

TABLE OF CONTENTS

Summary.....ii

COMMENTS OF THE WESTERN TELECOMMUNICATIONS ALLIANCE..... 1

I. The Western Telecommunications Alliance..... 3

II. Standard for Evaluating High-Cost Support Alternatives..... 4

 A. The Need for a Clear Evaluation Standard..... 4

 B. Encouraging Rural Network Investment Is the Appropriate Standard..... 5

 C. Promoting Competition Is Not the Appropriate Standard..... 9

 D. Minimizing High Cost Support Is Not the Appropriate Standard..... 9

III. An Embedded Cost Mechanism Will Encourage Investment Far More Effectively Than a Forward-Looking Economic Cost Mechanism..... 10

 A. Cost Recovery Is a Prerequisite for Rural Network Investment..... 10

 B. The High Cost Fund Has Become the Primary Rural Cost Recovery Mechanism..... 12

 C. The Existing Embedded Cost Mechanism Encourages Rural Network Investment..... 13

 D. FLEC Mechanisms Discourage Rural Network Investment..... 17

IV. “Rural Carriers” Should Not Be Redefined for Universal Service Purposes.....20

V. CETCs Should Receive High Cost Support on the Basis of Their Own Embedded Costs..... 22

VI. Conclusion.....24

SUMMARY

The Western Telecommunications Alliance urges the Joint Board and FCC to evaluate existing and proposed High Cost Fund mechanisms in this proceeding on the basis of their ability to encourage investment in rural telecommunications networks. This is fully consistent with the central and dominant pro-investment goal of the 1996 Act and its Section 254 universal service provision.

The Western Alliance submits that the existing embedded cost mechanism has furnished the assurances of cost recovery necessary to produce reasonable and prudent investment by rural telephone companies in their rural networks during the past two decades. The proven record of success of the embedded cost mechanism as an incentive for rural network investment mandates its retention for the purpose of determining and calculating High Cost Fund support for all rural telephone companies (including larger and medium-sized ones) as well as for competitive eligible telecommunications carriers (“CETCs”).

In contrast, FLEC mechanisms have not had any significant success in stimulating investment by non-rural carriers in their rural exchanges. If they were to be applied to rural carriers that depend significantly upon high-cost support for recovery of their investment costs, FLEC mechanisms would do substantial harm by curtailing or halting rural network investment projects. Not only do FLEC mechanisms lack inherent investment incentives, but their uncertainty and bias against full recovery of actual investment outlays will discourage rural telephone companies and their lenders from

making the investments needed to upgrade and modernize rural telecommunications networks.

There is no need for the Joint Board or FCC to re-define “rural telephone company” or “rural carrier” in order to remove larger or medium-sized rural telephone companies from the embedded cost mechanism, or to limit or reduce their high-cost support. The existing embedded cost mechanism has been far more successful than the FLEC mechanism imposed upon non-rural carriers in encouraging the upgrade and modernization of rural telephone exchanges. The Joint Board and FCC should not replace a successful mechanism with a dysfunctional one, nor deprive customers of larger and medium-sized rural telephone companies of the upgrades and other investments necessary to provide them with high quality, affordable and reasonably comparable services.

Finally, CETCs should be furnished high-cost support on the basis of their own embedded costs throughout the actual networks that they serve. If they wish to receive substantial amounts of high-cost support, they should be required to implement the accounting standards and cost reporting procedures necessary to determine and verify their costs and related support.

investment. The Joint Board and FCC should evaluate all existing and proposed high-cost mechanisms first and foremost upon their ability to encourage investment in rural networks.

The Western Alliance believes that the existing embedded cost mechanism remains the most accurate, effective, efficient and equitable means to encourage reasonable and prudent investment in rural telecommunications networks. The service and modernization record of the nation's rural telephone companies demonstrates that carriers and their lenders will invest in rural networks if they have reasonable assurance that they can recover the cost of such investments. The existing embedded cost mechanism provides the requisite assurances of cost recovery, and has been very successful in encouraging rural network investment. In stark contrast, forward-looking economic cost ("FLEC") and related proxy models render cost recovery uncertain and insufficient, and thereby discourage rural network investment.

The Western Alliance does not believe that the terms "rural telephone company" and "rural carrier" need to be re-defined, nor that high-cost support for larger or medium-sized rural telephone companies needs to be reduced or eliminated. Whereas the existing embedded cost mechanism has encouraged rural carriers to make substantial investments in their rural networks, the FLEC mechanism imposed upon non-rural carriers has provided them with virtually no incentive to make similar investments in their own rural networks. There is no reason to replace a successful mechanism with a dysfunctional one in areas served by larger and medium-sized rural carriers.

