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

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In the Matter of	)	
	)	
Elimination of Rate-of-Return Regulation of Incumbent Local Exchange Carriers	)	RM-____
	)	
Federal-State Joint Board on Universal Service	)	CC Docket No 96-45
	)	

PETITION FOR RULEMAKING TO ELIMINATE RATE-OF-RETURN REGULATION OF INCUMBENT LOCAL EXCHANGE CARRIERS

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October 30, 2003

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Western Wireless Petition for Rulemaking
To Eliminate Rate-of-Return Regulation of ILECs

Top Ten Reasons to Eliminate Rate-of-Return ("ROR") Regulation

1. **Save Money.** By far the largest cause of the growth of the high-cost universal service fund is disbursements to rural ILECs pursuant to ROR formulas Consumers across the country would save hundreds of millions, possibly billions, of dollars if ROR were eliminated and replaced with a system better targeted to support affordable service for consumers in high-cost areas

2. **Stop Waste, Fraud and Abuse.** Regulators and independent auditors rarely, if ever, look at the accounting books of most ROR carriers, and opportunities abound for carriers to overstate their costs and thereby increase their access charges and high-cost support The Supreme Court recognized that the ILECs' "book costs may be overstated by approximately $5 Billion " [*Verizon v FCC*, 535 U S 467, 518 (2002)]

3. **Prevent Cross-Subsidies and Cost Misallocation.** In the few cases where the FCC or a state commission examined carriers cost submissions, they found millions of dollars of misallocated costs including costs of unregulated affiliates assigned to the ILEC in order to inflate high-cost support In most cases, the FCC may lack authority to order remedies for such over-earnings "In an era of corporate governance problems and accounting depredations," [Adelstein/Copps statement, FCC 03-111, 5/19/03], the FCC should change the rules to eliminate the rewards for such anti-competitive misconduct

4. **Create Incentives for Efficiency.** ROR regulation gives carriers incentives "to adopt the most costly, rather than the most efficient, investment strategies," [3 FCC Rcd 3195, 3219-20] Ending ROR would create incentives for more efficient networks, and would benefit consumers

5. **Enhance Incentives for Innovation.** The FCC has recognized that ROR "may have a negative effect on innovation because a carrier's reward for such innovation is a reduction in its dollar earnings " [3 FCC Rcd 3195, 3223] Eliminating ROR regulation would enhance incentives to speed the deployment of new technologies, benefitting rural consumers

6. **Remove Barriers to Competition in Rural Areas.** Rural customers benefit from access to competitive telecom alternatives, but ROR regulation is a barrier to full competition ROR targets RLECs' revenues to achieve a guaranteed return on investment on all historical costs incurred, while the RLECs' competitors receive portable funding only if they can obtain ETC designation, and even then only with respect to the lines that they provide – and unlike the RLECs, competitive carriers' investments are at risk

7. **Fix Distorted Intercarrier Compensation.** Eliminating ROR would enable the FCC to remove implicit subsidies from the RLECs' access rates, as the Act requires The RLECs' current, unreasonably high access charges distort local and long-distance competition in rural areas, deprive rural consumers of access to long-distance alternatives, and interfere with the development of a comprehensive rational system of intercarrier compensation

8. **Rationalize and Modernize High-Cost Support.** The current high-cost support system is an irrational hodge-podge that gives rural ILECs vastly more support than larger carriers for serving

identical geographic areas, rewards them simply for being small, and ignores whether they are efficient or not. The ROR paradigm must be replaced with a competitively neutral system that ensures "sufficient funding of *customers*, not *providers*," as the 1996 Act requires. [*Alenco*, 201 F.3d 608, 620 (5th Cir. 2000).]

9. **Remedy Unhealthy Dependence of RLEC Sector.** Many RLECs receive 70% or more of their funding from universal service subsidies or intercarrier payments, rather than from their own customers. This unhealthy dependence insulates these carriers from any incentive to be responsive to their own consumers' needs. Eliminating ROR and rebalancing rates would put these carriers on a healthier financial footing.

10. **The FCC Was Correct and Should Keep Its Promises.** In the 2001 *RTF Order*, the FCC reaffirmed its 1997 commitment to adopting forward-looking cost-based support mechanisms for rural carriers. It is time for the Commission to deliver on this worthy commitment.

In sum, ROR regulation bloats the universal service fund, creates opportunities and incentives for waste, fraud and abuse, and inhibits the development of efficient, innovative, and competitive services for rural consumers. ROR regulation has outlived its time and must be replaced with a more appropriate form of regulation based upon today's competitive environment.

* * * * *

Western Wireless proposes to replace ROR regulation with a forward-looking cost-based system to determine universal service high-cost support and access charge rate levels.

- **Cost Methodology.** Develop a model or other cost analysis methodology that accurately estimates the forward-looking cost of wireline service in high-cost areas. Develop a similar model or other methodology to estimate the forward-looking cost of *wireless* service. Support would be based on the lower of the wireline or wireless forward-looking cost in each geographic area.

- **Support Methodology.** Provide two types of support: the first based on a simple comparison of the cost of service with a national benchmark, and the second based on statewide averages. As an inducement to rate rebalancing and eliminating implicit subsidies in retail rates, limit support to carriers with retail rates that are below minimum "affordable" levels.

- **Phase In the New System.** Implement the new rules in 2006 (at the end of the 5-year period provided by the *RTF Order*) for competitive ETCs, non-rural ILECs, and rural ILECs owned by relatively large holding companies. Phase in the rules over the following 6 years for smaller rural ILECs.

- **Establish "Safety Net" and "Hold Harmless" Mechanisms.** To avoid rate shock, implement the plan so that no study area loses more than a specified percentage of the amount of support it previously received in any one year. Offer additional support if a carrier can prove that the forward-looking support amount is insufficient given its particular circumstances.

- **Reform Access Charges.** Rebalance access charges by moving non-traffic sensitive costs and other implicit subsidies out of access charges paid by long-distance carriers, and into subscriber line charges. Set RLEC access rates based on forward-looking costs, price cap mechanisms, and/or generic intercarrier compensation rules.

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PETITION FOR RULEMAKING TO ELIMINATE RATE-OF-RETURN REGULATION OF INCUMBENT LOCAL EXCHANGE CARRIERS

Western Wireless Corporation ("Western Wireless"), by counsel and pursuant to Section 1 401 of the Commission's rule, hereby submits this Petition for Rulemaking to eliminate rate-of-return ("ROR") regulation of rural incumbent local exchange carriers ("RLECs"), for purposes of determining their federal high-cost universal service support and interstate access charges This petition seeks to facilitate the transformation of the local telecommunications market from a monopoly to a competitive environment by replacing a highly inefficient, non-competitive system of regulation with an efficient, competitively neutral approach to regulating RLECs By granting this Petition, the Commission will release rural consumers from the monopoly grips of the RLECs, whose dominant position in the local market threatens the ability of rural America to have access to basic and advanced services comparable to those available in urban areas.

