BEFORE THE FEDERAL COMMUNICATIONS COMMISSION

IN THE MATTER Of	**)**	
Federal-State Joint Board	**)**	**WC DOCKET NO. 05-337**
For Universal Service	**)**	**CC DOCKET NO. 96-45**
	)	

COMMENTS OF BALHOFF & ROWE, LLC ON BEHALF OF THE INDEPENDENT TELEPHONE AND TELECOMMUNICATIONS ALLIANCE

Balhoff & Rowe, LLC, ("Balhoff & Rowe") file these comments ("Comments") with and on behalf of the Independent Telephone and Telecommunications Alliance ("ITTA") in response to the Public Notice issued by the Federal Communications Commission ("FCC") for the Federal-State Joint Board on Universal Service ("Joint Board") seeking comments on the use of reverse auctions[1] to provide high-cost fund support and to supplement the record in the proceeding on other proposals to modify the FCC's rules relating to high-cost universal service support.[2]

SUMMARY

The Joint Board and FCC Chairman Kevin J. Martin have taken a bold step in focusing the industry's attention on the challenges inherent in the universal service mechanism. While responding to the potential use of auctions as a mechanism for disbursing high-cost universal service support, these Comments focus to a great extent on the Joint Board's invitation to supplement the record, provide updated data, and revisit actionable proposals that are already in the record. Because two years have elapsed since the Joint Board has sought comments on methodologies for high-cost universal service

[1] *In the Matter of Federal State Joint Board for Universal Service,* Public Notice, CC Docket No. 96-45, FCC No. 06J-1, rel. Aug. 11, 2006 ("Public Notice" or "Auctions Public Notice").
[2] *In the Matter of Federal State Joint Board on Universal Service,* Public Notice, CC Docket No. 96-45, FCC No. 05J-1, rel. Aug. 17, 2005 ("High Cost Public Notice").

support (and longer for the basis-of-support question deferred by the Joint Board in a prior proceeding), these Comments reference a series of specific recommendations that are, in most cases, already part of the record. The Joint Board is encouraged to review and consider comments already submitted, including Balhoff and Rowe's Comments filed September 30, 2005 in response to the High Cost Public Notice seeking comment on proposals to revise the high-cost universal service methodology which are referenced in these Comments.

These Comments:

1. Update and clarify the record concerning growth in the high cost fund overall and specific elements.
2. Make clear that the primary source of high cost fund growth now and going forward, which must be addressed, concerns support for Competitive Eligible Telecommunications Carriers or CETCs (overwhelmingly wireless companies).
3. Explain that support to rural ILECS is flat or declining, that payments to these companies is not related to growth in overall support, and that indeed program modifications are required to ensure that support is sufficient going forward.
4. Suggest a framework for evaluating policy alternatives grounded in a clear statement of goals; rigorous analysis; evaluation of alternatives on the basis of adoptability, achievability, sustainability, and continuity; and including a feedback mechanism to facilitate modifications based on changed circumstances.
5. Suggest an application of this framework, including some candidate goals and problem statements.

6. Tentatively apply the framework to auction proposals, including the Joint Board's Discussion Proposal attached to the Auctions Public Notice.
7. Suggest additional considerations concerning auction implementation and auction design, and suggest that if the Joint Board elects to recommend auctions it:
    a. Further consider these and other issues raised.
    b. Consider limited trials, for example in unassigned or abandoned areas.
    c. Not defer making recommendations on other constructive proposals in this proceeding while consideration of auctions is pending.
8. Strongly urge the Joint Board to focus on promptly recommending proposals already advanced in this docket that are actionable.

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I. INTRODUCTION.

ITTA was formed in 1994 to serve as a voice in Washington, DC, for midsize local exchange companies, on both legislative and government regulatory issues. ITTA's member companies[3] are providers of a broad range of high-quality wireline and wireless voice, data, Internet and video telecommunications services to over thirteen million customers in forty-three states.

Balhoff & Rowe is a consulting firm with over forty years collective experience in telecommunications finance, policy, and regulation. The firm emphasizes financially-sound solutions to public policy problems, and is especially focused on promoting a regulatory environment conducive to high-quality communications services in rural America.

Rural America is served by a variety of types of companies, including various groups of incumbent local exchange carriers ("ILECs"), which can be divided into "Tier 1" regional Bell operating companies ("RBOCs") with highly diverse operations in terms of geographies served and services provided; intermediate-sized companies emphasizing scale in the provision of high-quality service generally focused on more rural markets; small independent companies serving more limited geographies, often family-owned; and cooperatively-owned enterprises overseen by member boards.

Commercial Mobile Radio Service ("CMRS") and cable companies providing telephony and data services to rural areas are also diverse. Policymakers, including this

[3] ITTA member companies are CenturyTel, Commonwealth Communications, Comporium Communications, Consolidated Communications, Embarq Communications, FairPoint Communications, Iowa Telecom, Madison River Communications, Matanuska Telephone Association, and TDS Telecom. Individual companies do not necessarily endorse all aspects of these Comments, and in several cases will file additional comments of their own in this proceeding.

Joint Board, work with these companies, with their customer-base and with other state and federal public servants to create systems that send appropriate signals about investment and deployment to each type of communications services provider. All of these stakeholders are critical in the process of effecting service that is ubiquitous, affordable and high-quality in support of economic, public safety and social goals.

In addition to addressing auctions, which is the primary concern of the Auctions Public Notice, these Comments refresh the record concerning trends in Universal Service and High Cost support, suggest a framework for evaluating policy options, and urge in the strongest terms that the Joint Board act to recommend specific, constructive and actionable proposals that have been advanced in this docket.

The Joint Board is a unique forum for evaluating and advancing critical policy initiatives. It should not become a contributor to the delay that exacerbates extant problems. The present Joint Board has the intellectual resources, policy sophistication and other tools requisite to make unique and substantial contributions to sustainable telecommunications policy. Commenters are eager to contribute to the Joint Board's essential work.

II. THE PUBLIC NOTICE SUGGESTS CONCERN FOR CERTAIN APPROPRIATE VALUES AND CORRECTLY ASKS WHAT MECHANISMS MIGHT CONSTITUTE THE BEST WAY TO ACHIEVE THESE VALUES.