Finally, the embedded cost mechanism will provide the most accurate and appropriate investment signals for competitive eligible telecommunications carriers

("CETCs") as well as incumbent local exchange carriers ("ILECs"). CETCs should receive high-cost support on the basis of the embedded costs of their investments in their own networks.

I.

The Western Telecommunications Alliance

The Western Telecommunications Alliance is a trade association that was formed by the merger of the Western Rural Telephone Association and the Rocky Mountain Telecommunications Association. It represents approximately 250 rural telephone companies operating west of the Mississippi River.

Western Alliance members are generally small ILECs serving sparsely populated rural areas. Most members serve less than 3,000 access lines overall, and less than 500 access lines per exchange. Most members also generate revenues much smaller than the national telephone industry average, and rely upon federal high-cost dollars for the recovery of approximately 25-to-50 percent of their costs.

Western Alliance members serve remote and rugged areas where loop and switching costs per customer are much higher than in urban and suburban America. Their primary service areas are comprised of sparsely populated farming and ranching regions, isolated mountain and desert communities, and Native American reservations. In many of these areas, the Western Alliance member not only is the carrier of last resort, but also is the sole telecommunications provider ever to show a sustained commitment to invest in and serve the area.

Western Alliance members are highly diverse. They did not develop along a common Bell System model, but rather employ a variety of network designs, equipment

types and organizational structures. They must construct, operate and maintain their networks under conditions of climate and terrain ranging from the deserts of Arizona to the rain forests of Hawaii to the frozen tundra of Alaska, and from the valleys of Oregon to the plains of Kansas to the mountains of Wyoming.

Predictable and sufficient cost recovery is essential to Western Alliance members if they are to continue investing in and operating telecommunications facilities in high-cost rural areas, while providing quality services to their rural customers at affordable rates. Therefore, the Western Alliance has found it necessary to participate in this and other proceedings that affect the High Cost Fund.

II.

Standard for Evaluating High-Cost Support Alternatives

The Request for Comment asks questions about a number of mechanisms and methods for determining the basis of high-cost support for rural carriers, and for calculating high-cost support for particular rural carriers. However, it does not address the evaluation standard that should be used to analyze and compare the various options and alternatives. The Western Alliance believes that a basic evaluation standard -- the encouragement of investment in rural telecommunications networks -- needs to be established at an early stage if this "paper proceeding" is to be effective and efficient in selecting the most appropriate high-cost support mechanism.

A. The Need for a Clear Evaluation Standard

From 1998 to 2000, the Rural Task Force ("RTF") was afforded the time and flexibility to consider, discuss and debate a broad range and variety of High Cost Fund goals, mechanisms and issues. During more than two years of meetings, conference

calls, presentations and white papers, alternatives were evaluated thoroughly from a variety of perspectives, and an embedded cost mechanism having broad support throughout different industry sectors was ultimately recommended and adopted.

The presently contemplated “paper proceeding” will not have the advantage of interactive discussions and debates among representatives of varied industry interests and viewpoints. However, if the Joint Board and FCC have determined not to appoint a second Rural Task Force, they should, at minimum, determine and specify as soon as possible the standard they will use to evaluate various high-cost support mechanisms and alternatives. Only if a clear standard is established at an early stage of this proceeding can interested parties efficiently and effectively consider the numerous issues and evaluate various options and alternatives.

B. Encouraging Rural Network Investment Is the Appropriate Standard

The Western Alliance submits that High Cost Fund issues and mechanisms should be considered in light of the core objective of the High Cost Fund -- the encouragement of investment in essential telecommunications networks in rural and other high-cost areas.

The primary goal of the entire Telecommunications Act of 1996 was to encourage private sector investment in telecommunications networks, particularly state-of-the-art networks capable of delivering advanced telecommunications and information services in addition to traditional telecommunications services. The Conference Report for the 1996 Act (H. Rept. 104-458) explicitly declared that the pro-competitive, deregulatory national policy framework of the Act was "designed to accelerate rapidly private sector

deployment of advanced telecommunications and information technologies and services to all Americans." 142 Cong. Rec. H1078 (January 31, 1996).

During the mid-1990s, the Clinton Administration and the Congress wanted the public switched telecommunications network to be upgraded to accommodate the new voice, data and video services made possible by advancing technology. However, budget deficits and political constraints prevented the use of public tax dollars for telecommunications network investment. The statutory solution was to encourage investment in telecommunications networks by reducing regulation and by promoting competition among entities in the converging local telephone, long distance telephone, cable television and computer industries.

However, recognizing that airline deregulation had previously resulted in service losses for many rural communities, Congress added the universal service provisions of Section 254 as a "safety net" for rural and other high-cost areas where competition might not develop or where it might not produce the desired network investment. As Senator Byron Dorgan of North Dakota stated during the Senate discussion of the 1996 Act:

I come from a rural State. I know there are a lot of people in this Chamber who worship at the altar of competition and the free market. That is wonderful. But, I have seen deregulation. . . . Example: Airline deregulation. There was a move in this country and in these Chambers for airline deregulation, saying this will be the nirvana. If we get airline deregulation, Americans are going to be better served with more choices, more flights, lower prices, better service.