As the Commission has previously recognized "rate of return regulation provides regulated firms with very strong incentives to pad their rates," leads them "to adopt the most costly, rather than the most efficient, investment strategies because its primary means of increasing dollar earnings under rate-of-return constraints is to enlarge its rate base," and "may have a negative effect on innovation because a carrier's reward for such innovation is a reduction in its dollar earnings " 1/ Moreover, ROR regulation is based on an outdated monopoly paradigm of guaranteeing that a favored group of carriers "recover their investment in the total network facilities needed . . . ." 2/ This paradigm of protecting selected carriers' investments must be replaced with a paradigm of ensuring "sufficient and competitively-neutral funding to enable all customers to receive basic telecommunications services," since the 1996 Act "requires sufficient funding of *customers*, not *providers* " 3/ ROR regulation has outlived its time and must be replaced with a more appropriate form of regulation based upon today's competitive environment

I. INTRODUCTION AND SUMMARY

Western Wireless provides commercial mobile radio service ("CMRS") in 18 Metropolitan Statistical Areas ("MSAs") and 88 Rural Service Areas ("RSAs")

1/ *Policy and Rules Concerning Rates for Dominant Carriers*, Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195, 3219-20, 3223, ¶¶ 39, 46 (1988) ("*Price Cap FNPRM*")

2/ National Telecommunications Cooperative Association ("NTCA") Initial Comments, CC Docket No 96-45 (Joint Board Portability Proceeding) (filed May 5, 2003), at 7

3/ *Alenco Communications, Inc v FCC*, 201 F 3d 608, 620 (5th Cir 2000) ("*Alenco*") (emphasis in original) in 19 states The Company has also been designated as an eligible telecommunications carrier ("ETC") in 14 states, plus the Pine Ridge Indian reservation More and more consumers today rely on wireless services for the telecommunications needs Wireless and wireline services are becoming largely interchangeable, with both services increasingly competing to serve a consumer's telecommunications needs The ability of Western Wireless to effectively compete with the RLECs is seriously compromised by a system of regulation – Rate-of-Return regulation – that essentially guarantees the RLECs' dominant position in the marketplace

Western Wireless, like any business in a competitive environment, takes investment risks and receives revenues only to the extent that it is able to attract customers By contrast, RLECs are the beneficiaries of ROR regulation that provides them a perceived entitlement to recover all their operating expenses and depreciation on capital expenditures, plus a specified rate of return on investment. Western Wireless and other competitive carriers operate in a much different market, a market without entitlements, guarantees, or immunity from marketplace forces In the competitive market in which Western Wireless operates, consumers determine a carrier's fate

As explained below, ROR regulation disserves the public interest by inhibiting competition, enabling incumbent carriers to maintain a dominant position in the local exchange market, and creating an inefficient universal service funding mechanism that is growing too fast and exposes the public to serious risks of fraud and abuse

First, the system of ROR regulation, designed for a monopoly environment, has no place in an environment of local competition. The ROR system targets RLECs' access rates and high-cost support to achieve a guaranteed return on investment on all historical costs incurred, while RLECs' emerging ETC competitors receive funding only on a per-line basis for those lines served Unlike incumbent carriers, competitive entrants' investments are at risk. ROR regulation's reliance on the RLECs' historical costs is also inconsistent with the advent of local competition, since – as the Commission has long recognized, and as the Supreme Court recently affirmed, forward-looking costs are the only true measure of the factors that drive economic decision-making

Second, as the Commission has repeatedly recognized, ROR regulation interferes with incentives for carriers to operate efficiently, deploy new technologies, and reduce their operating costs. In today's increasingly competitive environment, it makes no sense to retain a system that gives carriers incentives to operate inefficiently and discourages them from introducing technological innovations The ROR system, which rewards carriers for being small and inefficient, also creates artificial and inefficient incentives for RLECs to remain as small as possible, and for larger ILECs to sell exchanges to smaller carriers, even if it would be economically efficient for RLECs to combine or for larger carriers to operate those exchanges 4/

Third, ROR regulation is the true cause for the growth of the high-cost universal service fund, which threatens the long-term viability of the fund A universal service funding mechanism based upon ROR regulation, the almost complete lack of independent oversight over the RLECs' cost reporting, and legal restrictions on the Commission's ability to require refunds or other remedies if and when it detects ROR over-earnings, leaves the public exposed to a very serious risk of fraud, waste, and abuse In this "era of corporate governance problems and accounting depredations," 5/ this risk should be unacceptable. 6/

This petition proposes eliminating and replacing ROR regulation of the larger RLECs beginning in 2006, and of smaller carriers over a gradual transition

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4/ Ideally, regulation should neither create incentives for concentration nor create incentives for de-concentration, but should allow the marketplace to determine the optimal size of telecommunications carriers

5/ *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements,* Further Notice of Proposed Rulemaking, WC Docket No 02-112, FCC 03-111 (released May 19, 2003) (separate statement of Commissioner Michael J Copps and Commissioner Jonathan S Adelstein, concurring) *See also 2002 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 Payments under Section 69.606 of the Commission's Rules,* Report and Order, CC Docket No 01-174, FCC 03-151 (released July 3, 2003) (statement of Commissioner Michael J Copps dissenting)

6/ In Attachment A to this Petition ("Rate of Return Regulation Problems That Can No Longer Be Ignored") we supply evidence of such malfeasance that state commissions in California Kansas, and other states have identified This information builds on additional evidence in a report submitted with Western Wireless' Reply Comments filed June 3, 2003 in the *Joint Board Portability Proceeding*, and included as Attachment B to this Petition ("Rate of Return Regulation A Failed Model for Economic Regulation") Moreover, record evidence already before the FCC shows that ROR ILECs earned at least $400 million of dollars in excess of what the existing ROR system allows over the past few years *See* AT&T Ex Parte Filing, CC Docket Nos 00-256, 96-45, 98-77, and 98-166 (filed May 9, 2003) period in subsequent years This petition also calls for instituting extensive new safeguards during the transitional time period during which ROR will remain in effect The time is right for a rulemaking to replace ROR regulation, particularly in light of the following closely related, pending and soon-to-be-initiated rulemaking proceedings

- First, the rulemaking proposed here is closely related to the pending *Joint Board Portability Proceeding*, which addresses "the methodology for calculating support for ETCs" – including incumbent as well as competitive ETCs – "in competitive study areas " 7/ This rulemaking proceeding would develop a comprehensive record for the establishment of a new high-cost support system for all ETCs in lieu of ROR regulation and would be helpful in addressing issues in the pending *Joint Board Portability Proceeding* Given the relationship among these issues, Western Wireless would support a referral to the Federal-State Joint Board on Universal Service of many of the issues discussed here Western Wireless would also support referral of related separations issues to the Federal-State Joint Board on Separations

- Second, the rulemaking sought here raises issues that are highly relevant to the forthcoming "comprehensive review of the high-cost mechanisms for rural and non-rural carriers as a whole," in which the Commission has committed to "consider all options, including the use of forward-looking costs, to determine appropriate support levels for both rural and non-rural carriers " 8/

- Third, the rulemaking sought here dovetails with the Further Notice of Proposed Rulemaking accompanying the *Tenth Circuit Remand Order*, in which the Commission seeks comment on additional targeted federal support to advance the goal that "states [ ] be encouraged to replace implicit support with explicit support mechanisms that will be sustainable in a competitive environment," which should help "achieve Congress' universal service goals by creating an explicit support fund

7/ *Portability Referral Order*, 17 FCC Rcd at 22645-46, ¶ 7, *Joint Board Portability Public Notice* 18 FCC Rcd at 1948, ¶ 15

