Before the
**Federal Communications Commission**
Washington, D.C. 20554

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| In the Matter of | ) | |
| | ) | |
| 2000 Biennial Regulatory Review -- | ) | |
| | ) | CC Docket No. 01-174 |
| Requirements Governing the NECA Board of Directors under Section 69.602 of the Commission's Rules | ) | |
| | ) | |
| and | ) | |
| | ) | |
| Requirements for the Computation of Average Schedule Company Payments under Section 69.606 of the Commission's Rules | ) | |

**COMMENTS**

National Exchange Carrier
Association, Inc.

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October 22, 2001

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## Summary

NECA fully supports the Commission's efforts to reduce regulatory burdens that are no longer in the public interest. The Commission should strive for the minimal amount of regulation necessary to achieve its goals, and not impose additional regulation on NECA or continue to regulate existing processes where it is no longer necessary to do so.

In the case of procedures governing election intervals for NECA's Board, no additional regulation is required other than that provided for under the laws of the state of Delaware in which NECA is incorporated. As is the case for all other membership corporations governed by Delaware Law, the Commission should allow NECA's members to decide how often elections for directors should be conducted. The Commission should also eliminate the requirement that contested elections take place every three years for independent director positions. This requirement is burdensome for NECA and independent director candidates and does not result in any offsetting benefits to NECA, its members or the public.

The Commission should substantially reform the processes used for developing and reviewing NECA's average schedule formulas. Rather than conduct a detailed advance review of the manner in which each average schedule formula is developed, the Commission should focus on the overall average schedule revenue requirements for access services, Local Switching Support and High Cost Loop Support. These would be adjusted annually based on year-to-year changes in demand and revenue requirements of representative cost companies.

In the case of the High Cost Loop Universal Service Fund (USF) formula, however, the Commission must establish base year funding levels that fully satisfy the "payment simulation" standard of section 69.606(a) of the rules. Also, the mechanism used to adjust average schedule high cost loop funding from year to year needs to recognize the fact that average schedule companies have cost per loop characteristics that are different than those of rural cost companies in general. A fair adjustment mechanism for average schedule high cost loop payments must take these differences into account.

Finally, the Commission should eliminate the current approval process for the formulas, and instead review NECA average schedule revenue requirements in the context of NECA's annual access tariff filings and USF submissions. In no other case does the Commission regularly require "approval" of a portion of a carrier's revenue requirement prior to a tariff filing. Moreover, current notice periods and filing requirements for average schedule formulas far exceed those applicable to carrier tariffs, even though year-to-year changes in average schedule revenue requirements are miniscule in proportion to total tariff revenue requirements. There is no need for the current redundant procedures applicable to the average schedules.

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## COMMENTS

The National Exchange Carrier Association, Inc. (NECA) submits these comments in response to the Commission's *Notice of Proposed Rulemaking* in the above-captioned matter.[1]

As part of its overall effort in this proceeding to eliminate unnecessary regulation and reduce administrative burdens imposed on regulated entities, the *NPRM* invites comment on certain Commission rules pertaining to NECA. Specifically, the Commission asks whether it should eliminate the requirement in Subpart G of the rules that NECA conduct annual elections for its board of directors. The *NPRM* also requests

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[1] 2000 Biennial Regulatory Review – Requirements Governing the NECA Board of Directors under Section 69.602 of the Commission's Rules and Requirements for the Computation of Average Schedule Company Payments under Section 69.606 of the Commission's Rules, CC Docket No. 01-174, *Notice of Proposed Rulemaking*, 66 Fed. Reg. 48406 (2001)(*NPRM*).

comment on whether the Commission should impose additional requirements on NECA's Board, such as the imposition of term limits or staggered terms for NECA Board members.[2]

The *NPRM* also requests comment on proposals to streamline the average schedule process specified under section 69.606 of the Commission's rules.[3] In this regard, the *NPRM* invites comments on proposals to reduce the complexity of current processes used to develop and review the average schedule formulas.

## I. The Commission Should Eliminate the Unnecessary Regulations that Restrict How NECA Conducts Elections for its Board of Directors.

Section 69.602 of the Commission's rules sets out a number of requirements governing the NECA Board of Directors. Specifically, the rule establishes various "subsets" of NECA companies, establishes the size of the Board, and specifies the representation of each subset.[4] Section 69.602 also requires that the Board include five "independent" directors elected to represent all member company subsets. Under the rules, all directors must stand for election each year. Rules governing the independent director positions, however, also require NECA to hold a contested election every three years.[5]

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[2] *Id.* at ¶ 2.

[3] *Id.*

[4] 47 C.F.R. § 69.602 (a) – (c).

[5] 47 C.F.R. § 69.602(f).

NECA is a non-stock membership company incorporated under the laws of Delaware. While the Delaware General Corporation Law (DGCL) imposes an annual election requirement on stock corporations, section 215 of the DGCL specifically exempts non-stock corporations from the annual election requirement.

The annual election process imposes burdens on NECA, its directors, and member companies. Since Delaware law does not impose an annual election requirement on non-stock corporations, the Commission should eliminate this unnecessary requirement imposed on NECA. This will permit NECA to develop reasonable election procedures, and conduct elections at reasonable intervals in accordance with the needs of its membership. Such a change would have no impact on member company representation since the number of directors representing each subset would remain unchanged. The DGCL adequately governs corporate board elections. Under state laws, directors remain fully accountable to the association's membership.

The *NPRM* requests that commenting parties suggest further proposals that the Commission should consider at this time.[6] NECA believes that the Commission should eliminate the requirement that independent directors run in a contested election every three years. The contested election requirement imposes burdens on NECA and independent director candidates. Independent directors are often unknown to a good portion of NECA's membership, and therefore, are required to run substantial campaigns. For this reason, it is often difficult to find qualified nominees for the independent director positions. Yet, the rule requires NECA to do so even when no outside party has

[6] *NRPM* at ¶ 5.

expressed an interest in running. As a result, NECA must spend considerable time and effort to find qualified nominees – an awkward process at best.