Several consequential concerns are reflected in the Auctions Public Notice, the prior August 17, 2005, High Cost Public Notice of four alternate plans, and various other significant public statements of individual Joint Board members. Balhoff & Rowe's September 30, 2005, Comments filed in response to the High Cost Public Notice suggested problems, implicit principles, and illustrative recommendations which

appeared to be reflected in the four proposals put forth by the Joint Board. Problems suggested there continue to be relevant to the present Public Notice, despite notable progress by the FCC on several fronts. Problems suggested or implied by the Auctions Public Notice include: growth in size of the high-cost fund, appropriate state roles in universal service mechanisms, the narrowing of the contribution base, proper CETC discipline, the parent-trap rule[4], proposed intercarrier compensation reforms that are placing pressure on the universal service fund, and uncertainty and potential volatility surrounding existing universal service fund mechanisms that is hurting rural infrastructure investment.

In 2002, then-Commissioner Martin authored a visionary statement, directly related to the high cost fund growth that animates this Public Notice and the underlying interest in auctions:

> I object to this Order's finding that the goals of universal service are to "provide greater mobility" and "a choice" of providers in rural areas. Rather, I believe the main goals of the universal service program are to ensure that all consumers—including those in high cost areas have access at affordable rates.
>
> During the past two years, I have continued to express my concerns with the Commission's policy of using universal service support as a means of creating "competition" in high cost areas. As I have stated previously, I am hesitant to subsidize multiple competitors to serve areas in which costs are prohibitively expensive for even one carrier. The Commission's policy may make it difficult for any one carrier to achieve the economies of scale necessary to serve all of the customers in rural areas.
>
> I am troubled by today's decision because the Commission fails to require ETCs to provide the same type and quality of services throughout the same geographic service area as a condition of receiving universal service support. In my view, competitive ETCs seeking universal service support should have the same "carrier of last resort" obligations as incumbent service providers in order to receive universal service support. Adopting the same "carrier of last resort" obligation for all ETCs is fully consistent with the Commission's existing policy of competitive and technological neutrality amongst service providers.

[4] 47 C.F.R. § 54.305.

> First, today's decision fails to require CETCs to provide equal access. Equal access provides a direct, tangible consumer benefit that allows individuals to decide which long distance plan, if any, is most appropriate for their needs. As I have stated previously, I believe an equal access requirement would allow ETCs to continue to offer bundled local and long distance service packages, while also empowering consumers with the ability to choose the best calling plan for their needs.[3]
>
> Second, the Commission redefines several rural telephone company service areas where Virginia Cellular's proposed service areas do not cover the entire service area of the incumbent rural telephone company. Given the potential for creamskimming, I do not support this redefining of the service areas of incumbent rural telephone companies. The Commission's decision to permit service area redefinition relies solely on an analysis of population densities of the wire centers that Virginia cellular can and cannot serve to determine whether the effects of creamskimming would occur, but fails to justify the decision based upon any cost data to verify whether Virginia Cellular is serving low-cost, high revenue customers in the rural telephone company's area.
>
> Finally, I am concerned that the Commission's decision on Virginia Cellular's application may prejudge the on-going work of the Federal-State Joint Board regarding the framework for high-cost universal service support. Today's decision provides a template for approving the numerous CETC applications currently pending at the Commission, and I believe may push the Joint Board to take more aggressive steps to slow the growth of the universal service fund such as primary line restrictions and caps on the amount of universal service support available for service providers in rural America.[5]

Then-Commissioner Martin's dissent in *Virginia Cellular* has been confirmed by subsequent data as a correct problem analysis. His identification of the problem in Virginia Cellular provides the benchmark in discussions about the efficiency of auctions as well as other mechanisms. Auctions and other mechanisms should be evaluated by how well they address the problems Chairman Martin previously identified and on which this Joint Board seeks comment.

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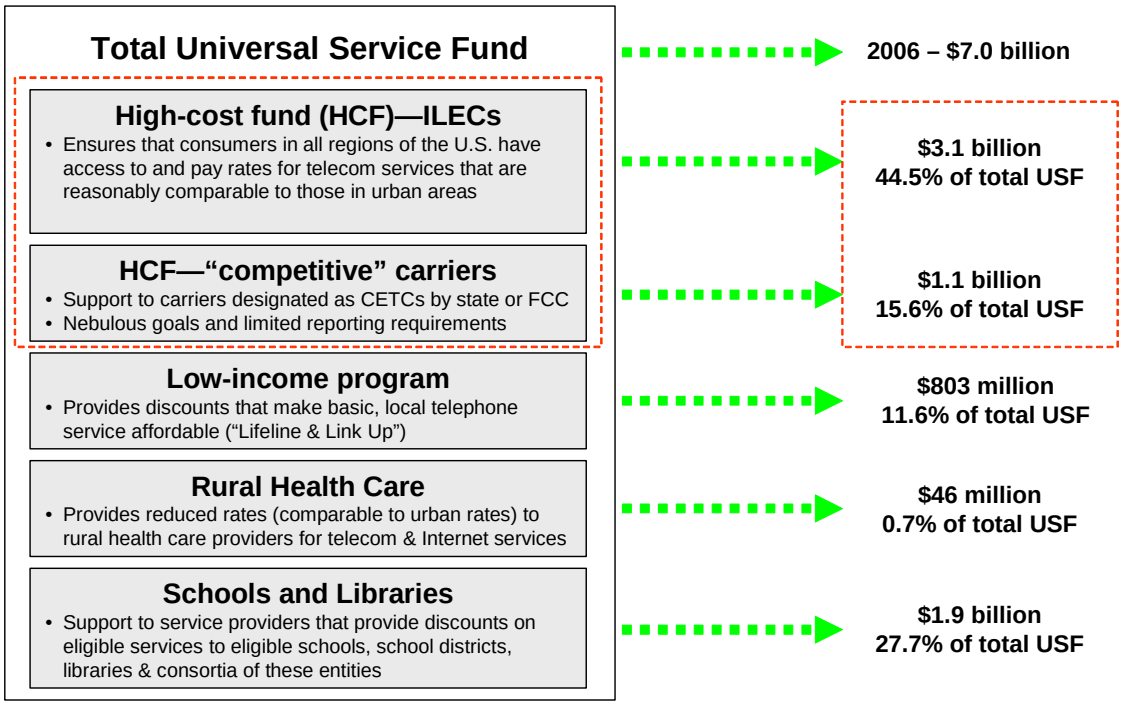
[5] *Dissenting Statement of Commissioner Kevin J. Martin, In the Matter of Federal-State Joint Board on Universal Service, Virginia Cellular, LLC Petition for Designation as an Eligible Telecommunications Carrier for the Commonwealth of Virginia, CC Docket No. 96-45, Memorandum Opinion and Order, 19 FCCR 1563 (2004).*

III. THE PUBLIC NOTICE APPROPRIATELY REQUESTED AN UPDATED RECORD FOR PREVIOUSLY IDENTIFIED ISSUES AND WHICH SOLUTIONS WOULD BE MOST PROMISING.

a. The Federal Universal Service Fund is growing.

