., p. 11); (b) that Path B will allow rural LECs to "opt out of competitive neutrality" (Id., p. 10); (c) that Path B will allow rural LECs to "decline to convert their implicit subsidies into explicit, portable, and competitively neutral funding (Id., p. 11); and (d) that rural LECs would be able "to exploit the discretion built into the MAG Plan to substantially increase the total amount of funding (Id., p. 12).

First, regardless of what any entity might wish to be the case, the clear and indisputable fact is that local exchange competition has not yet come to the vast majority of rural telephone company service areas. At this point in time, there is little indication that local exchange competition will come to a significant portion of rural telephone company service areas during the next five-to-eight years, or at any other future time. With the possible exception of a few highly-publicized legal proceedings initiated by Western Wireless Corporation and Smith-Bagley, Inc., the listed members of CUSC have given no indication of any present or future intention to serve a significant portion of Rural America on a long-term basis. Rather, CUSC members, like other competitive wireline and wireless carriers, have heretofore focused their efforts on the places where customers (especially business customers) and revenues are concentrated – namely, urban and suburban areas, and the heavily-traveled highway corridors between urban areas.

Interstate Telcom Group members and other rural LECs generally have been the only entities that have shown any sustained interest in making the investments necessary to furnish quality telecommunications services to rural service areas.[2] And there is no indication that this situation will change during the foreseeable future. Therefore, it makes absolutely no sense, from a public policy standpoint or any other sane perspective, to disrupt the financial stability of the sole carriers willing to serve major portions of Rural America in order to facilitate the "advent" of some theoretical "competition" that may never come to these areas.

Second, whereas some Interstate Telcom Group members are likely to elect the Path A incentive regulation proposed in the MAG Plan,[3] at least some small rural LECs with fluctuating investment patterns and operating expenses will certainly have "no significant incentive" to disrupt their financial stability and viability by electing Path A or any other known form of incentive regulation. As noted above and in the Interstate Telcom Group's initial comments, incentive regulation is designed for large carriers that have sufficient size and scale to enable them to spread fluctuations in the investment or expenses of a few

[2] Many constructed their exchanges during the first half of the 20th Century to serve areas unwanted by the Bell System and other large LECs, and have continued to be the only carrier showing any interest in serving these areas. Others acquired and upgraded their exchanges from large or small LECs that no longer had the ability or interest to serve them.

[3] This may not continue to be the case if Path A is significantly changed (for example, by imposing a productivity offset or eliminating the proposed Low End Adjustment).

exchanges over a large base of operation. It is wholly unsuitable for small carriers where such cost fluctuations cannot be apportioned over a significant operating base, but rather where they will dominate and overwhelm the incentive revenue mechanisms.

Third, access charges are not subsidies, but rather constitute the primary means whereby interexchange carriers pay for the use of the local exchange facilities that they need to originate and terminate their toll calls. In rural areas where the cost of constructing and operating these local exchange facilities is much higher than those in urban areas, access charges will be higher. However, the mere fact that a particular type of charge is higher in a high-cost area than in a low-cost area does not automatically mean that it includes a "subsidy."

Whereas it has become increasingly fashionable for groups like CUSC to bandy about claims of "subsidy" in connection with access charges, the Commission and the states have yet to develop a consensus regarding the respective portions of local exchange costs that should be borne by end users, interexchange carriers and universal service funds. Until such a consensus is reached, there is no way to determine how much, if any, of the interstate access charges paid by interexchange carriers include "subsidies" over and above the properly apportioned costs of the facilities and services that they are using.

Finally, there is no truth to the myth that rural LECs under rate of return regulation have gold-plated their networks, run up significant amounts of unnecessary and uncontrolled operating expenses, or otherwise "gamed" the system to increase and maximize their funding without regard to efficiencies. While there can be an occasional bad actor in any group, virtually all rural LECs have long been model corporate (or telephone cooperative) citizens that have quietly and capably brought quality services to their customers without a hint of profit gouging or financial scandal. Most of these rural LECs are very small companies that lack substantial cash reserves and assets, and that must borrow to make substantial investments. Their investments and expenditures are closely monitored and limited by their lenders (generally, the Rural Utilities Service, the Rural Telephone Finance Cooperative, CoBank and/or small local banks), as well as by the National Exchange Carrier Association's ("NECA's") auditors and by their state commissions. In addition, many rural LECs are telephone cooperatives whose investments and expenditures are equally closely monitored and limited by their member-owners and by the Boards of Directors elected by their owner-members. Given their limited resources and these multiple levels of oversight, rural LECs are unable to engage in reckless or inefficient spending to maximize their rate bases and revenues, even if they desire to do so. Hence, it is long past the time to put an end to the mythical straw man depicted as a "gold-plated" rural LEC.

In sum, the Path B option to remain subject to rate of return regulation needs to remain available for those rural LECs whose small scale, lumpy investment patterns and fluctuating costs are wholly unsuitable for incentive regulation. There is no evidence that these rural LECs have abused or manipulated the rate of return system in the past, or that they will do so in the future. Rather, rate of return regulation has permitted small LECs to serve rural areas that otherwise would have remained unserved or underserved, and that are not likely to attract competitors within the foreseeable future.