Well, that is fine. That has happened for some Americans but not for all Americans. Deregulation in the airline industry has had an enormously important impact if you live in Chicago or Los Angeles. ...

But I bet if you go to the rural regions of Nebraska, and I know if you go to the rural regions of North Dakota and ask consumers, what has airline deregulation done to their lives, they will not give you a similar story. . . . In fact, airline deregulation has largely, in my judgment, hurt consumers in rural America. We have fewer choices at higher prices as a result of deregulation.

* * *

First, a one-size-fits-all approach to competition in the local exchange may have destructive implications. In large, high-volume urban markets, competition will certainly be positive. However, in smaller, rural markets, competition may result in high prices and other problems. The fact is that in some markets (namely, high-cost rural areas) competition may not serve the public interest. If left to market forces alone, many small rural markets would be left without service.

That is why the protection of universal service is the most important provision in this legislation. S. 652 contains provisions that make it clear that universal service must be maintained and that citizens in rural areas deserve the same benefits and access to high quality telecommunications services as everyone else. 141 Cong. Rec. S. 7947-51 (June 8, 1995).

Senator Dorgan's concerns were echoed by legislators from both parties, including Senator Larry Pressler of South Dakota,² Senator Thomas Daschle of South Dakota³ and Senator Ernest Hollings of South Carolina.⁴

The High Cost Fund was developed as the cost recovery mechanism necessary to encourage investment in telecommunications networks in rural and other high-cost areas. Rural America needs high quality and affordable telecommunications networks in order to participate in the economic, political, social and public safety affairs of the nation. However, the sparse populations, long distances, harsh weather, rugged terrain, and/or minimal scale economies of many rural areas do not make them the most attractive places to construct, upgrade and operate telecommunications networks. Rather, given the minimal profit potential and high costs of rural areas, it is neither prudent nor financially feasible for the owners and lenders of many rural carriers to invest in capital-intensive

² "[T]his bill is also responsibly deregulatory. When it comes to maintaining universal access to telecommunications services, for instance, it does that. It establishes a process that will make sure that rural and small-town America doesn't get left in the lurch." 141 Cong. Rec. S7887-88 (June 8, 1995).

³ "While legislation focuses on competition and deregulation, the bill before us also contains essential rural safeguards. It would create a Federal-State Joint Board to oversee the continuing issue of rural service and to monitor and help evolve a definition of Universal Service that makes sense for the present day and for the kinds of services that will be coming on-line. 141 Cong. Rec. S8478 (June 15, 1995).

⁴ "Special provisions in the legislation address universal service in rural areas to guarantee that harm to universal service is avoided there." 142 Cong. Rec. S687 (Feb. 1, 1996).

telecommunications networks unless they have assurance that they can recover their investment costs.

The encouragement of sufficient and timely investment in telecommunications networks is the key to the availability of “quality services” at “just, reasonable and affordable rates” in rural and other high-cost areas. See 47 U.S.C. Sec. 254(b)(1). Adequate investment is also essential to access by consumers in rural, insular and other high-cost areas to telecommunications and information services reasonably comparable to those provided in urban areas at rates reasonably comparable to those charged in urban areas. See 47 U.S.C. Sec. 254(b)(3).

Moreover, investment in rural telecommunications networks produces economic and social benefits in rural communities that go far beyond the provision of telecommunications services. Rural telephone companies create attractive jobs that employ residents of their rural communities, and that enable them to support other businesses and organizations in their communities. Rural network investment further enhances the economic development of rural communities by providing high quality and affordable telecommunications services that help local Chambers of Commerce attract new businesses to their communities and retain existing businesses. Telecommunications network investment acts as a multiplier that produces ripple after ripple of new jobs and increased economic activity that allows rural communities to retain their young families, their children, their schools and their lifestyles, as well as to attract new residents and businesses. Although these telecommunications network investment impacts may not always be readily apparent to the FCC, they are extremely important to the economic viability and political and social life of the affected rural communities.

C. Promoting Competition Is Not the Appropriate Standard

The purpose of the High Cost Fund is not to promote competition. Rather, as noted above, competition was a primary “means” employed by the 1996 Act to achieve its goal of encouraging investment in telecommunications networks. In rural and other high-cost areas where competition does not develop or where competition discourages investment by splintering customer and revenue bases that are too small to permit multiple carriers to recover the costs of constructing capital-intensive networks, the High Cost Fund assumes the task of encouraging reasonable and prudent network investment.