The Federal Universal Service Fund ("USF" or the "Fund") represents a policy commitment to several purposes that include payments from users of the network, the long-standing support for high-cost networks, support for individuals who are designated as "low-income," and the programs introduced in the Telecommunications Act of 1996 ("Telecom Act") to ensure advanced services to Rural Health Care institutions and to Schools & Libraries. Figure 1 below depicts the four general elements of USF, and further subdividing the High Cost Fund into funding for ILECs and monies paid out to CETCs. The graphic provides perspective on the purposes and size of the individual funding requirements for the major programs of the Fund using 2006 disbursements.

Figure 1: USF Composition



Source: Balhoff & Rowe, LLC

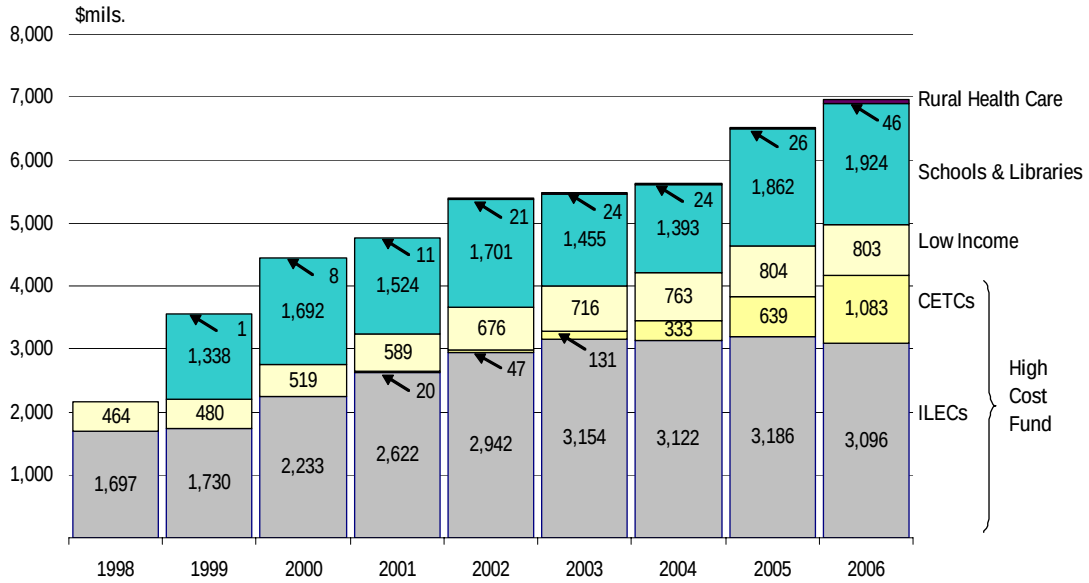
An increasingly important factor related to the USF has been "growth" in the overall size of the Fund. This "growth" has been an oft-stated concern of the Joint Board, the FCC, the U.S. Congress ("Congress"), and industry stakeholders. Unchecked USF growth frequently is considered to have a negative impact on consumers, as they must provide contributions to capitalize the fund. The Public Notice in this proceeding seeks comments on a proposal fundamentally oriented to limiting growth in the funding requirement (i.e. auctions). The Auctions Public Notice states: "By *limiting the number*

of supported networks in each area and *selecting the most cost-effective* proposal(s), auctions could *minimize the burden* on customers providing the support."[6]

It is clear that universal service disbursements overall have expanded since passage of the Telecom Act. The "growth" has occurred as result of both incremental statutory changes (e.g., creation of the Schools & Libraries program), and FCC implementation of Congressional policy directives (including incremental access charge replacement reforms). Another important policy implementation began in 2001 when payments to CETCs were first expanded, for the purpose of attempting to ensure competitively-neutral funding in high-cost regions. The increase in CETC funding, however, was not a simple "incremental" change. It has resulted in a different kind of expansion that is increasingly resulting in ongoing organic growth of the High Cost Fund. Thus, the CETC commitment precipitated what is a dramatic proportional and percentage increase in the entire High Cost Fund. Figure 2 below illustrates the growth in overall funding that has risen from slightly over $2 billion in 1998 to about $7 billion in 2006. The graphic also reveals the annual funding amounts for the various programs that compose the USF, including the CETC program.

[6] Auctions Public Notice at 2-3 (emphasis added.)

Figure 2: USF "growth"



Source: The Universal Service Administration Company; Balhoff & Rowe, LLC.