8/ *Federal-State Joint Board on Universal Service*, Fourteenth Report and Order, 16 FCC Rcd 11244, 11310, ¶ 169 (2001) ("*RTF Order*") to benefit consumers who need it and by eliminating the vestiges of implicit support that misallocate resources and distort competition." 9/

- Fourth, a rulemaking proceeding to eliminate ROR regulation will help the Commission achieve its objectives with regard to intercarrier compensation. 10/ Eliminating ROR regulation of the RLECs' access charges will enable the Commission to eradicate the implicit subsidies currently embedded in those rates, as the Act requires. 11/ It will also help the Commission to end the economic distortions in the local and long-distance marketplace caused by the RLECs' excessive access rates

- Finally, the recently opened Total Element Long-Run Incremental Cost ("TELRIC") review proceeding will address forward-looking costing questions that may also be relevant to the development of a new forward-looking cost-based universal service support system for RLECs, non-rural incumbent carriers and competitive ETCs. 12/

9/ *Federal-State Joint Board on Universal Service*, Order on Remand, Further Notice of Proposed Rulemaking, and Memorandum Opinion and Order, CC Docket No 96-45, FCC 03-249, ¶ 127 ("*Tenth Circuit Remand Order FNPRM*") (released Oct 27, 2003), *id*, Separate Statement of Chairman Michael K Powell, at 1

10/ *Developing a Unified Intercarrier Compensation Regime*, Notice of Proposed Rulemaking, 16 FCC Rcd 9610 (2001) ("*Intercarrier Compensation Notice*") The *Intercarrier Compensation Notice* specifically sought comment on moving the access charges of all local exchange carriers, including RLECs subject to ROR regulation, toward a bill-and-keep system *Id*, 16 FCC Rcd at 9644-45, ¶ 97 It also addressed the possible impact of such reforms on end-user rates and universal service support mechanisms *Id*, 16 FCC Rcd at 9654-55, ¶¶ 123-24

11/ *Texas Office of Public Utility Counsel v FCC*, 183 F 3d 393, 406 (5th Cir 1999), *Alenco*, 201 F 3d at 624, *Texas Office of Public Utility Counsel v FCC*, 265 F 3d 313, 318 (5th Cir 2001)

12/ *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Services by Incumbent Local Exchange Carriers*, Notice of Proposed Rulemaking, 18 FCC Rcd 18945 (2003) ("*TELRIC NPRM*") To be sure, the forward-looking economic cost methodology used for pricing network elements is different in important respects from the forward-looking economic cost model used in the context of universal service support, and the two methodologies need not be identical *TELRIC NPRM*, ¶ 46, *Federal-State Joint Board on Universal Service*, Tenth Report and Order, 14 FCC Rcd 20156, 20172, ¶ 32 (1999) ("*USF Inputs Order*"), *aff'd sub nom Qwest Corp v FCC*, 258 F 3d 1191 (10th Cir 2001) Nonetheless, there are important methodological and input questions that could affect both network element pricing and universal service, in particular the models and inputs used to determine forward-looking costs

We offer herein a brief history of ROR regulation, including the FCC's stated commitment to transition all high-cost universal service support to a forward-looking system Next, we provide more detailed support for why the obsolete and anti-competitive system of ROR regulation should be brought to an end as expeditiously as possible We discuss possible replacements for ROR regulation, including a forward-looking economic cost-based system to set high-cost universal service funding amounts in rural areas, and rate rebalancing and an overhaul of RLEC access charges as part of comprehensive intercarrier compensation reform. Finally, we offer a transition plan for phasing out ROR regulation and introducing a system of regulation based on forward-looking economic cost.

As demonstrated herein, ROR regulation has outlived its usefulness. Now is the time for the Commission to initiate a rulemaking proceeding to eliminate ROR regulation of the RLECs and replace it with a new system based on forward-looking economic costs

II. BACKGROUND

A. Rate-Of-Return Regulation Has Its Historical Roots In The Era Of Monopoly Local Telephone Service That No Longer Exists

ROR regulation based on historical, embedded costs was first introduced in the context of regulating a monopoly power company's return on investment In 1944, the Supreme Court upheld the Federal Power Commission's decision to use ROR regulation based on historical costs, and rejected a utility's argument that the agency should have used a "fair value" (based on reproduction costs) methodology (one form of what is now referred to as a forward-looking economic cost methodology) 13/ The Supreme Court, however, specifically rejected the notion that ROR is the only legally permissible approach to regulating even in a monopoly environment

> It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. * * * * [T]o declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates It has repeatedly been stated that no single method need be followed by the Commission in considering the justness and reasonableness of rates 14/

The FCC did not begin to formally develop its ROR system for regulating the then-monopoly incumbent local exchange carriers ("ILECs") until the mid-1960s, and conducted a number of major ROR ratemaking proceedings regarding the Bell System during the 1960s, 1970s and early 1980s 15/ However, the Commission never directly regulated the costs or rates of the small and mid-size ILECs (also known as "independent" carriers because they were not affiliated with the pre-divestiture Bell system). Prior to divestiture, the independent ILECs

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13/ *FPC v Hope Natural Gas Co*, 320 U S 591 (1944)

14/ *See id* at 602, 609 *See also Duquesne Light Co v Barasch*, 488 U S 299 (1989); *Verizon Communications, Inc v FCC*, 535 U S 467, 497-501 (2002) ("*Verizon v FCC*") (affirming FCC's use of forward-looking costs as the basis for setting UNE rates), *Alenco*, 201 F 2d at 620 ("The Act only promises universal service, and that is a goal that requires sufficient funding of *customers* not *providers* So long as there is sufficient and competitively-neutral funding to enable all customers to receive basic telecommunications services, the FCC has satisfied the Act and is not further required to ensure sufficient funding of every local telephone provider as well") (emphasis in original)

15/ *Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873, 2884-89, ¶¶ 18-28 (1989) ("*AT&T Price Cap Order*") (describing history of ROR regulation) received a share of long-distance revenues from the monopoly long-distance carrier, AT&T, through a "settlements" process that was "industry devised" and barely, if at all, overseen by the Commission 16/ The ILECs simply reported their costs to AT&T or its Bell company affiliates, which reviewed their cost studies, albeit with no independent regulatory oversight, and a settlement amount was negotiated

What the Commission *did* oversee, beginning in the 1960s, was the Separations Manual, which controlled the allocation of costs between the state and interstate jurisdictions 17/ The Separations Manual was utilized as an elaborately complex mechanism to funnel implicit universal service subsidies from long-distance to local rates. 18/ The separations rules (now in Part 36) continue to serve that purpose to this day

The system of "division of revenues" and "settlements" became unsustainable with the emergence of long-distance competition Thus, the FCC replaced that system with access charges, and created the National Exchange Carrier Association ("NECA"), consisting of ILEC members and run by the ILECs'

16/ *MTS and WATS Market Structure*, Notice of Inquiry and Notice of Proposed Rulemaking, 67 FCC 2d 757, 759, ¶ 8 (1978) Similarly AT&T's ILEC affiliates – the Bell Operating Companies - received a share of long-distance revenues through a "division of revenues" process

17/ *See American Telephone & Telegraph Co and the Associated Bell System Companies Charges for Interstate and Foreign Communication Service*, 9 FCC 2d 30, 90, ¶ 246 (1967) (first Commission order addressing separations rules) ("Although the content of the 'Separations Manual' is the product of cooperative studies and consultations involving the NARUC, this Commission and the telephone industry, [prior to this order] it has never been formally evaluated, approved, or adopted by this Commission in the context of either a ratemaking or rulemaking proceeding ")

18/ *See generally* P Huber, M Kellogg, and J Thorne, *Federal Telecommunications Law* 130-40 (2d ed 1999) representatives, 19/ to take over certain functions previously handled by AT&T: tariff coordination, monitoring of individual ILECs' cost studies, development of averaged rates, and pool administration. No independent regulatory authority ever thoroughly reviewed the cost submissions by the small, independent ILECs, although the FCC exercised a degree of oversight over NECA's tariff filings and other operations.