Contested elections likewise impose an unreasonable burden on incumbent independent directors. Once elected, an independent director must spend an extraordinary amount of time and effort learning NECA's pooling, settlement, and tariff processes and rules. Requiring such directors to run in mandatory contested elections wastes time and effort, and may have the effect of discouraging independent directors from remaining on the Board. Loss of such directors, with their hard-won understanding of NECA's unique role in the industry, would be harmful to NECA, its member companies, and the individuals involved.

The Commission's rules, as they are written today, subject NECA, a private corporation, to unnecessary regulations that other private companies do not face. The Commission should delete the annual election requirement for all board members, and delete the requirement that independent directors face contested elections every three years.

The Commission should not consider proposals that would unnecessarily increase regulatory burdens on NECA's Board. It is unnecessary to introduce more complexities into the NECA board election process or reduce flexibility for NECA in conducting its elections. Within the restrictions and rights of the DGCL, NECA's Board and its membership can decide if additional mechanisms, such as staggered terms, are necessary. The Commission should not institute term limits for NECA directors, as they would deny

NECA membership the expertise that directors attain after serving on the NECA Board for an extended period of time.[7]

Sections 69.602(e), (f) and (i) of the rules should accordingly be revised as specified in Appendix A.

## II. The Average Schedule Development and Review Processes Should be Simplified.

### A. Future Average Schedule Access Formula Updates Should be Based on Demand and Revenue Requirement Changes Experienced by Representative Cost Companies.

The average schedule "access" formula development process has evolved to include the following steps:

1) Collection of cost accounting data, including jurisdictional separations cost data and demand data (*e.g.*, access line counts, number of exchanges, access minutes) from a sample of cost companies;

2) Adjustment of jurisdictional separations data (from step 1) to reflect Commission rules that will be in effect in the coming settlement period;

3) Determination of statistical relationships between jurisdictional cost separations percentages (from Step 2) and commonly-used demand and network data;

[7] The fact that the Commission's rules currently impose term limits on directors of the Universal Service Administrative Company (USAC) (*see NPRM* at ¶ 5) does not warrant imposing term limits on NECA's directors. USAC is a relatively new company, with responsibility for administering programs that differ substantially from NECA's traditional access charge tariffing and revenue distribution functions. Consistent with the general goals of its Biennial review proceeding, the Commission might consider whether existing rules governing USAC are necessary, rather than imposing similar requirements on NECA. *See* Changes to the Board of Directors of the National Exchange Carrier Association, Inc. and Federal-State Joint Board on Universal Service, CC Docket Nos. 97-21 and 96-45, *Second Report and Order and Second Report on Reconsideration*, 12 FCC Rcd 18400 (1997), and Federal-State Joint Board on Universal Service, CC Docket No. 96-45, *Third Report and Order in CC Docket No. 97-21, Fourth Order on Reconsideration in CC Docket No. 97-21 and Eighth Order on Reconsideration in CC Docket No. 96-45*, 13 FCC Rcd 25058 (1998).

4) Collection of certain accounting cost data and demand data from a sample of average schedule companies;

5) Projection of sample average schedule company demand and cost data (from Step 4) to the coming settlement period;

6) Application of the cost relationships (from Step 3) to the projected data of sample average schedule companies (from Step 5) to estimate jurisdictional costs for the sample of average schedule companies;

7) Adjustments to allocated costs (from Step 6) to reflect changes in cost and demand trends, and calculation of total revenue requirement for each sample company for each settlement function, based on these adjusted costs;

8) Use of statistical regression techniques to develop formulas that relate estimated revenue requirements (from Step 7) of the average schedule company to various commonly-used demand units (*e.g.*, access lines per exchange).[8]

This process is complex, burdensome and time-consuming. The data gathering step described above, for example, requires that over a hundred small average schedule companies collect and submit extensive costs and demand information to NECA each year. With the help of the Industry Average Schedule Task Group,[9] NECA engages in extensive accounting and statistical analyses of these data, a process that occupies a

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[8] This description of the average schedule process differs from the procedures outlined at paragraph fourteen of the *NPRM.* For example, the *NPRM* states that at step 4, NECA applies the "cost relationships determined in Step 2 to the sample average schedule companies to estimate jurisdictional costs for the sample average schedule companies." Prior to the allocation of costs, however, NECA projects average schedule accounts and demand data. Additionally, the Commission's step five describes a kind of modeling process to determine estimated interstate costs. However, this step is not necessary since step six describes the development of formulas by statistical regression.

[9] This group consists of exchange carrier representatives sponsored by industry associations (*i.e.* the National Telephone Cooperative Association, the Organization for the Promotion and Advancement of Small Telecommunications Companies and the United States Telecom Association). The Task Group meets several times each year during the course of NECA's study, reviews the steps taken in developing the proposed formulas, advises NECA regarding the development of procedures for administration of the formulas, and assists the NECA Board of Directors in evaluating final proposed formulas.

substantial portion of each year. While not specified in the rules, the Commission nevertheless has required NECA to provide extensive documentation of each step in the average schedule development process, and often has required additional data filings and supplementary explanations of NECA's methodology. A large administrative record must be compiled in each average schedule review proceeding. Yet for all this effort, year-to-year changes in the average schedule access formulas have been relatively minor,[10] and NECA's filings rarely receive adverse comment.

As the Commission explains, recent changes in the Commission's rules, such as the adoption of a five-year "freeze" of separations factors, support the need for simplification.[11] In light of these developments, the *NPRM* suggests that future updates might use cost relationships from a sample of cost companies for a baseline year. The *NPRM* also suggests that NECA could continue to use current formula structures in future years, or perhaps "freeze" current formula structures and coefficients for use in future years.[12]

Basing average schedule updates on frozen cost company separations factors would still require NECA to obtain extensive sample data on average schedule costs, and

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[10] For example, access formula levels decreased by 3.3% in July 1999, remained unchanged in July 2000, and increased by 2.6% in July 2001, for a net change over three years of 0.7%. *See* National Exchange Carrier Association, Inc., 1999 Proposed Modifications to the Interstate Average Schedule Formulas, December 31, 1998; Letter from Patricia A. Chirico, Executive Dir., Tariff, Rates, Costs and Average Schedules, National Exchange Carrier Association, Inc., to Ms. Magalie Roman Salas, Secretary, FCC, December 30, 1999 ("Certification Letter"); and National Exchange Carrier Association, Inc., 2001 Proposed Modifications to the Interstate Average Schedule Formulas, December 28, 2000, *Erratum,* May 8, 2001.