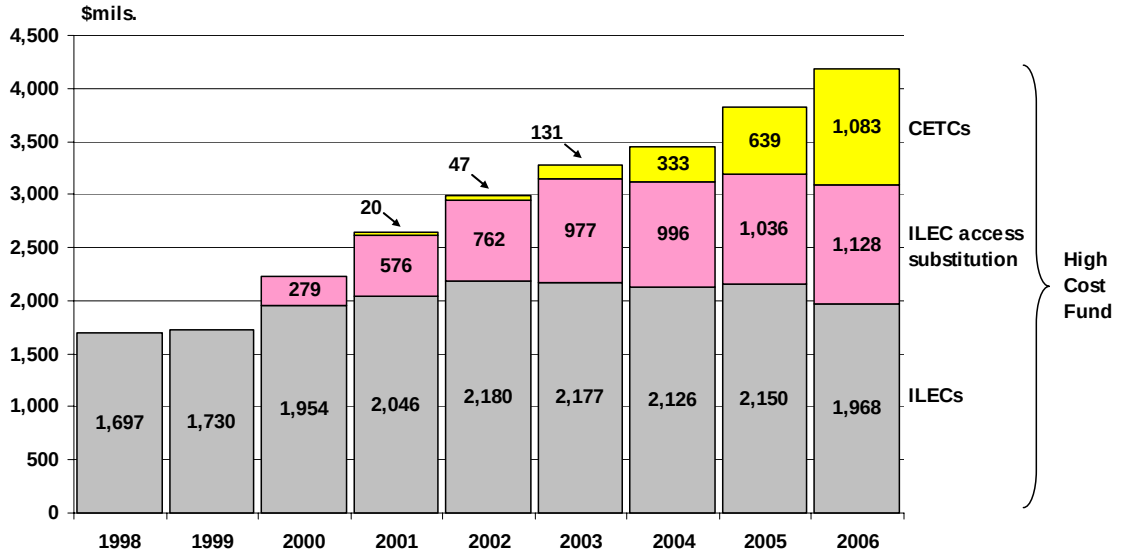
b. The Primary Causes of Expanded Funding Have Been New Universal Service Goals and the Implementation by the FCC of Policies Concerning Access Charge Replacement and CETCs.

While Congress and the FCC have committed to certain incremental programs, those initiatives generally have been controlled expansions of the Fund. That is, the Rural Health Care program has been a relatively small commitment. The Schools & Libraries program, while larger, is capped at $2.25 billion. The Low-Income program has grown, but most significantly because of the need to aid in paying higher Subscriber Line Charges ("SLCs") that resulted from long-distance access charge reforms.

Most of the recent attention has been focused on the High Cost Fund, which has expanded from about $1.7 billion in 1998 to slightly over $4 billion in 2006. Figure 3 below depicts the general funding elements of the High Cost Fund, highlighting several

points. First, the ILEC legacy funding increased from 1999 to 2002 as a result of several "true-ups," including an adjustment for the previously frozen level of funding for high-cost loop support. In reality, excluding access charge reform monies, the ILECs have not generated any real organic growth in legacy funding, and actually will receive less USF support in 2006 compared with 2005 (about $1.968 billion versus $2.150 billion). The major change for the ILECs was their receipt of access charge support that was introduced through gradual step-downs in access rates, an offset in a revenue-neutral form through increases in customer direct payments and in USF receipts. In aggregate, even including access charge replacement disbursements, ILECs have received relatively constant funding from 2002 through 2006.

Figure 3: High Cost funding, 1998 - 2006



Source: The Universal Service Administration Company; Balhoff & Rowe, LLC.

It should be noted that the graphic presents ILEC access support that includes both "non-rural" support for rural RBOC areas and "rural" support for the small and medium-sized rural local exchange carriers ("RLECs"). Access charge replacement funds reflect

reforms undertaken in the CALLS program for price-cap carriers, beginning in 2000, and the MAG (Multi-Association Group) program for rate-of-return carriers, beginning in 2002.[7]

It is important to recognize that access charge reform does not represent new monies to ILECs, but a transfer of payments from access to universal service. The reforms were intended to be revenue-neutral for ILECs, with carriers (and their customers) effectively paying reduced access fees that then resulted in offsetting increases to SLCs and USF charges on their bills. Customers theoretically paid the same amounts (as there was a correct presumption that interexchange carriers would pass through reduced costs of their services to consumers) and the carriers received the same aggregate amount of revenue but through explicit charges rather than implicit access charges. The reforms were implemented through the USF elements known as Interstate Access Support (offsetting the price-cap carrier access reductions) and Interstate Common Line Support (offsetting the rate-of-return carrier access reductions).

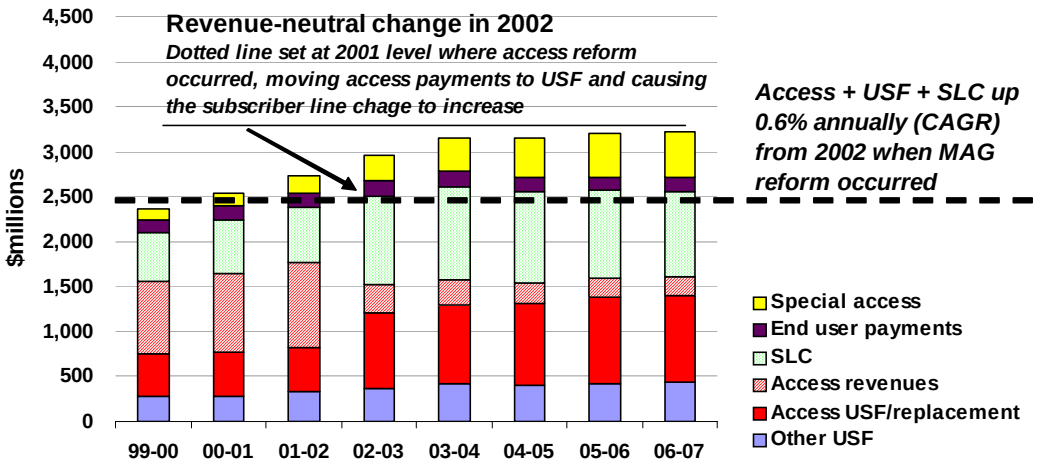
To provide insight into the transfers of access payments, Figure 4 below provides a partial, but helpful perspective. The data are drawn from the National Exchange Carrier Association's ("NECA") records of revenues generated by approximately 780 small companies that participate in the NECA revenue pools.[8] Because the data provide a more

[7] *See In re Access Charge Reform*, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCCR 12962 ("CALLS Order") and *Multi-Association Group (MAG) Plan for Regulation of Interstate Service of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, CC Docket No. 00-256, Second Report and Order, Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Fifteenth Report and Order, Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation, CC Docket No. 98-77, Report and Order, Prescribing the Authorized Rate of Return for Interstate Service of Local Exchange Carriers, CC Docket No. 98-166, Report and Order, 16 FCCR 19613 (2001) ("MAG Order").