Gradually, the rules were relaxed, and the larger ILECs were permitted to exit from NECA's rate pools and averaging. However, three mechanisms were established to preserve the pre-divestiture subsidies that the small, independent ILECs had enjoyed under the old "settlements" system. After the 1996 Act was enacted, contributions from the telecommunications carriers became the source of funding for these mechanisms (replacing some, but not all, of the interstate access charges paid by long-distance carriers). The disbursement rules for rural ILECs, however, remain essentially the same as they were prior to 1996, with only minimal exceptions, such as:

- First, for rural ILEC study areas that reported loop costs that were above the national average, the ILEC was allowed to recover a significantly higher proportion of its loop costs than it would have received under the standard separations rules. This mechanism, originally known simply as the "Universal Service Fund," survives today as "High-Cost Loop" support, and amounts to over $1.1 billion annually. 20/

19/ *See* 47 C.F.R. Part 69, Subpart G (rules governing NECA membership and board).

20/ *See* 47 C.F.R. Part 36, Subpart F. The support amounts listed in this and the following text are drawn from the Universal Service Administrative Co.'s 4th quarter 2003 filings with the FCC, available at http://www.universalservice.org/overview/filings/

- Second, for rural ILEC study areas with very small numbers of lines (regardless of the total number of lines provided by the holding company's other affiliates), the ILEC was also permitted to recover increased access charges This was originally implemented through a tweak in the jurisdictional separations rules known as Dial Equipment Minutes ("DEMs") Weighting, which assigned a significantly higher proportion of those ILECs' switching costs into the interstate jurisdiction than would have been justified by their relative interstate switch usage. This "DEMs Weighting" mechanism survives today as "Local Switching Support," amounting to over $400 million per year 21/

- Third, low-cost ILECs that departed from the NECA cost-averaging pools were required to make payments into the pools to support the high-cost ILECs remaining in the pools These payments, which were phased down during the 1990s but never entirely eliminated, survive today as "Long Term Support," and amount to over $500 million annually 22/

While the Commission has adopted some reforms to the RLECs' interstate access charge structure, such as reducing those charges from their pre-existing, absurdly high levels to levels that are still high, but more closely approaching those charged by larger ILECs, the ROR system remains the basis for setting the RLECs' access rates In fact, in order to perpetuate the ROR regulatory system, the Commission established the Interstate Common Line Support ("ICLS") fund targeted to guarantee revenue neutrality for the RLECs at the time of access charge reform 23/ The ICLS fund distributes over $400 million annually.

21/ *See* 47 C F R § 54 301

22/ *See* 47 C F R § 54 303

23/ *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, 16 FCC Rcd 19613 (2001) ("*MAG Order*"), *subsequent history omitted* *see also* 47 C F R Part 54, Subpart K

By contrast, the Commission long ago eliminated ROR regulation for AT&T and the large ILECs, and replaced that system with price cap regulation. In that proceeding (discussed at greater length below), the Commission found that ROR regulation gives regulated carriers inefficient investment incentives, impedes innovation, and creates opportunities for carriers to pad their expenses and misallocate costs in order to improperly increase their revenues On this basis, the Commission decided to eliminate ROR regulation as the basis for AT&T's long-distance rates in 1989, and as the basis for the large ILECs' interstate access charges in 1990 24/ State commissions shared the FCC's aversion to ROR regulation of telecommunications carriers, and all but six of them have abolished ROR for the Bell Operating Companies 25/

In enacting the 1996 Act, Congress specifically rejected ROR as the basis for setting rates for unbundled network elements ("UNEs"). Section 252(d)(1)(A)(i) directs the FCC and state commissions to set rates for interconnection and network elements "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element . . ." 26/ To be sure, the Commission has made it clear that the methodology for setting UNE rates differs from that used for

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24/ *See AT&T Price Cap Order*, *supra*, *ILEC Price Cap Order*, *supra*

25/ National Regulatory Research Institute, *Retail Regulation of Local Telecommunications Providers (as of April 2002)*, Jan 2003, available at http //www nrri ohio-state edu/programs/markets/pdf/reg-regime-adoption-by-state-map pdf

26/ 47 U S C § 252(d)(1)(A)(i)

determining universal service support 27/ Nonetheless, it is notable that the Supreme Court, in upholding the Commission's initial order rejecting the use of embedded costs in setting UNE rates, specifically noted the problematic nature of ROR regulation 28/ The Commission again "reaffirm[ed] [its] commitment to forward-looking costing principles" and declined to open any inquiry into "alternative pricing methodologies that rely in whole or in part on embedded costs" in its recent *TELRIC NPRM* 29/

B. The Commission Has Repeatedly Committed to Transitioning High-Cost Universal Service Support To A Forward-Looking Cost-Based System.

In implementing the 1996 Act's universal service policy, the Commission has repeatedly committed itself to eliminating the pre-1996 high-cost mechanisms based on embedded costs and ROR regulation, and replacing them

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27/ *TELRIC NPRM*, ¶ 46, *USF Inputs Order*, 14 FCC Rcd 20156, 20172, ¶ 32

28/ *Verizon v FCC*, 535 U S at 512 ("[T]he temptation would remain to overstate book costs to ratemaking commissions and so perpetuate the intractable problems that led to the price-cap innovation "), *id* at 517-18 ("the 'book' value or embedded costs of capital presented to traditional ratemaking bodies often bore little resemblance to the economic value of capital"), *id* at 518 ("[B]ook costs may be overstated by approximately $5 billion ") (*quoting FCC Releases Audit Report on RBOCs' Property Records*, Report No CC 99-3 (rel Feb 25, 1999) *See also TELRIC NPRM*, ¶ 40 n 82, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15499, 15846, ¶ 679 (1996) ("*Local Competition Order*"), *subsequent history omitted* ("Adopting a pricing methodology based on forward-looking, economic costs best replicates, to the extent possible, the conditions of a competitive market In addition, a forward-looking cost methodology reduces the ability of an incumbent LEC to engage in anti-competitive behavior ")

29/ *TELRIC NPRM*, ¶¶ 29, 37 *See also id* , Separate Statement of Chairman Michael K Powell ("*[O]ur commitment to retaining a forward-looking approach is unwavering* – what we are debating is the extent to which realistic assumptions about the incumbent's network should be included in our pricing rules ") (emphasis added), Separate Statement of Commissioner Kevin J Martin ("I believe that the prices for unbundled network elements should be based on the *forward-looking* replacement cost of the ILEC's network ") (emphasis added) with high-cost support based on forward-looking cost In the *Universal Service First Report and Order*, the Commission concluded that the pre-1996 mechanisms "neither ensure that ILECs are operating efficiently nor encourage them to do so" and are "contrary to sound economic policy" 30/ The Commission found that, for small rural carriers as well as for non-rural carriers, "basing support on forward-looking economic cost . will require telecommunications carriers to operate efficiently and will facilitate the move to competition in all telecommunications markets" 31/ The Commission elaborated on its view that a forward-looking mechanism would be consistent with the Act and better serve the statutory objectives