[11] *NPRM* at ¶ 17.

[12] *Id.* at ¶¶ 17 – 19.

to conduct extensive demand and cost growth forecasts and statistical analyses to determine formula structures each year.

On the other hand, formulas based on "frozen" payment structures and/or coefficients would quickly become outdated and inaccurate, and may even result in extreme under or over-payments to companies as technologies change and new services are deployed. In recent years, for example, NECA has found it necessary to revise the structure of some formulas as technologies and network architectures change. Deployment of fiber rings in the 1990s, for example, substantially altered the mileage assumptions underlying existing local transport formulas. A "freeze" of existing formulas would not allow such changes to be taken into account, and could either impede deployment of new services and technologies by average schedule companies or produce distorted settlement results as technologies change.[13]

NECA has identified a simplified approach that will reduce administrative burdens on carriers and the Commission while maintaining reasonable accuracy in formula settlements. Specifically, NECA proposes to use those cost companies identified as "Group C" companies in its access tariff development process as a representative group for purposes of adjusting overall average schedule access formula revenue

[13] The Commission should not rely on changes in inflation and demand as a way of adjusting the average schedule formulas. *See NPRM at* ¶ 21. Costs of providing service are driven by changes in technology that would not be measured adequately by inflation statistics. Additionally, the Commission should not add a productivity factor to the average schedule formula development process, as the *NPRM* suggests. *Id.* Section 69.606(a) of the Commission rules requires that the formulas "simulate" disbursements of representative cost companies. The Commission's rules do not currently apply any productivity adjustments to rural cost companies. There is no basis, therefore, for applying a special productivity adjustment to average schedule settlements.

requirements.[14] These companies are local exchange carriers that serve small study areas, and as such are representative of the population of average schedule companies for purposes of determining changes in access charge costs and demand.

Each year, NECA would examine changes in common line and traffic sensitive revenue requirements for Group C companies, and develop formula adjustment percentages that describe how common line and traffic sensitive revenue requirements per line have changed for this group. These factors would then be applied to average schedule revenue requirements to determine overall projected revenue requirements for the population.

The following exhibit illustrates the method that NECA would use to determine the overall adjustment to projected settlement levels:

[14] Group C companies are generally small study areas that perform annual cost studies. *See* National Exchange Carrier Association, Inc. Access Service Tariff F.C.C. No. 5, Transmittal No. 901 at Vol. 2, Sec. 2(B) (filed June 18, 2001). In contrast, larger cost companies participating in NECA's tariffs are classified as Group B companies. As of June 16, 2001 Group C LECs comprised 43% of the Common Line pool revenue requirement and 52% of the traffic sensitive pool revenue requirement.

Exhibit 1

Average Schedule Revenue Requirements

Group C Cost Companies in the June 18, 2001 Tariff Filing

| | CL | TS - Switched |
|---|---|---|
| A Annual Revenue Requirements ($Millions) | | |
| 1 PYCOS | $578.7 | $409.3 |
| 2 Test Period 2001-2002 | $637.2 | $438.6 |
| | | |
| B Access Lines | | |
| 1 PYCOS | 4,107,786 | 2,497,422 |
| 2 Test Period 2001-2002 | 4,351,422 | 2,650,734 |
| | | |
| C Annual Revenue Requirement Per Access Line | | |
| 1 PYCOS | $140.87 | $163.87 |
| 2 Test Period 2001-2002 | $146.44 | $165.45 |
| | | |
| D Formula Adjustment | | |
| 1 RR per Line Growth (C2/C1 - 1) | 3.95% | 0.96% |
| 2 Annual Adjustment [(2/3) x D1] +1 | 1.0263 | 1.0064 |

Average Schedule Companies in the June 18, 2001 Tariff Filing

| | CL | TS - Switched |
|---|---|---|
| E PYCOS Settlement per Access Line | | |
| 1 Settlement ($Millions) | $240.39 | $298.46 |
| 2 Access Lines | 2,678,930 | 2,347,503 |
| 3 RR Per Line (E1 / E2) | $89.73 | $127.14 |
| | | |
| F Test Year Revenue Requirement - Under Proposed New Rules | | |
| 1 Annual Access Line Growth Rate | 4.60% | 4.60% |
| 2 Access Line Growth Factor (1+ 1.5 x F1) | 1.0690 | 1.0690 |
| 3 Projected Access Lines (E2 x F2) | 2,863,776 | 2,509,481 |
| 4 Revenue Requirement ($ Millions) (D2 x E3 x F3) | $263.74 | $321.11 |

Exhibit 1 shows that annual common line and traffic sensitive revenue requirements per line for Group C cost companies increased from year 2000 to the year beginning July 2001 by 3.95% and .96%, respectively. Under NECA's proposal, these factors, which reflect overall changes in cost and demand for representative cost companies, combined with forecasted average schedule access lines, would be used to project overall average schedule access revenue requirements for the upcoming tariff period.

These changes would also determine changes to individual company payments via adjustments to the individual access formulas. However, in the case of individual formulas, NECA would retain the flexibility to make adjustments to formula structures as technology and demand trends change, so long as overall projected revenue requirements conform to levels established by the method described in Exhibit 1.[15]

This would provide a simple, yet fair, method for updating the average schedule access formulas. It would result in formula adjustments that continue to recognize changes in industry cost and allocation trends, but at a substantially reduced cost to NECA and average schedule companies compared to current methods.