The Joint Board and the Commission may consider and determine, in this proceeding or in a later docket, whether the High Cost Fund should: (a) encourage investment in only one essential network in each high-cost service area; (b) provide cost recovery for any and all networks constructed to serve a particular high-cost service area; or (c) limit the provision of cost recovery to a reasonable number of networks that serve a particular high-cost service area. However, whether it supports a single network or multiple networks, the dominant purpose of the High Cost Fund remains to encourage investment in such network(s).

D. Minimizing High Cost Fund Support Is Not the Appropriate Standard

Finally, whereas the recent growth in the size of the Universal Service Fund (which includes the Schools and Libraries Fund, the Rural Health Care Fund, the Access Universal Service Fund and other mechanisms in addition to the High Cost Fund) is cause for legitimate concern, the purpose of any new or modified High Cost Fund mechanism must be to encourage network investment and not to minimize universal

service outlays. The making of sufficient and timely network investments is the most cost-effective solution to universal service issues in the long run, for it avoids service, quality and economic losses from degenerating network facilities, and renders unnecessary expensive catch-up programs to make up for years of neglected maintenance and modernization. Whereas there are several options available for controlling the growth of the High Cost Fund⁵, the primary focus of this proceeding must be the encouragement of investment in telecommunications networks that will serve high-cost areas.

III

An Embedded Cost Mechanism Will Encourage Investment Far More Effectively Than A Forward-Looking Economic Cost Mechanism

The existing embedded cost mechanism of the High Cost Fund is far superior to FLEC mechanisms and models in providing the assurance of cost recovery necessary to encourage investment in rural networks. Both FCC and state commission staff assisting the Joint Board should be well aware that rural telephone companies receiving high-cost support from the existing embedded cost mechanism have an excellent record of investing in the upgrade and modernization of their rural networks, whereas non-rural carriers receiving high-cost support under the current FLEC model have a far less satisfactory record of investment in their rural exchanges.

A. Cost Recovery Is a Prerequisite for Rural Network Investment

Investment decisions are generally made by balancing prospective rewards against likely risks. In urban markets where customer bases and possible profits are both

⁵ These include: (a) more stringent standards for designation of CETCs; (b) preservation of reasonable revenue streams for access cost recovery and other forms of intercarrier compensation, and termination of

large, entities often are willing to invest in projects with large potential pay-offs even if there is substantial risk that they will not recover their costs. However, in sparsely populated rural markets where customer bases and profit potentials are much smaller, prospective investors normally are willing to incur much less risk and generally require much greater assurance that they will be able to recover their investment costs.

This basic risk-reward difference between urban and rural investment is exacerbated in the case of capital-intensive telecommunications networks. All telecommunications networks require expensive switches, distribution facilities, connections to other providers, and administrative systems. However, these investment costs pose a relatively much higher hurdle for rural carriers because of their smaller customer bases and lack of economies of scale. In fact, rural distribution facilities (e.g., customer loops and cellular towers) and rural inter-office facilities (e.g., trunks and microwave paths) are generally much more expensive in both relative and absolute terms because of the great expanses of territory they must cover, as well as the rugged terrain and harsh climates in which they must be constructed, operated and maintained. As the FCC noted in its MAG Order, a loop in a mountainous and sparsely populated Wyoming wire center may cost an estimated \$866.27 compared to an estimated \$9.97 cost for a loop in a New York City wire center.⁶

the practice of transferring these revenue streams into the High Cost Fund; and (c) discontinuing the provision of high cost support to CETCs in excess of their own actual costs.

⁶ The FCC noted that overhead cost adjustments could greatly increase this already massive cost difference. Second Report and Order and Further Notice of Proposed Rulemaking in CC Docket No. 00-256, Fifteenth Report and Order in CC Docket No. 96-45, and Report and Order in CC Docket Nos. 98-77 and 98-166 (Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers), FCC 01-304, released November 8, 2001, at para.45 and n.140.

B. The High Cost Fund Has Become the Primary Rural Investment Cost Recovery Mechanism

The limited profit potential of sparsely populated rural markets offers little or no incentive for private entities to make the substantial investments necessary to construct, maintain and upgrade rural telecommunications networks unless they have reasonable assurance that they can recover their investment costs. Prior to the establishment of the Universal Service Fund in 1985, the Rural Electrification Administration ("REA") loan program, the Bell System settlements system, state commission certification and carrier-of-last resort requirements, and rural telephone cooperatives were all employed in various ways to induce the construction of telephone networks in rural areas where normal economic processes and incentives had not produced sufficient network investment.

