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Sent: Tuesday, February 17, 2004 6:34 PM

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Subject: Economic Analysis Confirms Pervasive Problems with Rate-of-Return Regulation

I'm enclosing Western Wireless' reply comments regarding its petition for rulemaking on the elimination of Rate of Return (ROR) regulation of the rural ILECs. I'm also including an attachment to Western Wireless' reply comments -- a detailed economic analysis prepared by Economics & Technology, Inc., entitled "*Lost in Translation: How Rate of Return Regulation Transformed the Universal Service Fund for Consumers into Corporate Welfare for the RLECs*."

The economic analysis examines cost data from NECA's 2003 USF submission, encompassing 90% of the loops served by rural ILECs, as well as more detailed operating data for a sample of 140 rural ILECs in Ohio, Texas, and Wisconsin. The report confirms that ROR regulation gives rural ILECs powerful incentives and opportunities to operate inefficiently. For example:

- About **$545 million** of the Corporate Operations Expense (overheads) reported by the RLECs in 2002 -- **33% of the total** amount reported -- appear to reflect inefficiencies, such as the cost of excessive numbers of management and executive personnel. (This $545 million amount, developed through a comparison with a benchmark based on the top-performing 25% of comparably-sized carriers, far exceeds the annual amount of federal high-cost funding to competitive ETCs.) The FCC's rules allowed 77% of these inefficiently incurred overhead expenses to enter into the support calculations for the High Cost Loop Fund.
- Excessive levels of overhead costs also indicate inefficiencies in other areas of an ILEC's operations. For example, the attached analysis shows that the Texas rural ILECs with the highest Corporate Operations Expenses also report substantially higher Total Plant In Service per access line than other ILECs. These same carriers are among the largest recipients of federal universal service money in the state.
- The report analyzes financial data regarding transactions in the small ILEC sector, and confirms that rural ILECs have systematically foregone opportunities to obtain increased economies of scale - a key driver of efficiencies and cost savings in the telecommunications sector - through mergers and/or consolidation of study areas. Instead, the ROR system gives the rural ILECs strong incentives to remain small, since they receive larger amounts of support as a consequence.
- Neither the FCC nor state regulators have the resources or the capacity to monitor the earnings of most RLECs. This lack of oversight encourages and rewards operational inefficiencies among the RLECs.

With these reply comments, the record in this proceeding is complete and ready for action. Western Wireless has encouraged the FCC to refer to the Joint Board issues concerning the elimination of the ROR-based rural ILEC universal service mechanisms and replacement of those mechanisms with a new forward-looking, competitively

neutral system. This could be coordinated with, or incorporated into, the upcoming "rural/non-rural reconciliation" proceeding.

We look forward to continuing to work with you on these important issues. We'll plan to set up presentations in the near future regarding these economic findings and the Western Wireless petition for rulemaking. In the meantime, if you have any questions, please don't hesitate to ask.

Thank you.

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Proceeding: *RM-10822*	**Type Code:** *RC*	**Date Received/Adopted:** *02/13/04*	**Date Released/Denied:**
	Document Type: *REPLY COMM*		**Total Pages:** *102*
File Number/Community:		**DA/FCC Number:**	
Filed on Behalf of: Western Wireless Corp.			
Filed By: *Hogan & Hartson L.L.P.*			
Attorney/Author Name: *David L. Sieradzki*			**Document Date:**
Complete Mailing Address: *555 13th Street, NW Washington, DC 20004*			
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