For years, NECA has developed average schedule formula updates based on detailed studies of accounting data supplied by average schedule companies and cost allocations of representative cost companies. Each year, these studies have resulted in

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[15] In the case of the average schedule special access settlement formula, however, NECA currently uses a retention ratio approach that sets settlements based on a percentage of revenues received by companies. Because NECA will update special access tariff rates each year based on changes in cost company costs, this formula would not need further modification absent material changes of pool membership – average schedule special access settlements will automatically reflect changes in cost company special access costs.

modest increases or decreases in overall formula levels. In its 2000 filing, for example, NECA conducted a full-scale study of average schedule costs and cost company allocations and proposed formulas that were, on average, about 2.58% higher than the prior formulas. As shown in the above chart, NECA's proposed method would have produced an upward adjustment to the common line formula of 2.63%, and an upward adjustment to the traffic sensitive formulas of .64%, producing a net change in formula disbursements of 2.16% -- quite close to the overall change produced by NECA's full-scale study (2.58%).

The Commission requests comment on how changes in proposed development methods would affect access rates. [16] As can be seen from the above, because average schedule company cost trends closely "track" relative changes in representative cost company costs, the overall impact on NECA's access rates from this change in methods would be negligible.[17]

The Commission should accordingly revise its rules to specify that, effective in 2002, average schedule access formulas should be revised periodically based on the overall change in representative cost company cost and demand. Proposed revisions to section 69.606(a) incorporating this method are included in Appendix A.

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[16] *See NPRM at* ¶ 21.

[17] The *NPRM* also requests comment on how proposals to revise average schedule development methods might affect access rates in areas where competition has not developed, and asks further whether a different method should apply in areas where competition exists. *Id.* at ¶ 21. Average schedule companies typically operate in areas where competitive carriers are not willing to provide service. However, it bears noting that the average schedule formulas typically contribute to reductions in rates, even in areas without competition, because average schedule company costs tend to be lower than those of cost companies. Because the formulas developed under NECA's proposed method would continue to reflect these lower baseline costs, the proposed change in methods would have a neutral effect on existing or potential competition.

### B. Universal Service Formula Updates Should Also Be Based on Changes Experienced by Representative Cost Companies, Provided, However, that Base Year Payments Are Adequate and that Adjustments to the High Cost Formula Recognize the Cost Per Loop Characteristics of Average Schedule Companies.

NECA submits two average schedule USF formulas on October 1 of each year for approval by the Commission. These are the Local Switching Support (LSS) and High Cost Loop (HCL) USF formulas.

#### *1. Local Switching Support Formula*

The Commission's jurisdictional separations rules have recognized that small telephone companies tend to incur disproportionately high local switching costs. LSS, a component of the Commission's federal universal service program, is intended to provide additional support to these telephone companies.[18] LSS amounts for cost companies are determined based on the fraction of costs allocated to the interstate jurisdiction in excess of relative interstate usage. These amounts are then recovered from funds administered by USAC rather than through access rates.[19]

NECA's LSS formula simulates this process for average schedule companies by determining how much of the local switching portion of average schedule central office payments (as determined by the Central Office Formula) is attributable to LSS. As such, the LSS formula does not affect average schedule local switching settlements but is only used to determine the portion of local switching revenue requirements to be recovered

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[18] 47 C F.R. § 36.125.

[19] *See* Federal-State Joint Board on Universal Service, CC Docket No. 96-45, *Report and Order,* 12 FCC Rcd 8776 at ¶ 304 (1997).

through the LSS mechanism. The remainder of the local switching revenue requirement continues to be recovered through access charges.

NECA proposes that the development process for the average schedule LSS formula be simplified by allowing LSS fractions to be increased or decreased in proportion to LSS fraction changes reported by Group C cost companies.[20] This proposal complements NECA's access formula development proposal as described above. NECA would continue to offset local switching revenue requirements by the amount of LSS payments determined in this manner when developing its local switching tariff rate.

### 2. *High Cost Loop Formula*

Under Part 36 of the Commission's rules, cost companies receive high cost loop support based on the extent to which their *unseparated* (*i.e.*, total company) loop costs exceed the national average cost per loop (NACPL).[21] NECA proposes that the development process for the HCL formula be simplified as well by increasing or decreasing overall high cost loop USF payments in accordance with the percentage change in high cost loop USF payments per loop experienced by representative cost companies and in proportion to average schedule company loop growth.

Before such simplification can be accomplished for the HCL formula, however, the Commission must permit HCL formula payments for the base year to rise to a level that is consistent with high cost loop USF payments to representative cost companies.

[20] For example, if the fraction of LSS to Group C local switching revenue requirements increases by 2%, NECA would make a corresponding change in the fraction of average schedule LSS to the local switching formula payments.

[21] 47 C.F.R. § 36.601, *et seq.* A company's "loop cost" includes expenses, return on net investment, and federal income tax obligation on portions of specific accounts that include costs incurred in providing subscriber loops.

HCL payments to average schedule companies in recent years have fallen substantially below levels that are required to meet the "simulation" test of section 69.606(a). This has occurred because, in each of the past three years, increases in HCL payments to average schedule companies have been limited to the percentage growth in loops among average schedule companies.[22] Because loop growth has not kept pace with increases in HCL payments required by section 69.606(a) of the Commission's rules, the current formulas do not provide adequate high cost fund settlements to average schedule companies.[23]

Further shortfalls in HCL funding have resulted from the manner in which the Commission's *RTF Order*[24] has been implemented for average schedule companies. In

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[22] *See* National Exchange Carrier Association, Inc. Proposed Modifications to the 1998-99 Interstate Average Schedule Formulas, *Order*, 14 FCC Rcd 4049 (1999)(*1999 Order*); National Exchange Carrier Association, Inc. Proposed 2000 Modification of Average Schedule Universal Service Formulas, *Order*, 15 FCC Rcd 5065 (2000)(*2000 Order*); and National Exchange Carrier Association, Inc. Proposed 2001 Modification of Average Schedule Universal Service Formulas, *Order*, 16 FCC Rcd 25 (2001)(*2001 Order*).