From the break-up of the Bell System to the implementation of the 1996 Act, access charges and the initial Universal Service Fund provided sufficient assurances of cost recovery to encourage most rural telephone companies to invest in and upgrade their telecommunications networks. Since 1997, the FCC's shift of approximately \$2.0 billion per year of cost recovery⁷ from interstate access revenues into the High Cost Fund has made federal High Cost Fund support the predominant cost recovery mechanism for most rural telephone companies. Federal high-cost support currently constitutes at least 25-to-50 percent of the revenue streams of most Western Alliance members, and will grow even larger if pending "bill and keep" proposals eliminate or further reduce interstate and/or intrastate access revenues. Hence, the amount and future stability of federal High

⁷ The FCC has transferred approximately \$500.86 million in annual Long Term Support ("LTS"), \$426.72 million in annual Local Switching Support ("LSS"), \$650.00 million in annual Access Universal Service Fund support ("AUSF") and \$372.34 million in annual Interstate Common Line Support ("ICLS") from interstate access charge mechanisms into the High Cost Fund. In addition, a substantial reason for the growth in Lifeline and Link-Up support from \$155.70 million in 1995 to \$740.00 million in 2003 has been

Cost Fund support constitute the most critical factors in the assessment of investment projects and associated cost recovery prospects by rural telephone companies and their lenders.

C. The Existing Embedded Cost Mechanism Encourages Rural Network Investment

The existing High Cost Fund mechanism based upon embedded (i.e., historical) costs has worked well to encourage investment to maintain, upgrade and modernize rural telecommunications networks.

The more than 1,000 existing rural telephone companies are very different from each other. They have different histories and developmental processes, different owners and management philosophies, different state regulatory requirements, different equipment and network designs, different climates and topographies, and different customer densities and cost structures. No presently conceivable “one size fits all” model can accurately and equitably determine what the investment and costs for each of these different rural telephone companies “should” be. Rather, each carrier’s actual embedded costs provide the most accurate and equitable measure of its costs, and can readily be reviewed and adjusted by the traditional “reasonable and prudent” test to limit or disallow unnecessary or inefficient investments.

Rural carriers and their lenders (including government lenders such as the Rural Utilities Service (“RUS”) as well as private lenders) know that cost recovery under the existing embedded cost mechanism of the High Cost Fund will be based upon the actual dollars invested by the carrier in its network and other relevant actual expense outlays. The rural carrier does not have to worry that technology changes or equipment price

the need to offset increases in the federal Subscriber Line Charge (“SLC”) adopted by the FCC as a part of

decreases after it makes its investment will preclude it from recovering the entire cost of its investment, or delay future upgrades by extending its current investment cost recovery period by several years. Lenders do not have to worry about (or increase their interest rates to adjust for): (a) uncertainties due to the potential recalculation of “costs” as something less than actual dollar investments and expense outlays in order to account for future changes in technology and equipment prices; or (b) uncertainties due to the workings of complex models that determine a carrier’s theoretical “costs” without regard to many or all its particular circumstances.

The simplicity, stability, certainty, accuracy and sufficiency of the existing embedded cost mechanism have encouraged reasonable and prudent investment in rural telecommunications networks. Joint Board members and staff should recognize and note that the vast majority of Western Alliance members and other rural telephone companies have made the investments necessary to provide quality services comparable to those available in urban areas at affordable rates that are comparable to urban rates. Rural telephone companies have been in the forefront of upgrading their networks to install digital switches and softswitches, to implement Signaling System 7, to bury lines to limit weather damage and outages, to provide local or centralized equal access, to offer custom calling options, to comply with Emergency 911 (“E-911”) and Communications Assistance for Law Enforcement (“CALEA”) responsibilities, and to enable access to the Internet and information services. In sum, the present embedded cost mechanism has worked extremely well to encourage the rural network investments necessary to provide quality, affordable and reasonably comparable services to the rural residents and businesses served by rural telephone companies.

its "access reform" orders.

Contrary to urban legend, these network investments and upgrades have been achieved without significant inefficiency and gold-plating. Rural telephone companies have very minimal access and leverage in the capital markets, and must detail and justify their investment and business plans to the RUS, CoBank, the Rural Telephone Finance Cooperative, equipment vendors and/or local banks before they can obtain the financing necessary for substantial investments in their rural networks. The loan application and review process has ensured that most rural network investment projects are lean and efficient, or become so before they are approved and funded. Moreover, if the FCC, state commissions and/or the National Exchange Carrier Association (“NECA”) were to suspect that certain rural carriers were not making efficient investments, they would have the right to conduct audits and to disallow those costs and expenses, if any, that were not reasonably and prudently incurred.

In sum, the record of rural telephone companies in modernizing and upgrading their networks since 1985 demonstrates the ability and success of the existing embedded cost mechanism to encourage investment in rural telecommunications networks. By allowing carriers in high-cost rural areas with limited profit potential to recover their actual investment outlays, the embedded cost mechanism reduces investment risks to levels where reasonable and prudent network investments can be justified to owners, directors and lenders. In addition, embedded costs are relatively easy to measure and verify, and remain stable and predictable over the useful lives of the new or upgraded network facilities. They are readily understood and used by carriers and their lenders, and can be readily reviewed and audited by federal and state regulators.