[8] Most small local exchange carriers pool their access revenues together and receive access revenues based on their costs. NECA is the administrator of this pooling mechanism.

precise insight into specific revenue components, they provide a relatively accurate illustration of what has occurred among all rural carriers. The figure illustrates pooled company revenues from 1999 through 2007. The dotted line in the figure is set at the combined level of interstate switched access revenues, universal service receipts, and SLCs in 2002 when the MAG access reform was implemented. Using that baseline, the figure highlights that these combined small local exchange carrier revenues have been virtually flat, rising only at a compound annual growth rate of 0.6 percent since 2002. While these small LECs' retail revenues (end user payments) have been stable, customers are paying less for long-distance access which is offset by the regulatory-mandated increases of SLCs. The only significant source of increased revenues noted below is interstate special access, which is closely associated with provisioning data services.

Figure 4: Are ILECs receiving additional revenues? USF partially offsets access reductions!

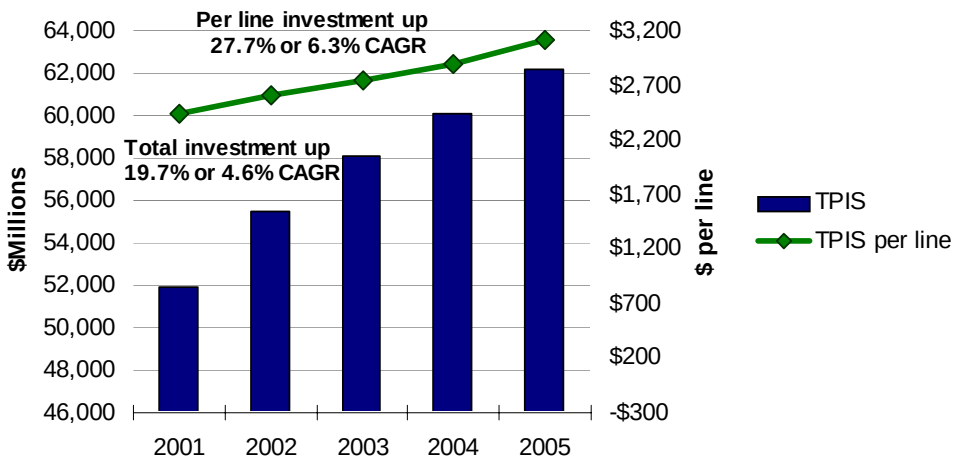


Source: NECA Pooled-Company data; Balhoff & Rowe, LLC.

Figure 5 below illustrates an important insight related to the previous graphic. Despite the essentially flat High Cost Fund support flowing to RLECs, rural providers continue to fulfill their Carrier of Last Resort responsibilities, and are continuing to make

significant investments in their networks to provision data services, as reflected in the growth in interstate special access revenues. Figure 5 reports that, from 2001 to 2005, total rural-carrier investment increased 19.7 percent, a compound annual growth rate of 4.6 percent. Over the same period, per-line investment increased 27.7 percent, a compound annual growth rate of 6.3 percent.[9] Importantly, rural customers benefited from this network investment through higher quality service, most notably in advanced high-speed services.[10]

Figure 5: RLECs increasing investment to provide more service



Source: USAC appendices HC04; Balhoff & Rowe, LLC.

While many commentators are concerned about USF growth, there have been unintended consequences that actually have resulted in diminished receipts of USF for ILECs. As loop investment has increased, the current administrative cap on the ILEC

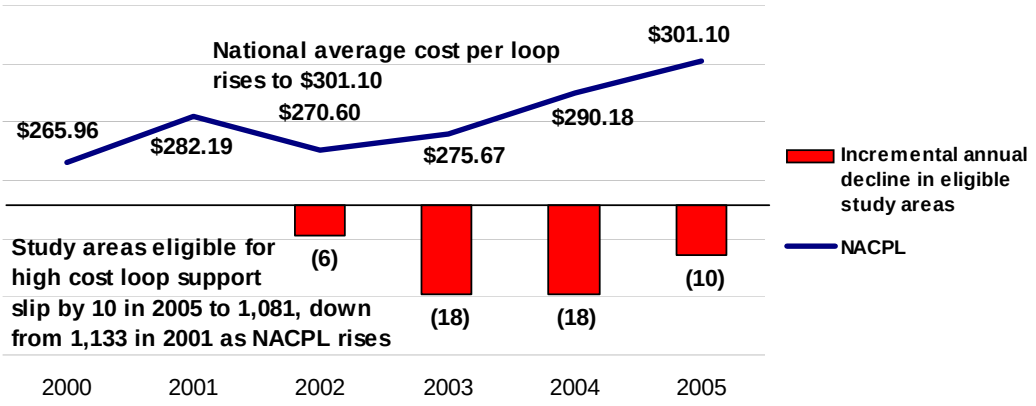
[9] Per line investment increased at a higher rate than total investment due to the loss of access lines. To some extent, access line loss is a function of investment, as DSL deployment, for example, facilitates replacement of second dedicated data lines or even voice lines.

[10] *See, e.g. NTCA 2006 Broadband/Internet Availability Survey Report(describing generally the status of broadband availability among its member companies)* (*http://www.ntca.org/content_documents/2006%20NTCA%20Broadband%20Survey%20Report.pdf*) *and Trends 2006: Making Progress in Broadband* published by the National Exchange Carrier Association (describing current technologies used by its member companies to provide broadband and other telecommunications services) (http://www.neca.org/media/trends_brochure_website.pdf)

high cost loop portion of the High Cost Fund has *reduced* the number of rural study areas eligible for support. The phenomenon is displayed below in Figure 6 which graphs the increase in the National Average Cost per Loop ("NACPL") that has resulted in cumulative reductions in study areas that receive loop support. The problem has occurred because of the formula used to cap the high cost loop portion of the High Cost Fund (known as the Rural Growth Factor) which was set to expand the cap if the number of access lines expanded. But overall, the number of access lines has contracted at relatively high rates. As a result, the Rural Growth Factor formula is causing the high cost loop portion of the Fund to shrink in size rather than remain at a fixed or rising level.