[23] The extent of these shortfalls is documented in Applications for Review of the Commission's 2000 and 2001 Orders, which are currently pending before the Commission. *See Application for Review,* filed by the National Exchange Carrier Association, Inc., In the Matter of National Exchange Carrier Association, Inc. Proposed 2000 Modification of Average Schedule Universal Service Formulas, ASD 99-43 (Apr. 17, 2000); and *Application for Review,* filed by the National Exchange Carrier Association, Inc., In the Matter of National Exchange Carrier Association, Inc. Proposed 2001 Modification of Average Schedule Universal Service Formulas, ASD 00-42 (Jan. 26, 2001). In June 2001, the U.S.Court of Appeals for the District of Columbia Circuit denied NECA's Petition for Review of the Commission's 1999 Order without reaching the merits of the issue. *See* National Exchange Carrier Association, Inc, v. FCC, 253 F.3d 1 (D.C. Cir. 2001).

[24] *See* Federal-State Joint Board on Universal Service, CC Docket No. 96-45, 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, *Fourteenth Report and Order, Twenty-Second Order On Reconsideration and Further*

the *RTF Order*, the Commission took extraordinary action to correct funding imbalances caused by the interim "cap" on USF growth imposed on the fund in 1993. Specifically, the Commission decided to "rebase" the USF fund by recalculating the fund size at year 2000 fund levels as if the cap were not in effect in that year. Increased payments using the rebased fund began on July 1, 2001 for rural cost companies.

On October 5, 2001, Commission staff permitted NECA to adjust HCL payments to average schedule companies by increasing pre-RTF payments by an amount equal to the overall percentage increase estimated for all cost-based rural incumbent local exchange carriers.[25] This increase, while helpful, did not allow average schedule companies to receive the full benefits available to similarly situated cost companies under the *RTF Order* for 2001 because, as discussed in more detail below, rural cost companies as a whole have different cost per loop characteristics than average schedule companies. As a result, adjusting average schedule HCL payments by the percentage change experienced by all rural cost companies does not reflect actual cost trends of average schedule companies.[26]

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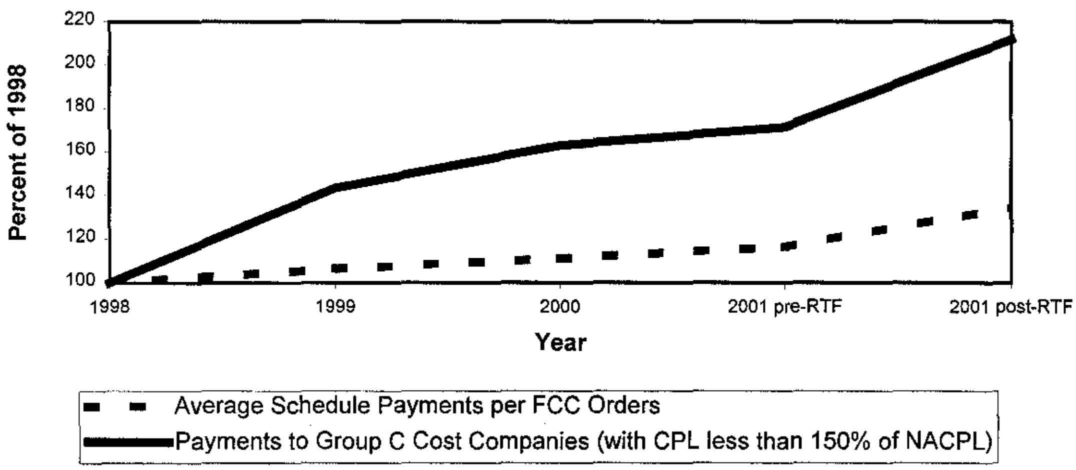
*Notice of Proposed Rulemaking in CC Docket No. 96-45, and Report and Order in CC Docket No. 00-256*, 66 Fed. Reg. 30080 (2001)(*RTF Order*).

[25] Letter from Kenneth P. Moran, Chief, Accounting Safeguards Division, Federal Communications Commission, to James W. Frame, Vice President, National Exchange Carrier Association, Inc. (Oct. 5, 2001).

[26] *See infra* pp 18-21. Moreover, even though the Commission's *RTF Order* expressly requires that year 2000 payments to all rural companies should be recalculated for purposes of "rebasing" the high cost fund, staff has not permitted NECA to recalculate year 2000 USF payments to average schedule companies to reflect this change. Failure to include average schedule payments in rebasing calculations causes additional underpayments to both average schedule and rural cost companies in the last half of 2001 and succeeding years.

Taken together, the Commission's continued use of a loop-growth only adjustment mechanism for average schedule HCL payments since 1999, and incomplete implementation of the *RTF Order* for average schedule companies in 2001, have caused substantial shortfalls in HCL payments to average schedule companies. This divergence is amply illustrated by the following table, which compares percentage increases in HCL funding for representative cost companies since 1998 with percentage increases permitted by the Commission for average schedule companies during the same period:

**Exhibit 2**
**Comparison of USF Increases Since 1998**
**Average Schedule vs. Representative Cost Companies**




NECA's October 1, 2001 average schedule USF filing demonstrated that HCL payments to average schedule companies must increase significantly in 2002 in order to satisfy the "payment simulation" standard of section 69.606(a).[27] If the proposed 2002 formulas are approved as filed, the resulting payments would provide a reasonable baseline for future formula adjustments. On the other hand, if the Commission does not approve NECA's 2002 filing, average schedule HCL payments may never "catch up" to the level required under 69.606(a). Establishing an adequate baseline level for average schedule HCL payments is critical to achieving a fair simplification method for this formula.

Assuming a base year amount is established that satisfies the payment simulation test of section 69.606(a), a two-tier adjustment mechanism must be specified in order to assure that average schedule high cost loop USF payments continue to "simulate" high cost loop USF payments to representative cost companies in future years.