> Consistent with the Joint Board's recommendation, we anticipate, however, that forward-looking support mechanisms that could be used for rural carriers within the continental United States will be developed within three years of release of this Order. We conclude that a forward-looking economic cost methodology consistent with the principles we set forth in this section should be able to predict rural carriers' forward-looking economic cost with sufficient accuracy that carriers serving rural areas could continue to make infrastructure improvements and charge affordable rates Like the Joint Board, we conclude that calculating support using such a forward-looking economic cost methodology would comply with the Act's requirements that support be specific, predictable, and sufficient and that rates for consumers in rural and high cost areas be affordable and reasonably comparable to rates charged for similar services in urban areas Moreover, such a mechanism could target support by calculating costs over a smaller geographical area than the study areas currently used. In addition, we find that the use of mechanisms incorporating forward-

30/ *Federal-State Joint Board on Universal Service*, First Report and Order, 12 FCC Rcd 8776, 8934-35, ¶ 292 (1997) ("*Universal Service First Report and Order*"), *subsequent history omitted* *See also id* at 8934-35, ¶ 292 ("Indeed, by guaranteeing carriers recovery of 100 percent of all loop costs in excess of 150 percent of the national average loop cost, the current high-cost funding mechanisms effectively discourage efficiency")

31/ *Id*

> looking economic cost principles would promote competition in rural study areas by providing more accurate investment signals to potential competitors 32/

The Commission reaffirmed its long-term commitment to the use of forward-looking costs to set universal service support levels in its recent *RTF Order* The Commission specifically stated that it "disagree[d]" with rural ILEC representatives who argued "that the forward-looking cost mechanism should not be used to determine rural company support and that only an embedded cost mechanism will provide sufficient support for rural carriers." 33/ Rather, the Commission reaffirmed its previous conclusions regarding the transition from a universal service system based on rate-of-return to one based on forward-looking costs

> The Commission previously determined that support based on forward-looking cost is sufficient for the provision of the supported services and sends the correct signals for entry, investment, and innovation . . While the Rural Task Force demonstrated the inappropriateness of using input values designed for non-rural carriers to determine support for rural carriers, we do not find that its analysis justifies a reversal of the Commission's position with respect to the use of forward-looking cost as a general matter. 34/

The Commission indicated that it would soon initiate a "comprehensive review of the high-cost mechanisms for rural and non-rural carriers as a whole," in which it

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32/ *Id* at 8935, ¶ 293 The Commission, however, declined to move rural ILECs immediately into a forward-looking cost-based system immediately due to concerns about the applicability of the cost models to rural ILECs *Id* at 8935-37, ¶¶ 294-95

33/ *RTF Order*, 16 FCC Rcd at 11311, ¶ 174 (2001) (emphasis added)(citations omitted)

34/ *Id* *Accord*, *Texas Office of Public Utility Counsel v FCC*, 183 F 3d 393, 412 (5th Cir 1999) (affirming that forward-looking support satisfies statutory "sufficiency" criterion), *Alenco* , 201 F 3d at 620 (same) would "consider all options, including the use of forward-looking costs, to determine appropriate support levels for both rural and non-rural carriers." 35/

It is time for the Commission to deliver on these commitments. The Commission should promptly open the rulemaking Western Wireless proposes, and should work toward eliminating ROR regulation and replacing it with a system based on forward-looking costs

III. THE FAILED SYSTEM OF RATE-OF-RETURN REGULATION MUST BE ELIMINATED AND REPLACED EXPEDITIOUSLY

In adopting the 1996 Act, Congress challenged regulators to adopt a new regulatory paradigm that would be consistent with the emergence of competition throughout the telecommunications industry, including in rural and high-cost areas, while also preserving and advancing the goal of universal service Up to now, the Commission has delayed the inevitable changes to the ROR system of regulating RLECs, perhaps due to concerns about the impact of this competitive transformation on rural carriers and their customers and the need for a gradual transition However, the time has come to begin making the changes necessary to focus universal service policy on "sufficient funding of *customers*, not *providers*." 36/

As discussed below, the existing ROR system is pernicious for three reasons (1) it precludes the development of competition on a level playing field, and thereby harms consumers in rural areas who are deprived of the benefits of

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35/ *RTF Order* 16 FCC Rcd at 11310, ¶¶ 169-70

36/ *Alenco*, 201 F 3d at 620 (emphasis in original) such competition, (2) it gives carriers incentives to operate inefficiently and discourages them from introducing technological innovations, to the detriment of rural consumers, and (3) it creates opportunities for waste, fraud and abuse and causes the unwarranted expansion of the universal service fund, harming consumers nationwide who ultimately pay into the fund

A. ROR Regulation Artificially Interferes With Competition

ROR regulation harms consumers in rural areas by artificially interfering with competition Competition in the universal service market benefits consumers by "increasing customer choice, innovative services, and new technologies," by promoting "the deployment of new facilities and technologies" while providing "an incentive to the incumbent rural telephone companies to improve their existing network to remain competitive," and by "creating incentives to ensure that quality services are available at 'just, reasonable, and affordable rates ' " 37/ But such competition on a level playing field is impossible under the current ROR rules.

First, the current funding mechanism asymmetrically provides full historical cost recovery for incumbents, but per-line recovery for new entrants. It thereby creates a bias in favor of the incumbent This can distort competitive outcomes and reduces economic efficiency There can be no level competitive playing field when the incumbent not only enjoys the natural advantages of

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37/ *Federal-State Joint Board on Universal Service, Western Wireless Corp Petition for Designation as an Eligible Telecommunications Carrier in the State of Wyoming*, 16 FCC Rcd 48, 56 ¶ 17 (Com Car Bur 2000), *aff'd* 16 FCC Rcd 19144 (2001) incumbency, but also enjoys a government-guaranteed return on investment, while competitive ETCs' investments are completely at risk. ROR regulation provides revenue guarantees for ILECs, but not competitive ETCs, which is fundamentally antagonistic to competition. 38/

Second, ROR concepts drive a fundamentally unbalanced high-cost regime for rural ILECs and competitive ETCs. Rural ILECs are assured a particular level of support even if they lose access lines and market share to a competitor. The Commission originally adopted a rule that would have taken support away from ILECs as competitive ETCs gain market share, but abandoned this competitive market-based rule for a return to ROR regulation. 39/ Competitive ETCs receive support only for the customer connections they serve – that is, they receive support only to the extent they garner market share, and if they lose customers, they lose support. Competition on a level playing field is impossible when one class of competitors receives such unbalanced regulatory advantages. 40/

Third, ROR-based access charges and universal service support create inaccurate and inefficient incentives for competitive entrants, as well as for incumbent carriers. The Commission's recent condemnation of the use of historical

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38/ Rather than creating revenue guarantees for competitive ETCs as well, as some parties suggest, the Commission should eliminate such guarantees for all carriers.