During recent years, there has been some slowing and postponement of investment by rural telephone companies. In addition to the influence of the business cycle and world events, this slowdown has been caused by uncertainty over the outcome of the pending or promised FCC rulemakings affecting the future of High Cost Fund mechanisms, “portability” and contributions, as well as by uncertainty over the future of the access revenue stream. Moreover, the cap on high cost support is cutting increasingly into the support otherwise receivable by rural telephone companies, and is preventing them from recovering the entire cost of their investments during their originally projected useful lives.

Continued investment in rural telecommunications networks will remain necessary during the foreseeable future. Even if (as some predict) Voice over Internet Protocol (“VoIP”) calling may replace a substantial portion of traditional circuit-switched voice traffic during the next decade or so, rural telecommunications networks will remain necessary to carry the VoIP calls of most rural residents and businesses over at least a portion of their routes. Vonage, Pulver.com and other early VoIP providers have not been investing in rural networks, and there is no indication that they plan to do so during the foreseeable future. Rather, rural telephone company networks will continue for a long time to originate, terminate and/or transport VoIP calls as well as other voice and data traffic.

The Joint Board and FCC can reinvigorate rural network investment by eliminating as much as possible of the current regulatory uncertainty by making a clear and long-term commitment to a specific, predictable and sufficient High Cost Fund. For

rural telephone companies, this means a long-term commitment to the existing embedded cost mechanism, and the rejection of FLEC mechanisms and models.

D. FLEC Mechanisms Discourage Rural Network Investment

FLEC methodologies may or may not be useful in some other contexts, but they are certain to discourage investment by rural telephone companies and other small carriers if they are used to determine the availability or amount of high-cost support in rural telephone company service areas.

Under a FLEC mechanism, each carrier's high-cost support would be calculated without any reference to its actual investment. FLEC mechanisms offer no inherent incentive to investment in rural networks, because support will not change regardless of how much or how little a carrier actually invests in rural network upgrades and modernization.

In fact, FLEC mechanisms are most likely to produce significant disincentives for rural network investment. Because FLEC mechanisms focus upon the costs that a carrier will incur in the future to construct and maintain a theoretical efficient network, they appear to preclude the carrier from recovering its actual investment dollar outlays if equipment prices decrease or if technological change produces less expensive options. For example, if a rural carrier invests \$1.0 million in new network facilities with an expected useful life of 10 years and the market price of the same equipment decreases to \$800 thousand during the next two years, it does not appear that a FLEC mechanism would allow the carrier to recover its full \$1.0 million investment outlay. Likewise, if the rural carrier invests \$1.0 million in new network facilities with an expected useful life of 10 years and a technological advance three years later permits the same functions to be

performed by new equipment costing \$700 thousand, it does not appear that a FLEC mechanism would allow the carrier to recover its full \$1.0 million investment outlay. However, notwithstanding the price and/or technology changes that may take place after it made its investment, the rural carrier has spent \$1.0 million for network facilities that it cannot scrap just because something cheaper or better has come along, and must still repay the loan and recover the cash that it used to make the investment. It is not likely that a rural telephone company's lender will forgive \$200 thousand of its \$1.0 million construction loan just because a FLEC mechanism subsequently determines that technology or price changes have rendered the "forward-looking economic cost" of the facilities as \$800 thousand rather than the actual \$1.0 investment.

If a small rural carrier and its lenders do not have reasonable expectations and assurances that investment outlays will be recovered, they will not make the investments necessary to upgrade and modernize its network. In other words, if the Joint Board and FCC replace the current specific and predictable embedded cost mechanism with an uncertain FLEC mechanism that appears to place investment cost recovery at the mercy of future equipment price decreases and technical advances, they will ensure that rural carriers and their lenders will constantly be waiting for equipment prices to level off and technological changes to slow before making significant network investments. That is, most investment by rural telephone companies and other small carriers in rural telecommunications networks will slow to a crawl, or cease entirely.

A FLEC mechanism will also be much more complex and difficult to administer than the existing embedded cost mechanism. Whereas the embedded costs for each rural carrier can be determined and verified from its invoices, contracts and similar

transactional documents, the estimation of forward-looking economic costs for over 1,000 different rural carriers will require significant additional assumptions, predictions and modeling. Moreover, notwithstanding the length of the Uniform System of Accounts (including the abbreviated version applicable to smaller carriers), the fact of the matter is that performing and auditing the accounting for rural telephone companies is a routine and established process that is far less complicated and time-consuming than the task of developing and verifying a FLEC model. The FCC will not be forced to deal with truckloads of accounting and cost studies like in the days of the former Bell System. Rather, rural telephone companies are generally smaller companies with relatively simplified accounting systems that keep track of relatively limited business lines, facilities, revenue streams, expenses and staff. The depreciation calculations, overhead allocations, and other accounting determinations for such small entities are not very onerous to perform, review or audit. In contrast, the development and maintenance of a FLEC model that can accurately determine high-cost areas and/or calculate sufficient high-cost support for over 1,000 rural telephone companies with differing histories, network designs, demographics, geographies, topographies, climates and other potentially relevant factors is a daunting task that may never be accomplished in a satisfactory manner. A threshold question is whether the benefits of such a model will ever be worth the cost and effort of developing it.