Adjusting average schedule HCL payments based on a simple average of payment changes experienced by rural companies in general, or Group C cost companies in total, will not accurately estimate average schedule company high cost loop USF changes. The Commission's Part 36 USF rules prescribe different payment calculations for cost companies depending on whether their costs per loop are under 115 percent of the NACPL, between 115 percent and 150 percent of the NACPL, or over 150 percent of the NACPL. Because average schedule companies' costs per loop tend to fall disproportionately in the lower payment threshold categories, their average cost per loop profile is substantially different than those of cost companies in general.

Common sense suggests why this is so. The Commission's rules permit average schedule companies a "one way" option to convert to cost settlements. Over time, as higher-cost average schedule companies have converted to cost-based settlements, the average cost per loop levels of small cost companies and average schedule companies have diverged substantially, with cost companies predominantly falling into the higher

[27] *See* 2002 NECA Modification of Average Schedule Universal Service Formulas,

cost per loop categories and average schedule companies predominantly falling into the lower cost per loop categories.

Lower-cost companies (*i.e.*, those with costs per loop close to the 115% threshold for high cost loop USF eligibility)[28] receive relatively small amounts of high cost loop USF funding. But *percentage changes* in payments to this group tend to be much more sensitive to changes in the NACPL. Put another way, a small change in cost per loop for a low-cost company might increase or decrease payments by few dollars, but because the amounts involved are small, those few dollars can equate to a large percentage change in payments.

These points are illustrated in the following table, which displays preliminary estimates of percentage changes in high cost loop USF payments for rural cost companies resulting from implementation of the *RTF Order*:

National Exchange Carrier Association, Inc., October 1, 2001.

[28] Under the Commission's Part 36 rules, companies with costs in excess of 115% of the NACPL are entitled to receive USF expense adjustments. *See* 47 C.F.R. § 36.631.

**Exhibit 3**
**Rural Cost Company Annualized 2001 High Cost Loop USF Payments[29]**

| Band (based on NACPL = 240) | Pre-RTF (annualized) payment | RTF (annualized) payment | Percent change |
|---|---|---|---|
| | | | |
| Less than 115% of NACPL | $0 | $0 | 0% |
| Between 115% and 150% of NACPL | $39,567,890 | $71,064,183 | 79% |
| Over 150% of NACPL | $769,496,718 | $875,859,973 | 14% |
| | | | |
| Total | $809,064,608 | $946,924,156 | 17% |

It is readily apparent from the above display that dramatic differences exist between rural cost companies in the category between 115% and 150% of the NACPL and those in the category above 150% of the NACPL. Whereas the *RTF Order* increased funding to the higher cost group by $106.4 million effective July 1, 2001, that amount equaled only a 14% change in funding. In comparison, while funding for the lower cost group increased by only $31.5 million, that amount equaled a 79% change in funding.[30] Because the high cost companies receive the lion's share of HCL funding, however, the *overall average* change for both groups was only 17%.

The Commission must take this critical difference into account when considering possible ways to simplify the HCL formula development process in future years. Since

[29] This exhibit reflects calculations based on data attached to the November 10, 2000 ex parte letter from William R. Gillis to the FCC. *See* Letter from William R. Gillis Chair, RTF, to Magalie Roman Salas, Secretary, FCC (Nov.10, 2000). These calculations are currently being updated to reflect updated USF data. An adjustment to average schedule HCL payments due to the *RTF Order*, based on the updated USF data, will be filed shortly in accordance with the Commission's October 5, 2001 Letter.

[30] These companies tend to experience large percentage changes in payments because of the mechanics of the Part 36 USF rules. As an example, a company with costs just above or below 115% of the NACPL can see payments increase or decrease by 100% with a change of only a few cents in the NACPL or per-loop costs.

average schedule companies fall disproportionately within the lower-cost category, use of the overall percentage change in rural company HCL payments to adjust average schedule HCL payments in future years will produce distorted results. This problem can be solved easily, however, by using an average adjustment factor that is weighted according to the cost per loop characteristics of the average schedule population.

The following two exhibits show how this adjustment mechanism would be calculated:

**Exhibit 4**

**Illustrative Average Schedule HCL Adjustments Based on Cost Per Loop Categories**

| | | < 150% of NACPL | > 150% of NACPL |
|---|---|---|---|
| A | Annual USF Payments ($Millions) | | |
| | 1 Capped Fund – 2000 | $40.0 | $400.0 |
| | 2 Capped Fund – 2001 | $60.0 | $450.0 |
| B | USF Subscriber Loops | | |
| | 1 2000 | 5,000,000 | 2,000,000 |
| | 2 2001 | 5,250,000 | 2,100,000 |
| C | Annual Payment Per Loop | | |
| | 1 Capped Fund – 2000 | $8.00 | $200.00 |
| | 2 Capped Fund – 2001 | $11.43 | $214.29 |
| D | Payment Per Loop Adjustment (C2 / C1) – 1 | 43.3% | 7.1% |

This chart shows the method of calculating percentage changes in Group C cost company per loop HCL payments depending on cost per loop levels in relation to NACPL.

The following exhibit displays the calculation of a weighted average schedule adjustment that takes into account the relative number of average schedule companies in each of the two payment categories, based on these percentage changes:

**Exhibit 5**
**Proportional Adjustment Method – Illustrative Example**

| | | < 150% of NACPL | > 150% of NACPL | Total |
|---|---|---|---|---|
| A | Cost Company Factors (Exhibit 4, Line D) | 43.3% | 7.1% | |
| B | Average Schedule Payment Per Loop | | | |
| | 1 Capped Fund – 2000 | \$12.00 | \$18.00 | |
| | 2 Capped Fund – 2001 (1+A) x B1 | \$17.20 | \$19.30 | |
| C | USF Loops | | | |
| | 1 2000 | 2,000,000 | 500,000 | |
| | 2 2001 | 2,100,000 | 525,000 | |
| D | Payment Levels | | | |
| | 1 Capped Fund – 2000 (B1 x C1) | \$24.0 | \$9.0 | \$33.0 |
| | 2 Capped Fund – 2001 (B2 x C2) | \$36.1 | \$10.1 | \$46.2 |
| E | Overall Average Schedule Payment Adjustment (D2 / D1 –1) | | | 40% |

In the above example, NECA's method would adjust average schedule HCL payments by 40%, an amount that would represent the change in HCL payments experienced by cost companies that are representative of average schedule companies. Use of this approach in the future will assure that HCL payment adjustments will continue to be made in proportion to changes that would be experienced by cost companies with cost per loop characteristics that are representative of average schedule companies.