39/ *Federal-State Joint Board on Universal Service*, Ninth Report and Order, 14 FCC Rcd 20432 (1999), *rev'd in part on other grounds sub nom. Qwest Corp. v. FCC*, 258 F.3d 1191 (10th Cir. 2001). *See also* Rural Task Force, *RTF White Paper #5: Competition and Universal Service* at 16 (Sept. 2000) (available at http://www.wutc.wa.gov/rtf).

40/ *See Western Wireless Corp. Petition for Preemption of Statutes and Rules Regarding the Kansas State Universal Service Fund Pursuant to Section 253 of the Communications Act of 1934*, 15 FCC Rcd 16227, 16231, ¶ 10 (2000).

costs in UNE rate setting applies with equal force to the use of historical costs in setting rural ILECs' access charge rates and universal service support levels:

> In addition to the problems associated with reliance on incumbent LEC accounting records, the use of historical costs does not necessarily provide efficient investment signals to potential entrants. As many economists have noted, it is forward-looking costs, not historical costs, that are relevant in setting prices in competitive markets. If historical costs are higher than the forward-looking costs an entrant would face, setting rates on the basis of historical cost could result in UNE prices that deter entry generally, or cause entrants to build their own facilities even when it is inefficient to do so. Conversely, if historical costs are lower than forward-looking costs, UNE rates based on historical costs might cause entrants to lease facilities when it was more efficient either to build their own or not to enter a particular market. 41/

B. ROR Regulation Creates Incentives for Inefficiency and Impedes Innovation

ROR regulation creates incentives for ILECs to operate inefficiently (even in a monopoly environment), because it entitles them to cost recovery regardless of how inefficient the investment. The Commission recognized this problem over ten years ago:

> First, as a profit-maximizer, the firm is led to adopt the most costly, rather than the most efficient, investment strategies because its primary means of increasing dollar earnings under rate-of-return constraints is to enlarge its rate base. * * * Second, since all operating expenses are included in a firm's revenue requirement under rate of return, management has little incentive to minimize operating costs. * * * In both cases, consumers suffer because these distorted incentives increase the cost of doing business – and thus the rates consumers must pay for service. * * * * *
>
> The distorted efficiency incentives established by rate-of-return regulation also may have a negative effect on innovation. Clearly, rate-of-return establishes no incentive to 'do the same old thing a better

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41/ *TELRIC NPRM* at ¶ 32

> way' – for example, by providing the same service at lower cost – because a carrier's reward for such innovation is a reduction in its dollar earnings Such regulation may well have similar effects on incentives to produce new products and services. 42/

The Commission expanded on this analysis in its 1989 order eliminating ROR regulation for AT&T and proposing to eliminate it for the large ILECs, concluding as follows.

> Under rate of return, however, "normal" profit levels are established in advance by regulatory fiat The dynamic process that produces socially beneficial results in a competitive environment is strongly suppressed In fact, rather than encourage socially beneficial behavior by the regulated firm, rate of return actually discourages it.
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> The distorted incentives created by rate of return regulation are easily illustrated. In a competitive environment, where prices are dictated by the market, a company's unit costs and profits generally are related inversely If one goes up, the other goes down. Rate of return regulation stands this relationship on its head. Although carriers subject to such regulation are limited to earning a particular percentage return on investment during a fixed period, a carrier seeking to increase its dollar earnings often can do so merely by increasing its aggregate investment. In other words, under a rate of return regime, profits (*i e* , dollar earnings) can go up when investment goes up. This creates a powerful incentive for carriers to "pad" their costs, regardless of whether additional investment is necessary or efficient. And, because a carrier's operating expenses generally are recovered from ratepayers on a dollar-for-dollar basis, and do not affect shareholder profits, management has little incentive to conserve on such expenses. This creates an additional incentive to operate inefficiently Moreover, in situations in which carriers providing more than one service face competition for one or more of such services, rate of return regulation enables carriers to distort the competitive process by manipulating their reported cost allocations.
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> A system that establishes such incentives is unlikely to encourage efficiency Moreover, administering rate of return regulation in order

42/ *Price Cap FNPRM,* 3 FCC Rcd at 3219-20, 3223, ¶¶ 39, 46, *see also* Harvey Averch and Leland L Johnson, "Behavior of the Firm under Regulatory Constraint," 52 Amer Econ Rev 1052 (1962, Alfred E Kahn, *The Economics of Regulation Principles and Institutions*, vol 2, at 47-59 (1971)

> to counteract these incentives is a difficult and complex process, even when done correctly and well. This is so primarily [because] . . . . a regulator may have difficulty obtaining accurate cost information as the carrier itself is the source of nearly all information about its costs. Furthermore, no regulator has the resources to review in detail the thousands of individual business judgments a carrier makes 43/

The Commission went on to observe the difficulty of preventing cost misallocations and cross-subsidies, particularly in an environment of technological advancement, increasing competition, and "a continuing shift in the boundaries between the competitive and less competitive segments of the telecommunications marketplace" 44/

Thus, rate of return regulation is widely recognized as eliminating incentives for carriers to operate efficiently, improve productivity, or introduce innovative technologies and services 45/ As the U S Court of Appeals for the D.C. Circuit explained in upholding the shift from ROR to price caps for larger ILECs, "because a firm can pass any cost along to ratepayers (unless it is identified as imprudent), its incentive to innovate is less sharp than if it were unregulated." 46/ This conclusion is supported by empirical econometric research, which confirms that

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43/ *AT&T Price Cap Order*, 4 FCC Rcd at 2889-90, ¶¶ 29-31 (emphasis in original).

44/ *Id* 4 FCC Rcd at 2890-91, ¶ 34

45/ *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd 8961, 8973, ¶ 27 (1995), subsequent history omitted, *ILEC Price Cap Order*, 5 FCC Rcd at 6789-90, ¶¶ 22, 29-32

46/ *National Rural Telecom Ass n v FCC*, 988 F 2d 174, 178 (D C Cir 1993) "using rate-of-return regulation does have the unintended consequence of decreasing the firm's expenditures on R&D." 47/

In the *Universal Service First Report and Order*, the Commission specifically recognized the inefficiency of the current embedded-cost support mechanisms in the context of rural ILECs operating under ROR regulation:

> We find that the current support mechanisms neither ensure that ILECs are operating efficiently nor encourage them to do so. Indeed, by guaranteeing carriers recovery of 100 percent of all loop costs in excess of 150 percent of the national average loop cost, the current high-cost funding mechanisms effectively discourage efficiency. Thus, we agree with [Citizens for a Sound Economy] that calculating high-cost support based on embedded cost is contrary to sound economic policy. We conclude that basing support on forward-looking economic cost or perhaps competitive bidding will require telecommunications to operate efficiently and will facilitate the move to competition in all telecommunications markets. 48/

In addition, the current unjustifiable disparity between the regulatory systems for areas served by so-called "non-rural" ILECs and areas served by rural ILECs creates very strong, uneconomic incentives for large ILECs to sell exchanges to small ones, even though there are economies of scale that can be achieved by the larger carriers. 49/ While sparsely populated rural *areas* undoubtedly are more

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47/ *See, e.g.*, Mark W. Frank, *The Impact of Rate-of-Return Regulation on Technological Innovation* at 124 (Ashgate Publishing Ltd, Aldershot, England and Burlington, VT 2001).