A second problem has been associated with higher broadband investment, resulting in certain carriers losing funding even when they increase their investment. The NACPL therefore is no longer at the FCC set $240 per loop nor the actual level of per line investment, but is now simply the level at which the capped monies run out for carriers that are seeking recovery of their high-cost investments. NACPL is not really an average cost at all, but is the break-point for eligibility in light of the high cost loop cap and the contraction caused by the Rural Growth Factor. This phenomenon of shrinking support as investment increases arguably is inconsistent with national policy intended to promote investment in high-quality, ubiquitous infrastructure, as well as the long-standing principle of paying for one's use of the network. For 2006, the difference between what would be the uncapped support of $1.682 billion and the capped support of $1.047 billion produces an apparent shortfall in support to rural incumbent wireline carriers of $637 million.

Figure 6: NACPL causes study areas to lose support



Source: USAC Quarterly appendices, HC01 and HC05; Balhoff & Rowe, LLC.

Before proceeding, it is critical to fully understand the true sources of problems with USF if real solutions are to be implemented and policy is to move in constructive and sustainable directions. This is what then-Commissioner Martin did in his *Virginia Cellular* dissent.[11] It would be especially tragic if the new solutions were not precise and effective in resolving the foundational problems, or if the new solutions created damaging collateral policy distortions. Based on the brief review of ILEC USF receipts and public policy changes above, it appears that much of the change was consistent with what Congress and the FCC intended, including replacing implicit support with explicit support, as far as possible, resulting in increases to the USF size as planned. If the incremental funding was correct and is relatively capped, this analysis raises the question: what is the underlying problem with "growth?" What problems need to be addressed with solutions that might include alternative approaches such as auctions? As will be shown, the problem is CETC-based growth.

[11] *See infra*.

c. Growth in support to CETCs is the critical driver of overall growth of the Fund and must be addressed directly.

There are various USF "problems" including competitively-asymmetric contributions to the Fund, the Rural Growth Factor formula related to the High Cost Fund allowing for unintended contraction of disbursements, and possible certain shortcomings related to the non-rural mechanism. However, ongoing, organic "growth" of the High Cost Fund remains arguably the most pressing problem. And this specific problem appears to be related to the new CETC "discipline" that allows CETCs to receive the same revenue per line as the ILEC, with the ILEC receipts based on its actual network investment and the use of its network by other carriers.

In contrast to flat and declining ILEC support, CETC support as a percentage of overall USF growth is increasing sharply, and that growth is a major cause of concern. While large year-over-year percentage increases might be expected in the first years of a program, CETC growth will again drive USF growth in 2006, accounting for 102 percent of USF growth for 2006 over 2005 (offset by other USF programs that are contracting).

Consistent with this analysis, the Congressional Budget Office concluded:

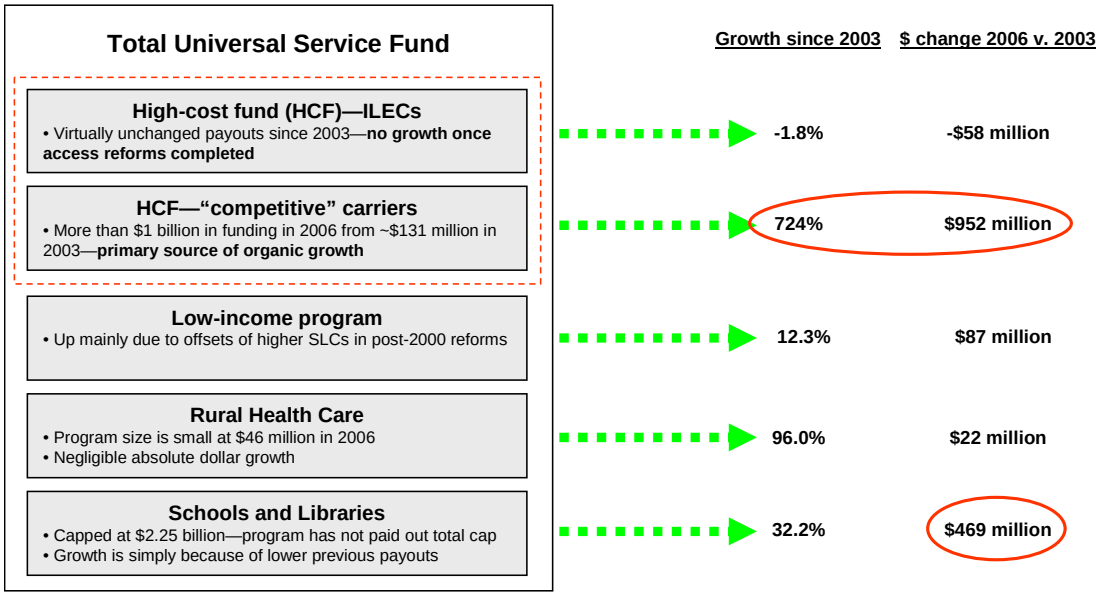
> Virtually all of the growth in spending for the Universal Service Fund's High-Cost program in the past three years reflects payments to an increasing number of competitive eligible telecommunications carriers. Most of those new entrants to rural markets use wireless technology . . .[12]

Figure 7 below illustrates the USF programs and the change in funding from 2003 through 2006. As described above, ILEC high-cost funding has contracted, while the Low-Income and Rural Health Care programs have risen slightly. As affirmed by the Congressional Budget Office, *the real growth in the Fund is the uncapped program in*

[12] Congressional Budget Office, *Factors That May Increase Future Spending From the Universal Service Fund*, page 11 (June 20, 2006).

support of CETCs. CETC payouts have risen by approximately $952 million since 2003 and are poised to rise higher in the years to come. If growth is to be addressed effectively, it will be through careful consideration of the fundamental problem and an assessment of potential solutions related to CETCs. In fact, it appears that the most recent CETC increases are simply part of an ongoing expansion that risks further harm to important and successful policy commitments including Schools & Libraries (although oversight of this program has been criticized by some), Rural Health Care, Low-Income, and network investment in rural regions.

Figure 7: Which USF programs are driving the fund growth?