### C. The Commission Should Eliminate the "Approval" Requirement for NECA's Average Schedule Formulas and Consolidate Review of the Formulas with Review of NECA's Access Tariff Filings.

The Commission seeks to adopt a more streamlined and flexible procedural process for review of NECA average schedule formulas.[31] In this regard, the Commission notes that the current six-month review period for NECA average schedule formulas far exceeds the period applicable to industry tariffs.[32] The Commission accordingly seeks comment on whether the review of NECA average schedule formulas can be consolidated with review of NECA's access tariff filings, and whether Commission review should be limited to the tariff filing only.

NECA believes that reform can best be accomplished by revising section 69.606(a) of the Commission's rules to eliminate the requirement that NECA's average schedule formulas be "approved" each year by the Commission.[33] The requirement for positive approval of NECA's formulas is unique. In no other case does the Commission

[31] *NPRM* at ¶ 23.

[32] *Id.* at ¶ 24.

[33] Section 69.606(a) of the rules states that payments to average schedule companies "shall be made in accordance with a formula approved or modified by the Commission. . . ." 47 C.F.R. § 69.606(a).

require annual approval for any individual components of a carrier's tariff revenue requirement.[34]

The Commission's review of average schedule filings in the past several years has included detailed analysis of data, methods by which proposed formulas have been developed, studies of related statistical estimation theory, and analyses of detailed settlement effect on each company. No parallel analyses are included in Commission review of tariff filings, which are not "approved" by the Commission but are instead, simply allowed to become effective.

Furthermore, the approval process is redundant. NECA's access tariff filings include average schedule revenue requirements. The Commission now reviews the average schedule revenue requirement twice – once in the context of the special "approval" process conducted pursuant to section 69.606 of the rules, and again when NECA files its tariff incorporating the formula payments.[35]

The grossly disproportionate process for approval of average schedule formulas cannot be justified on the basis of public concern. Past average schedule access filings

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[34] In its July 26, 2000 letter to the Commission, NECA pointed out that individual average schedule formulas for many years were neither reviewed nor approved at all by the Commission. They were, instead, the product of negotiations that took place between Bell System and independent telephone company representatives, and as such were part of the traditional division of revenues process that governed intra-industry settlements prior to the AT&T divestiture. Commission oversight of the process was conducted via Commission review of overall Bell System tariffs (which included average schedule revenue requirements as a component- not at the individual formula level). *See* Letter from Richard A. Askoff, Deputy General Counsel, NECA, to Magalie R. Salas, Secretary, FCC (July 26, 2000).

[35] *See* National Exchange Carrier Association, Inc. (NECA) Proposed Modifications to the 1997 Interstate Average Schedule Formulas, *Order on Reconsideration and Order*, 13 FCC Rcd 10116 (1997) (describing the average schedule approval process as an "intermediate step" in the tariff review process).

have rarely met any substantial adverse comments or oppositions.[36] Since 1984, NECA's access formula proposals have generally been approved as filed.[37]

Instead of conducting a separate proceeding to approve or modify the average schedule formulas, Commission review of NECA's average schedule settlements should take place within the context of NECA's access tariff filings. Eliminating the average schedule approval process, and reviewing the overall revenue requirement adjustment within the context of the tariff filings is a logical approach to reforming the average schedule review process, especially if the Commission adopts the simplified method for developing average schedule formula revenue requirements described above. Under NECA's proposed plan for updating the formulas, there would be no need for

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[36] NECA's initial access-based average schedule formulas, filed in 1985, were opposed by a small group of local exchange carriers who were shown to have been receiving windfall settlements under the prior mechanism. NECA's formulas were eventually approved by the Commission, and survived a subsequent challenge in the U.S. Court of Appeals, *See* MTS and WATS Market Structure: Average Schedule Companies, CC Docket No. 78-72 Phase I, *Memorandum Opinion and Order*, 6 FCC Rcd 6608 (1991), aff'd *ICORE, Inc., et al., v. FCC*, 985 F.2d 1075 (D.C. Cir. 1993). Since that time, only a few parties have filed comments with respect to NECA's filings. *See, e.g.*, National Exchange Carrier Association, Inc. Proposed Modifications to the Interstate Average Schedules, *Memorandum Opinion and Order*, 8 FCC Rcd 4861 (1993); National Exchange Carrier Association, Inc., Proposed Modifications to the Interstate Average Schedules, *Memorandum Opinion and Order*, 10 FCC Rcd 13252 (1995). None of the questions raised by these commenters warranted rejection of NECA's proposals.

[37] In a few instances, internal Commission review of NECA's proposals has resulted in changes to those proposals. In 1997, for example, the Bureau approved NECA's traffic sensitive formulas but prescribed a new common line formula. The overall effect of this change reduced NECA's 1997 proposed formulas by $6.5 million, less than 3/10ths of one percent of NECA's overall tariff revenue requirement. NECA has also worked cooperatively (and informally) with Bureau staff to resolve staff concerns relating to central office settlements paid to high-volume companies. These changes could, however, as easily be accomplished in the context of a proceeding to review NECA's tariff, instead of a separate average schedule "approval" proceeding.

Commission review of individual formulas. Instead, NECA would simply adjust the total revenue requirement for average schedule companies based on changes in representative cost company cost and demand characteristics.[38]

Reviewing the overall revenue requirement, including average schedule revenue requirements, within the access tariff review process will allow the Commission and interested members of the public to have full opportunity to comment on NECA's revenue requirement calculations.[39] As it does with all tariff filings, the Commission could determine whether to allow proposed changes to become effective, or to suspend the tariff filing and investigate any substantial questions of lawfulness.