The likely outcome of the FCC's adoption of a FLEC mechanism is: (a) that some carriers will be "winners" that recover more than actual investment costs; (b) that most carriers will be "losers" that are unable to recover their actual investment costs; and (c) that the specific identities of the "winners" and "losers" will change unpredictably from

time to time as the FCC adjusts the FLEC model to correct discrepancies and aberrations and/or to reflect changed economic or technological conditions. The ultimate result of the increased uncertainty of cost recovery will be substantial disincentives to and decreases in rural network investment.

The Western Alliance does not understand why the Joint Board or the FCC would want to replace an embedded cost mechanism having a proven record of encouraging rural network investment with a complex and uncertain FLEC mechanism that will deter rural carriers and their lenders from undertaking many network investment projects. It urges the Joint Board and the FCC to retain the tried and true embedded cost mechanism.

IV

“Rural Carriers” Should Not Be Redefined For Universal Service Purposes

The Western Alliance recommends that the Joint Board and FCC retain the current statutory definition of “rural telephone company” in 47 U.S.C. Sec. 153(37) to determine which carriers are “rural carriers” for High Cost Fund purposes. This will encourage rural telecommunications network investment as much as possible within the confines of the present size and scope of the High Cost Fund.

The differences in rural network investment between the non-rural carriers receiving high-cost support via the existing FLEC-based proxy model for large carriers and the rural carriers receiving high-cost support via the existing embedded cost mechanism demonstrates the superiority of the embedded cost mechanism as a provider of investment incentives. As noted above, rural carriers have been in the forefront of upgrading their networks to install digital switches and softswitches, to implement SS7 signaling, to bury lines to limit storm damage and outages, to provide local or centralized

equal access, to offer custom calling options, to comply with E-911 and CALEA responsibilities, and to enable access to the Internet and information services. In contrast, non-rural carriers frequently have lagged behind their smaller rural carrier counterparts in the upgrade and modernization of many of their rural exchanges. Even though many are large corporations, these non-rural carriers do not have unlimited resources and must answer to their shareholders, and to the stock markets and the capital markets, for the profitability of their investment decisions. Because the FLEC mechanism imposed upon non-rural carriers does not provide sufficient recovery of the costs of their investments in their rural exchanges, many non-rural carriers have exercised their fiduciary duties to their stockholders and bondholders by foregoing risky and relatively unprofitable investments in their rural exchanges and by focusing instead upon more attractive investments in urban areas and abroad. In fact, many non-rural carriers have sold many of their less profitable rural exchanges because they had no incentive or justification to invest further in them.

The Western Alliance is not advocating that the Joint Board or the FCC address at this time the lack of High Cost Fund incentives for non-rural carriers to invest in their rural exchanges, for this could require a large increase in the size of the High Cost Fund. However, the Joint Board and the FCC should not subject the rural networks of larger and medium-sized rural carriers to similar investment disincentives by redefining the term “rural carrier” so as to reduce or eliminate their investment cost recovery from the High Cost Fund. Rather, the predominant, pro-investment objective of the 1996 Act requires that the High Cost Fund continue to encourage investment in as many rural networks as practicable. The rural residents and businesses served by these networks need high

quality and reasonably comparable telecommunications services at affordable and reasonably comparable rates whether their particular network is operated by a larger, medium-sized or smaller rural carrier.

V

**CETCs Should Receive High Cost Support
On The Basis Of Their Own Embedded Costs**

Competitive eligible telecommunications carriers (“CETCs”) will receive appropriate investment signals and incentives only if they receive high-cost support on the basis of their own embedded costs of investing in their own networks.

If a CETC receives “portable” high-cost support based upon the substantially higher embedded costs of an ILEC, it will have an artificial incentive to enter the market to take advantage of the high-cost support windfall. If a CETC receives “portable” high-cost support based upon the substantially lower embedded costs of an ILEC, it will have little incentive to enter the market or to invest further in its network because it may not be able to recover its own actual investment outlays. The most economically reasonable and competitively neutral approach is to provide high-cost support to each ETC on the basis of the embedded costs of its own network.