Source: Balhoff & Rowe, LLC

It is estimated that 97% of CETCs are CMRS providers. CETC funding is based on the "identical support" rule, under which CETCs receive per line support identical in amount to that paid to the ILEC in the area for which the CETC is certified.[13] In most cases,

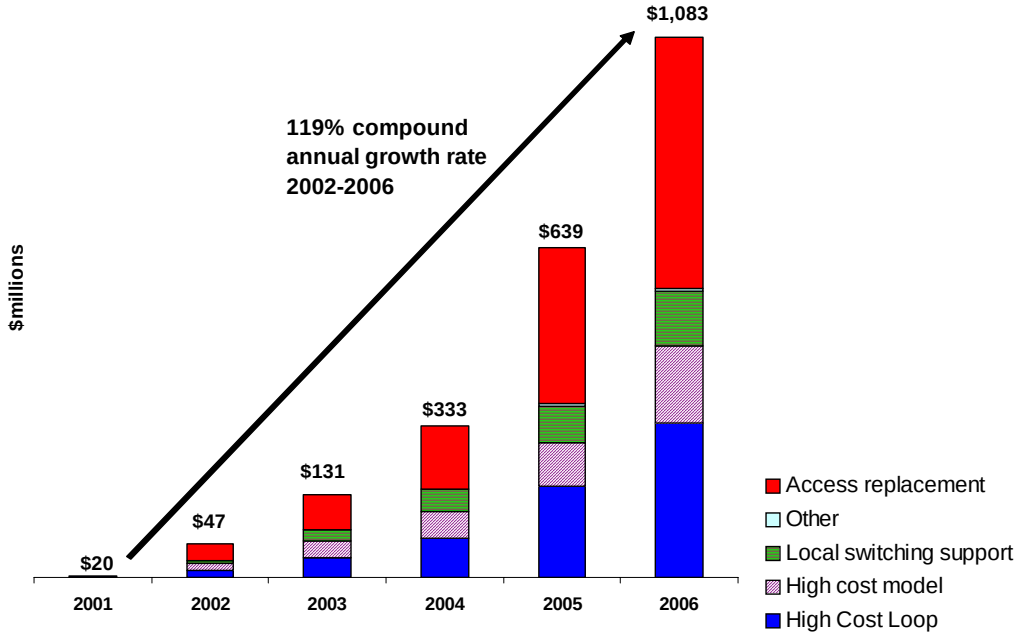
[13] *See* 47 C.F.R. 54.307

states certify CETCs.[14] Figure 8 below illustrates that CETC support grew $27 million from 2001 to 2002, $84 million from 2002 to 2003, $202 million from 2003 to 2004, $306 million from 2004 to 2005, and $444 million from 2005 to 2006. Obviously, the dollar amount increase in funding to CETCs is accelerating, exacerbating the USF "growth" problem. The figure also charts the approximate CETC funding by program element using the data from the Universal Service Administrative Company ("USAC") quarterly reports to the FCC. The compounded annual growth rate in support to CETCs from 2002 to 2006 is 119 percent.

Using the USAC reports, access charge replacement (currently Interstate Common Line Support and Interstate Access and, before 2005, Long Term Support) appears to account for 46% of the current CETC total, although wireless CETCs were never received access charge revenue and indeed benefited from reductions in the access charge rates they paid to ILECs. Local switching support, which was designed to offset the proportionately higher switching costs of smaller carriers serving relatively fewer lines, is also paid to CETCs. There is no relationship between the cost basis of this funding element and the costs a CMRS carrier faces in serving a broad geographical region off a single switch. Nevertheless, local switching monies are paid to wireless CETCs because it is perceived that the result is "competitively-neutral." Similarly, CETCs receive support based on an ILEC acquirer's cost of rehabilitating distressed wireline properties that the ILEC may have purchased from another carrier such as an RBOC. This support element is by definition unrelated to any costs a CETC might incur now or in the past.

[14] Federal provides that states have jurisdiction to set ETC guidelines. If a state does not feel it has jurisdiction to certify carriers as ETCs, then the statue allows the FCC to certify carriers as ETCs. The FCC has released a set of guide-lines that states may choose to follow in determining ETC certification criteria. *See* 47 U.S.C. § 214(e) and *In the Matter of Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, FCC 05-46, 20 FCCR 6371 (rel. Mar. 17, 2005) (*"ETC Designation Order").*

Figure 8: Growth and classification of CETC Funds



Source: USAC Quarterly appendices HC01 (only eligible and ETC-approved funding); Balhoff & Rowe, LLC

There are other statistics that appear to illustrate the difficulty in controlling the CETC funding problems. For example, in eighteen rural study areas, funded CETCs are reporting that they serve more subscribers than ILECs have access lines. Adding pending CETC applications, fifty-four study areas would have more CETC subscribers than ILECs have access lines in the specific service regions. USAC reports 259 study areas that have 70% or more CETC subscribers to ILEC access lines. The study area average ratio of CETC-to-ILEC access lines is now about 45%.[15] At a minimum, these statistics indicate that funding is being disbursed to numerous service providers in service areas that are by definition uneconomic for even a single carrier to serve.

Currently, CETCs have few obligations to invest the monies they receive from the USF or to provide carrier-of-last-resort ("COLR") obligations comparable to those many

[15] USAC 4Q06 Appendix HC 18. *See also*, CenturyTel ex parte describing areas where numerous CETCs had been certified and where the number of supported lines exceeds the number of customers. *Letter from Karen Brinkman to Marlene H. Dortch*, Docket Nos. 96-45, 01-92 (September 13, 2006).