The logic of eliminating the separate "approval" requirement for NECA's average schedule access formulas applies as well as to NECA's average schedule universal service formulas.[40] As noted above, NECA has in recent years filed average schedule universal service formulas separately from its annual access formula filings. Although revenue requirements associated with these universal service support formulas are not included in NECA's access tariffs, high cost loop amounts are reported to the Commission in NECA's annual USF data submissions (filed in October of each year pursuant to section 36.613 of the Commission's rules). Both average schedule high cost

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[38] In the event that controversies arise between NECA and an average schedule company, which cannot be resolved by NECA, an average schedule company could still petition the Commission for a declaratory ruling on the issue. A similar mechanism has been utilized in the past for interpretation of Commission rules.

[39] NECA will continue to provide average schedule companies with advance notice of upcoming adjustments to the formulas to assist them in their decision-making processes.

[40] NECA's USF filings include proposed formulas for high loop cost fund disbursements and local switching support amounts. *See, e.g.,* National Exchange Carrier Association, Inc. Proposed Modifications to the 1999-2000 Interstate Average Schedule Formulas, ASD 99-43, *Order*, 15 FCC Rcd 87 (2000).

loop fund amounts and local switching support amounts are included in the Administrator's quarterly submissions of universal service fund revenue requirements (filed pursuant to section 54.709 of the Commission's rules).

Revised rule language reflecting elimination of the current approval process for the average schedule formulas is included in Appendix A.

## III. Conclusion

The Commission should revise section 69.602 of its rules so as to eliminate the requirement that NECA conduct annual elections for its board of directors. Additionally, the Commission should remove the requirement that outside directors must run in a contested election every three years. Eliminating these requirements will allow NECA to elect its Board as other private corporations, in accordance with the Delaware General Corporation Law.

The Commission should also reform the average schedule formula development process by specifying a method for updating total access charge and USF payments in proportion to changes experienced by representative cost companies. Before doing so for the HCL USF formula, however, the Commission must establish a base year USF payment for average schedule companies that conforms to the "payment simulation" standard of section 69.606(a). Also, because average schedule high cost loop USF recipients have different cost characteristics than the total population of rural cost companies, a "two tier" method must be adopted for identifying percentage changes in high cost loop USF payment levels of representative cost companies. Assuming these issues are taken into account, however, there is no reason why streamlined development approaches cannot be applied to all average schedule formulas, substantially reducing administrative burdens on both the Commission and average schedule companies.

Finally, the Commission should streamline the process used to review NECA average schedule formulas. The Commission should eliminate the requirement that average schedule formulas be "approved" and should instead incorporate review of NECA average schedule revenue requirements within its review of NECA's access tariff. Consolidating review of the average schedule revenue requirement with review of NECA's tariffs would eliminate current redundant procedures without significant adverse impact on ratepayers or the Commission.

Respectfully submitted,

NATIONAL EXCHANGE CARRIER
ASSOCIATION, Inc.

***By:*** /s/ Regina McNeil

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***Its Attorneys***

October 22, 2001

Appendix A

Sections 69.602 of the rules should be revised as follows:

* * *

(e) Each subset shall select the directors who will represent it individually through ~~an annual~~ periodic elections in which each member of the subset shall be entitled to vote for the number of directors that will represent such members' subset.

(f) The association membership shall select the directors ~~for the following calendar year~~ who will represent all three subsets through ~~an annual~~ periodic elections in which each member of the association shall be entitled to one vote for each director position. ~~There shall be at least two candidates meeting the qualification in paragraph (d) of this section for each such director position:~~

> ~~(1) In an election in which the most recently elected director for such position is not a qualified candidate;~~
> ~~(2) If there has been no election for such position having more than one qualified candidate during the present and the two preceding calendar years; and~~
> ~~(3) In any election for which the ballot lists two or more qualified candidates.~~

* * *

(i) ~~Directors shall serve for a term of one year commencing January 1 and concluding on December 31 of each year.~~

Section 69.606 of the rules should be revised as follows:

(a) Overall average schedule revenue requirements shall be determined by updating revenue requirements for each formula category, coincident with association tariff filings made pursuant to § 69.3, based on the projected line growth of the average schedule population, and percentage change of revenue requirement experienced by cost companies that are representative of average schedule companies. ~~Payments shall be made in accordance with~~ Individual formulas shall be designed by the association to produce disbursements to ~~an~~ average schedule compan~~y~~ies that simulate ~~the~~ changes in disbursements ~~that would be~~ received ~~pursuant to § 69.607~~ by ~~a~~ cost compan~~y~~ies that ~~is~~ are representative of average schedule companies.

~~(b) The association shall submit a proposed revision of the formula for each annual period subsequent to December 31, 1986, or certify that a majority of the directors of the association believe that no revisions are warranted for such period on or before December 31 of the preceding year.~~

Section 54.301(f) of the rules should be revised as follows:

* * *

(1) The local switching revenue requirement for average schedule companies, as defined in § 69.605(c) of this chapter, shall be calculated in accordance with a formula ~~approved or modified by the Commission~~ developed pursuant to § 69.606(a). ~~The Administrator shall submit to the Commission and the Common Carrier Bureau for review and approval a formula that simulates the disbursements that would be received pursuant to this section by a company that is representative of average schedule companies. For each annual period, the Administrator shall submit the formula, any proposed revisions of such formula, or a certification that no revisions to the formula are warranted on or before December 31 of each year.~~

(2) ~~The Commission delegates its authority to review, modify, and approve he formula submitted by the Administrator pursuant to this paragraph to the Chief, Common Carrier Bureau.~~

Section 61.39 of the rules should be revised as follows:

* * *

(2) (ii) For subsequent filings, an amount calculated to reflect the Traffic Sensitive average schedule pool settlement the carrier would have received if the carrier had continued to participate, based upon the most recent average schedule formulas developed pursuant to § 69.606(a). ~~approved by the Commission.~~

## CERTIFICATE OF SERVICE

I hereby certify that a copy of the Comments was served this 22nd day of October 2001, by electronic delivery or by mailing copies thereof by United States Mail, first class postage paid, to the persons listed below.

By: /s/ Shawn O'Brien
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