Network-based support is a crucial consideration. High-cost support should be calculated and distributed to telecommunications carriers on the same basis that telecommunications facilities are constructed and that telecommunications services are provided -- as networks. Carriers do not invest in and construct "lines" or wire centers; they invest in and build networks. Customers do not purchase service on "lines" or wire centers; they subscribe to service on a network so that they can communicate with all the other people connected to or through the network.

The Western Alliance believes that many of the problems and distortions of the current "portable" high-cost support mechanism are due to a lack of focus upon the essential network character of telecommunications investment and service. Calculation and distribution of high-cost support to both ILECs and CETCs on a "per line" basis has distorted both infrastructure investment and support outlays because both ILECs and CETCs invest in, build and operate their facilities as networks rather than as lines.

Networks can be readily defined and determined by the customers, communities and areas served by a switch or a commonly-owned hierarchy of switches. For example, a rural telephone company that serves four exchanges by means of a host switch and three remote switches is operating a network. Likewise, a wireless carrier that serves the I-70, I-76 and I-25 corridors of Colorado via a switch in Denver and fifty cell sites in Denver, Fort Collins, Colorado Springs, Pueblo and Grand Junction and along the three interstate highways is operating a network. In the latter instance, if the wireless carrier is designated as a CETC, it should receive high-cost support on the basis of its averaged embedded costs throughout its entire network, and not on the basis of its costs within a particular cell site or on the basis of the costs of a rural ILEC whose service area it overlaps along a portion of a highway. In other words, large wireless carrier networks serving states or large regions should receive high-cost support on the same basis as the regional networks of the Regional Bell Operating Companies and other comparable ILECs.

CETCs requesting high-cost support should be required to adopt and implement the same accounting and cost reporting practices as ILECs and other eligible telecommunications carriers ("ETCs"). While the Western Alliance does not favor the

gratuitous expansion of regulatory requirements, competitive neutrality requires federal high-cost support to be distributed on the same basis to all ETCs requesting it. Put another way, if a carrier expects to receive tens or hundreds of thousands of dollars of federal high-cost support to help it to recover its actual costs of investing in a rural network, it is only reasonable that it be required to maintain the accounts and records necessary to calculate and verify its subject costs and support.

VI

Conclusion

The Joint Board and FCC must evaluate existing and proposed High Cost Fund mechanisms on the basis of their ability to encourage investment in rural telecommunications networks. This is fully consistent with the central and dominant pro-investment goal of the 1996 Act and its Section 254 universal service provision.

The Western Alliance submits that the existing embedded cost mechanism has furnished the assurances of cost recovery necessary to produce reasonable and prudent investment by rural telephone companies in their rural networks during the past two decades. The proven record of success of the embedded cost mechanism as an incentive for rural network investment mandates its retention for all rural telephone companies (including larger and medium-sized ones) as well as its use for CETCs.

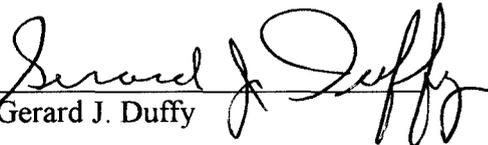
In contrast, FLEC mechanisms have proven unsuccessful in stimulating investment by non-rural carriers in their rural exchanges. If they are applied to rural carriers that depend upon high-cost support for recovery of their investment costs, FLEC mechanisms will do significant harm by curtailing or halting rural network investment. Not only do FLEC mechanisms lack inherent investment incentives, but their uncertainty

and bias against full recovery of actual investment outlays will discourage rural telephone companies and their lenders from making the investments needed to upgrade and modernize rural networks.

There is no need for the Joint Board or FCC to re-define “rural telephone company” or “rural carrier” to remove larger or medium-sized rural telephone companies from the embedded cost mechanism, or to limit or reduce their high-cost support. The existing embedded cost mechanism has been much more successful than the FLEC mechanism imposed upon non-rural carriers in encouraging the upgrade and modernization of rural telephone exchanges. Customers of larger and medium-sized rural telephone companies should not be deprived of the upgrades and other investments necessary to provide them with high quality, affordable and reasonably comparable services.

Finally, CETCs should be furnished high-cost support on the basis of their own embedded costs throughout the actual networks that they serve. If they wish to receive substantial amounts of high-cost support, they should be required to implement the accounting standards and cost reporting procedures necessary to determine and verify their costs and related support.

Respectfully submitted,
**THE WESTERN TELECOMMUNICATIONS
ALLIANCE**

By 
Gerard J. Duffy

Its Attorney

Blooston, Mordkofsky, Dickens, Duffy & Prendergast
2120 L Street, NW (Suite 300)
Washington, DC 20037
Telephone: (202) 659-0830
Facsimile: (202) 828-5568
E-mail: gjd@bloostonlaw.com

Dated: October 15, 2004