48/ *Universal Service First Report and Order*, 12 FCC Rcd at 8934-35, ¶ 292. The Commission, however, declined to move rural ILECs into a forward-looking cost-based system immediately due to concerns about the applicability of the cost models to rural ILECs. *Id.* at 8935-37, ¶¶ 293-95.

49/ *See RTF Order*, 16 FCC Rcd at 11310, ¶ 169; *see also* Western Wireless Opposition to Valor Telecommunications of Texas, L.P. Petition for Waiver of Section 54.305, CC Docket No. 96-45 (filed May 30, 2003), at 2-3. There are dozens – possibly hundreds – of cases in which small ILECs have purchased exchanges from larger ILECs and realized economic gains from increased universal service support, with the FCC's sanction. *See, e.g.*, *Nemont Telephone* costly to serve, there is nothing unique about the rural *ILECs*, and no economically principled reason to provide differing amounts of high-cost support to small ILECs, large ILECs, or competitive ETCs, if the carriers serve similar or identical geographic areas. 50/

C. Embedded Cost-Based Universal Service Support Generates Excessive Funding And Is Highly Susceptible to Fraud, Waste, and Abuse.

Embedded-cost-based support in a system of ROR regulation is arbitrary and not properly reflective of true costs First, as a theoretical matter, embedded costs are economically irrelevant to economic decision-making, and therefore the use of embedded costs in setting rates and high-cost support is inaccurate There is a consensus among economists that "it is forward-looking costs, not historical costs, that are relevant in setting prices in competitive markets." 51/ Forward-looking costs – *not* sunk costs – represent the costs that, in the real world, drive the economic decision-making of both incumbent providers and prospective

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Cooperative, Inc , et al , Joint Petition for Waiver of the Definition of "Study Area," 18 FCC Rcd 838, 842-43, ¶ 11 (Wireline Comp Bur 2003) (noting that the acquiring companies expect to receive additional interstate common line support as a result of the transfer), *Citizens Utilities Rural Co , Inc and Qwest Corp , Joint Petition for Waiver of the Definition of "Study Area," Order*, 16 FCC Rcd 13032, 13036, ¶ 10 (Com Car Bur 2001) (permitting Qwest to transfer 38 telephone exchanges to Citizens and noting that "the transferred exchanges may receive increased interstate access universal service support as a result") *See also* 47 C F R § 54 902

50/ While there *are* differences between rural areas and other geographic areas – it costs more to serve areas where the population is sparse, whether using wireline or wireless technology, regulation should be neutral on the issue of carrier identity and size, and certainly should not reward a carrier just for being small or for being an incumbent

51/ *TELRIC NPRM* at ¶ 32

new entrants regarding investment, production, and pricing 52/ Thus, a truly "cost-based" system would utilize forward-looking costs, not embedded (or backward-looking) costs

Second, even if embedded cost-based regulation were appropriate as a theoretical matter, in practice the existing ROR regulatory system is fatally flawed by generations of regulatory distortions ROR regulation is driven by FCC rules (principally Parts 32, 36, and 69) that were designed for the primary purpose of generating cross-subsidies and/or shifting revenues between the state and federal jurisdictions 53/ There is no reason to think that the revenues driven by these existing rules have any relationship to the "reality" even as generated by accounting costs

Third, and perhaps most significantly, the ROR regulatory system is likely to be highly inaccurate because it depends heavily on the ILECs' self-reporting based on their own accounting records, which have never been audited or scrutinized by independent auditors or regulators. As the Commission recently pointed out,

> Traditional rate-base/rate-of-return ratemaking has generally been based on the use of historical costs, *i.e.*, the costs the regulated firm incurred in building its network and providing service and that it

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52/ *Id* at ¶ 30 *See also Local Competition Order*, 11 FCC Rcd at 15813, ¶ 620, Walter Nicholson, *Microeconomic Theory Basic Principles and Extensions*, pages 279-82 (3rd ed , 1984) (explaining difference between economists' focus on forward-looking costs and accounting focus on sunk costs). Thomas T Nagle, *The Strategy & Tactics of Pricing: A Guide to Profitable Decision Making*, 14-28 (1987) (at page 15 "Only forward-looking costs are relevant for pricing because only they represent the true cost of doing business ")

53/ *See* Peter W Huber, Michael K Kellogg, and John Thorne, *Federal Telecommunications Law* at 551-560 (2d ed 1999)

> recorded in its books of account. As an initial matter, an historical cost approach is highly dependent on the accuracy of an incumbent LEC's accounting records, which potentially creates a significant information asymmetry that benefits the incumbent LECs. 54/

But no comprehensive audit of the regulatory accounts of the vast majority of rural ILECs has been conducted in the past decade, either by the FCC, state commissions, NECA, 55/ the Universal Service Administrative Co. ("USAC"), or independent auditors retained by the ILECs themselves. Thus, there is no reason to presume the accuracy of the regulatory books of account (kept separately from the books of account maintained and audited for tax purposes).

Indeed, there is good reason to think that the rural ILECs' costs may be significantly overstated, which would result in a bloated high-cost fund. The existing regulatory system provides ample opportunities and incentives for ROR-regulated ILECs to misreport costs in a manner that would improperly augment universal service disbursements and "pad their rates," 56/, such as by improperly allocating costs to ILEC regulated operations that more properly should have been allocated to other activities. As demonstrated in Attachment A to this Petition, certain state commissions have unearthed extensive incidents of cross-subsidization and other improper accounting practices.

54/ *TELRIC NPRM* at ¶ 32.

55/ While NECA does review ROR carriers' cost study and high-cost fund submissions, the scope and outcomes of these reviews are not made public. Moreover, NECA does not have sufficient staff to conduct stringent reviews or audits of all carriers' cost data, and given that NECA (through its Board of Directors) is run by and for the ILECs themselves, NECA is not sufficiently independent of rate of return ILEC interests to support a strong oversight function.

56/ *Price Cap FNPRM*, 3 FCC Rcd at 3219-20, ¶ 39.

- The California Public Utilities Commission found that a mid-sized company had (i) improperly misallocated corporate/managerial costs, regulatory costs, land and building costs, and other expenses to the ILEC that should have been allocated to the company's cable television, wireless, long-distance, and alarm monitoring affiliates, in violation of the FCC's Part 64 rules, (ii) expensed software development costs in a single year, contrary to Generally Accepted Accounting Principles, and (iii) improperly booked the costs of institutional and goodwill advertising in the ILEC's regulated accounts.

- The Idaho Public Utilities Commission reduced an ILEC's claim to recover the cost of payments to affiliates and certain software capital leases, since those expenditures were related to the provision of unregulated services. The Idaho commission also rejected recovery of the costs of equipment that was no longer in service and costs of fiber that had not yet been placed into service, and it disallowed recovery of corporate image advertising costs and a depreciation reserve deficiency.

- The Kansas Corporation Commission reached a settlement with two RLEC subsidiaries of one holding company that precluded them from receiving any state universal service support, based on a finding that the holding company had improperly allocated the entire cost of management stock incentives and financial advisory fees paid to the owners of the holding company to the regulated ILEC, and had allocated no corporate costs to unregulated subsidiaries.