Even CUSC recognizes that the Commission might decide "to create multiple regulatory systems to accommodate the variation among rural ILECs" (Id., pp. 12-13). In addition, AT&T Corp. ("AT&T"), which demands the imposition of mandatory incentive regulation upon large non-price cap LECs, concedes that smaller LECs can be afforded the option of electing incentive regulation or remaining on rate of return regulation (AT&T Comments, p. 14).

The Interstate Telcom Group believes that all rural LECs should be able to elect to remain subject to rate of return regulation (Path B). However, it recognizes that the availability of this option is most critical for the smallest LECs that are least able to withstand substantial fluctuations in the investment or expenses of a couple of exchanges. Therefore, the Interstate Telcom Group urge the Commission to retain the Path B option for at least those rural LECs serving 50,000 or fewer access lines. This would preserve the more flexible Path B option for the smallest LECs that lack the size, resources and economies of scale required to operate in an effective and stable manner under incentive regulation. It is also consistent with Section 36.125 of the Rules, which provides Local Switching Support only to the smallest LECs (that is, those serving 50,000 or fewer access lines in their study area).

Finally, the Interstate Telcom Group notes that the potential aggregate cost of retaining the Plan B option for the smallest LECs is miniscule. With all due respect to those arguing whether the access cost reductions from the MAG Plan should be passed through to toll service users, the access revenues received by the smallest LECs are such a small portion of total interstate access revenues as to be wholly immaterial on a national level. Small LECs with 50,000 or fewer access lines serve far less than half of the approximately 8 percent of U.S. access lines served by all existing rate of return LECs, and receive far less than half of the approximately 9 percent of U.S. access revenues received by all existing rate of return LECs. Put simply, on a national scale, the interstate access revenues received by the small LECs that might elect Path B will have no perceptible impact (much less, an adverse impact) upon nationwide interstate long distance toll rates or upon the underlying interstate access costs of interexchange carriers. Hence, whereas retention of the Path B option is critical for the stability and survival of some small rural LECs, it will not have any discernible adverse impact on interstate toll carriers or rates.

No Productivity Offset Should Be Included In Path A

In its initial comments, the Interstate Telcom Group showed that small LECs under incentive regulation do not possess the size or operating scale to support an annual productivity offset like that imposed upon the large price cap LECs. Therefore, the Commission should not add an X-factor or consumer productivity dividend to the proposed Revenue Per Line (RPL) mechanism of Path A.

AT&T and others argue that an X-factor should be applied to the rate of return carriers that convert to incentive regulation under the MAG Plan (AT&T Comments, p. 16). However, these parties give no indication that they have considered how such annual productivity offsets would be applied to, or impact, small rural LECs.

The Interstate Telecom Group reiterates that its typical member serves one to nineteen exchanges, and has a staff of seven to twelve employees. Many of these small LECs operate from a single office, and have employees who perform a variety of plant and/or administrative functions. Most group members have maintained a relatively stable employee count during the past 3-to-5 years. One small LEC has had only two employees during the period.

Whereas large carriers serving hundreds or thousands of exchanges and having staffs comprised of thousands or hundreds of thousands of employees can generate significant economies of scale and realize annual productivity increases, this is not possible for small LECs like those in the Interstate Telcom Group. How does a small rural LEC with a staff of 7-to-12 employees who perform multiple functions at a single office increase its productivity by a factor of 3, 5 or 7 percent per year for several years? Many small LECs maintain only one main office, and therefore lack a second or third office that can be closed and consolidated to create a potential "productivity gain." Likewise, many small LECs maintain small staffs comprised of busy employees trained to do a variety of tasks, and do not have the "luxury" of laying off any of these employees to reduce costs or increase "productivity" without impairing service quality. Finally, all of the Interstate Telcom Group members have installed digital switches and many have in-house information systems. Consequently, these rural LECs have little room to "increase productivity" by replacing employees with automated functions.

In sum, the X-factor was designed solely with large price cap carriers in mind, and is applicable only to large carriers of comparable size, scale and operating conditions. It is not suitable for small LECs that elect incentive regulation, and should not be applied mindlessly to them.

Conclusion

The Interstate Telcom Group continues to support generally the interstate access reform proposals set forth in the MAG Plan. It believes that retention of the Path B rate of return option is essential for small LECs, particularly those serving 50,000 or fewer access lines. It further believes that a productivity offset must not be imposed upon the small LECs that elect to be regulated under Path A incentive regulation.

Respectfully submitted,
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Dated: March 12, 2001

CERTIFICATE OF SERVICE

I, Douglas W. Everette, hereby certify that I am an attorney with the law firm of Blooston, Mordkofsky, Dickens, Duffy & Prendergast, and that a copy of the foregoing **reply comments of The Interstate Telcom Group** concerning the proposals of the Multi-Association Group to be served by first class mail or hand delivery this 12th day of March, 2001, to the persons listed below.

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