- The Kansas commission found that another ILEC had claimed depreciation expenses on plant that had already been fully depreciated, misallocated deferred income taxes relating to non-regulated affiliates, and improperly booked consulting fees that had no relationship with regulated operations

- The Kansas commission found that a carrier had claimed more property tax expense than it had actually paid during the test year, utilized depreciation rates in excess of those permitted by the commission, and improperly included lobbying and corporate image advertising expenses.

- The Oregon commission disallowed an ILEC's claim to depreciation recovery for equipment that had already been retired, rejected recovery of executive bonuses paid for achieving corporate financial goals that benefited shareholders rather than ratepayers, and made adjustments for the company's failure to reflect the reduction in expenses realized through the sale of several exchanges.

- The Vermont commission rejected an ILEC's attempt to recover the non-recurring costs of operational support systems ("OSS"), which had already been recovered through interconnection rates, and of local number portability implementation, for which the FCC had already developed an interstate cost recovery mechanism.
- The Washington commission disallowed an ILEC's recovery of corporate image advertising costs, rejected its attempt to use depreciation rates that the commission had already rejected, and disallowed the costs of purchases from an affiliate at prices that exceeded market prices.

Other examples are discussed in Attachments A and B.

Given the very strong perverse incentives and the lack of effective auditing or oversight of their ROR accounting, undoubtedly a far greater number of incidents are never detected, resulting in excess support flowing to the ILECs. The Commission cannot ignore the ROR ILECs' interstate overearnings (*i.e.*, revenues from interstate access charges plus universal service fund disbursements that exceed the 11.25% allowed rate-of-return) of over $218 million in the 2001-2002 period, $92 million in 1999-2000 and $121 million in 1997-1998 57/

Moreover, even if and when the Commission does detect ROR carriers' over-earnings, the Commission may not be able to remedy them In a recent case, the Commission found that an ILEC had earned excessive amounts by improperly allocating certain costs to the interstate jurisdiction that applicable rules required to be treated as intrastate The reviewing court upheld the Commission's

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57/ *See* AT&T Ex Parte Filing, CC Docket Nos 00-256, 96-45, 98-77, and 98-166 (filed May 9, 2003) (demonstrating that numerous rate-of-return ILECs are earning in excess of the 11 25% authorized rate of return) conclusion that the ILEC had misallocated these costs. 58/ Nonetheless, the court held that, because the Commission had not suspended the tariff rates and established an investigation at the time the relevant tariff was filed, the rates were conclusively "deemed lawful" under 47 U S.C § 204(a)(3), and therefore the Commission was without authority to order rate refunds or damages 59/ Thus, even with respect to those incidents of ROR malfeasance that the Commission detects (most likely a small minority), in most cases the Commission may lack authority to order an effective remedy. In effect, this could well mean that ROR regulation is unenforceable in the context of tariffed interstate access charges An alternative regulatory framework is urgently needed

"In an era of corporate governance problems and accounting depredations, this Commission has an especially high burden" of responsibility to establish and enforce accounting safeguards "that help prevent and detect anticompetitive behavior" by rural ILECs 60/ The most effective way to preclude such waste, fraud, and abuse would be to eliminate the ROR regulatory system, which provides the opportunity and incentives for such misconduct. However, during the time period when ROR regulation remains in effect, we propose a

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58/ *ACS of Anchorage, Inc v FCC*, 290 F 3d 403 (D C Cir 2002), *affirming in part and reversing and remanding in part General Communication, Inc v Alaska Communications Systems Holdings, Inc* , 16 FCC Rcd 2834 (2001)

59/ *Id*

60/ Separate Joint Statement of Commissioner Michael J Copps and Commissioner Jonathan S Adelstein, Concurring, *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No 02-112, Further Notice of Proposed Rulemaking, FCC 03-111 (released May 19, 2003) number of interim steps that the Commission should take to oversee the ROR regulatory process more stringently, enhance the transparency of the process, and limit the potential for abuse. Specifically, the FCC should make the following changes immediately

- Carriers' cost studies, work papers, and other data submissions supporting their high-cost funding should be made publicly available, given that high-cost support is a form of public funding.

- As with the 1999 audits of the Bell companies' Continuing Property Records, 61/ the results of any reviews of cost studies or other data submissions involving high-cost funding conducted by the NECA or USAC over the past three years should be made publicly available

- Truly independent auditors (*i.e.*, public accounting firms) should be retained under the supervision of the Commission and/or USAC to conduct audits of the data underlying the high-cost submissions of ROR ILECs no less frequently than every three years, and more frequently if there is a significant increase in a company's year over year funding requests. Companies should be required to provide full access to their books and records, and the results of the audits would be made publicly available

- Among other matters, audits should focus on whether the subject ILEC is properly classifying its loops and other facilities in reporting loop counts and network investments, whether the carrier has proper cost accounting manuals, with adequate internal controls in place; whether the carrier complies with affiliate transactions rules; and whether costs are booked to the correct Part 32 accounts, and other factors such as interest expense on debt and interest during construction, and cash working capital are recorded and accounted for correctly 62/

61/ *Ameritech Corporation Tel Op Cos Continuing Property Records Audit*, 14 FCC Rcd 4273 (1999), *BellSouth Tel Continuing Property Records Audit*, 14 FCC Rcd 4258 (1999), *Bell Atlantic (South) Tel Cos Continuing Property Records Audit*, 14 FCC Rcd 5541 (1999), *Bell Atlantic (North) Tel Cos Continuing Property Records Audit*, Order, ASD File No 99-22 (Mar 12, 1999) *Pacific Bell and Nevada Bell Tel Cos Continuing Property Records Audit* 14 FCC Rcd 5839 (1999), *U S West Tel Op Cos Continuing Property Record Audits*, Order, ASD File No 99-22 (Mar 12, 1999), *Southwestern Bell Tel Co Continuing Property Records Audit*, 14 FCC Rcd 1242 (1999) (collectively, "*RBOC Audit Orders*") (subsequent history omitted)

62/ *See* Attachment B, at 10-11

- The Commission should immediately suspend and investigate *__all__* tariff filings of ROR carriers in order to avoid the statutory "conclusive presumption" that the rates are "deemed lawful," and thereby preserve the Commission's ability to order refunds or damages in the event that over-earnings are later detected

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In sum, the current system of embedded cost-based support for rural ILECs and ROR regulation artificially inhibits the development of competition, encourages inefficiencies, and creates opportunities for ILECs to improperly expand the size of their funds through fraud, waste, and abuse. Rather than making regulatory changes that would impose further artificial constraints on competition, such as eliminating portability, it is time to eliminate embedded cost-based support and ROR regulation

IV. THE COMMISSION SHOULD ESTABLISH A COMPETITIVELY NEUTRAL, PORTABLE HIGH-COST FUNDING SYSTEM BASED ON FORWARD-LOOKING COSTS

The Commission should open a proceeding to develop a more appropriate high-cost funding system based on forward-looking costs to determine identical support amounts for all ETCs serving a particular geographic area. As the Commission recently explained

> A forward-looking costing methodology considers what it would cost today to build and operate an efficient network (or to expand an existing network) that can provide the same services as the incumbent's existing network. The benefit of a forward-looking approach is that it gives potential competitors efficient price signals in deciding whether to invest in their own facilities or to lease the incumbent's facilities That is, if construction of new facilities by a competitive LEC would cost less than leasing facilities at prices based