ILECs are required by state law to provide. Given the absence of comparable obligations and the rapid growth in funding, it would appear to fail the straight-face test to suggest that the current CETC program is anything like what Congress, the Joint Board, or the FCC contemplated.[16] Again, then-Commissioner Martin's problem analysis in *Virginia Cellular* is confirmed by facts subsequent.[17]

Turning to an important theoretical question, CETC support mechanisms appears even to fail the purpose of being competitively neutral. The "identical support" rule originally was justified under the rubric that support should be technology agnostic and competitively neutral.[18] However, when industries use different technologies, deploy different architectures, have different regulatory regimes and expectations, continue to serve both differing (whether complementary or competing) and to some extent overlapping (competitive) functions, the resulting cost structures necessarily will be very different. As a result, paying identical High Cost Fund dollars results in profitability disparities that can be profoundly anti-competitive. Providing identical support to carriers with asymmetric obligations, especially Carrier of Last Resort responsibilities,

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[16] "Carrier of last resort obligations require a provider to expand capacity to serve new customers on reasonable request and constitute a barrier to exit from areas already served. Because the very need to enforce carrier of last resort obligations implies that service must be provided at noncompensatory rates, such obligations also pose the threat of burdensome cross-subsidies that carriers will have strong incentives to avoid when possible. Because new entrants can assure themselves lower burdens than incumbents by carefully selecting their service territories, unless symmetry in geographic coverage is required, asymmetric incidence of carrier of last resort obligations is virtually assured." *See* "Unilateral and Bilateral Rules: A Framework for Increasing Competition While Meeting Universal Service Goals," Cherry and Wildman, *Making Universal Service Policy: Enhancing the Process Through Multidisciplinary Evaluation*, Barbara A. Cherry, Steven S. Wildman, Allen S. Hammond, IV, editors (Lawrence Erlbaum Associates, Mahwah NJ 1999) at page 48.

[17] *See infra*.

[18] The Telecom Act requires that in implementing universal service policy, the Joint Board and FCC must adhere to a set of statutory principles, including . . . . The statue allows for the Joint Board and FCC to create "additional principles." The Joint Board and FCC acted on this statutory opportunity and added the additional principle of "competitive neutrality" when it released its First Universal Service Order. *In re Federal-State Joint Board on Universal Service*, First Report and Order (CC Docket No. 96-45), FCC 97-157, 12 FCCR 8776 (rel. May 8, 1997) ("First Universal Service Order").

cannot be represented as being competitively neutral. Stated differently, an "identical" methodology is preferable to identical dollars, so there is less likelihood of competitive distortions or of excessive USF funding. If wireless carriers have a lower cost structure and if they have lesser regulatory-mandated commitments in true high-cost regions, the result should be a contraction in USF funding obligations, all as a result of a consistent ("identical") methodology.[19] Further, this would resolve an important policy problem in addressing the disparity between the rural ILEC support mechanism, which is investment driven,[20] compared with the CETC program, which is revenue driven.

The "identical support" rule is fundamentally anticompetitive, is wasteful, and apparently is not grounded in the investment goals that are core to legacy USF approaches. This problematic CETC "system," coupled with confused and uncertain policy goals and practices, is producing stunningly unintended consequences that appear to be frustrating a clearly-stated public policy oriented toward ensuring network stability and expansion.[21] The appropriate methodology for calculating disbursements to CETCs

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[19] One CMRS carrier has argued for an identical support methodology that "Must not establish [a] different methodology for different technologies. This would violate competitive and technological neutrality. And send the wrong signals and incentives to the market." *Competitive Universal Service*, presentation by Western Wireless Corporation to the Regional Oversight Committee for Qwest, Phoenix, Arizona, March 14, 2005, p. 9.

[20] Even the non-rural company USF support program is based on economic models of the recipients' investments and expenses.

[21] Chairman Martin has repeatedly expressed concern about confused or disparate policy, and has expressly acknowledged the necessity for a link between carrier of last resort obligations and individual carrier's receipt of universal service support. According to the Chairman: "(C)ompetitive ETCs seeking universal service support should have the same 'carrier of last resort' obligations as incumbent service providers in order to receive universal service support. Adopting the same 'carrier of last resort' obligation for all ETCs is fully consistent with the Commission's existing policy of competitive and technological neutrality amongst service providers." [*Separate Statement of Commissioner Kevin J. Martin Dissenting In Part, Concurring in Part, Federal-State Joint Board on Universal Service,* FCC _____, (released February ___, 2004); *Dissenting Statement of Commissioner Kevin J. Martin, Federal-State Joint Board on Universal Service; Highland Cellular, Inc., Petition for Designation as an Eligible Telecommunications Carrier in the Commonwealth of Virginia,* 19 FCCR 6438, (2004)*; Remarks of Kevin J. Martin, T*ELECOM 05 Conference, United States Telecom Association, Las Vegas, NV; Delivered via Satellite from Washington, DC on Oct. 26, 2005.]

was deferred from the Joint Board's previous proceeding[22] and has been pending in the current docket for over two years. *The single, most valuable action the Joint Board can take in this docket is to recommend that support be paid to all recipients using a methodology based on their own costs, however determined.*

IV. THE FRAMEWORK FOR EVALUATING POLICY ALTERNATIVES PREVIOUSLY SUGGESTED BY THE COMMENTORS CONTINUES TO BE VALUABLE, AND COULD BE USED AS A TOOL TO EVALUATE AUCTIONS AND OTHER RECOMMENDATIONS.

Balhoff & Rowe's comments in the High Cost Public Notice proceeding suggested a framework by which the Joint Board could evaluate various recommendations and proposals.[23] Other evaluation frameworks are certainly valid and helpful. The point is to undertake a structured analysis that incorporates practical and political considerations as well as economic, financial, legal, and other data, intended to select policies that may realistically be implemented and will address not exacerbate real world problems. Again, this insight appears to have been at the core of then-Commissioner Martin's *Virginia Cellular* dissent.[24] The framework previously outlined by Balhoff & Rowe (and the framework we again suggest here) is that, at a minimum,

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[22] *See infra.* Those comments suggested a framework that included, among other things, that the Joint Board make recommendations that are adoptable, achievable, sustainable, that take into account the point at which reform is commencing, that focus on the universal service program's emphasis on network support, etc.

[23] Balhoff and Rowe's High Cost Public Notice Comments at pp. 10-13, "The Joint Board Should Make Recommendations that are Adoptable, Achievable, Sustainable, and Take Into Account the Point at which Reform is Commencing." *Citing* Barbara Cherry, Ph.D., "The Telecommunications Economy and Regulation as Coevolvng Complex Adaptive Systems: Implications for Federalism," presented at the *32nd Telecommunications Policy Research Conferenc*e, Arlington, Virginia (October, 2004); Barbara Cherry and Johannes Bauer, "Adaptive Regulation: Contours of a Policy Model for the Internet Economy" (September 2004), presented at the *International Telecommunications Society 15th Biennial Conference*, Berlin Germany.

[24] *See infra.*

policy recommendations should have the following characteristics to ensure they are effective:

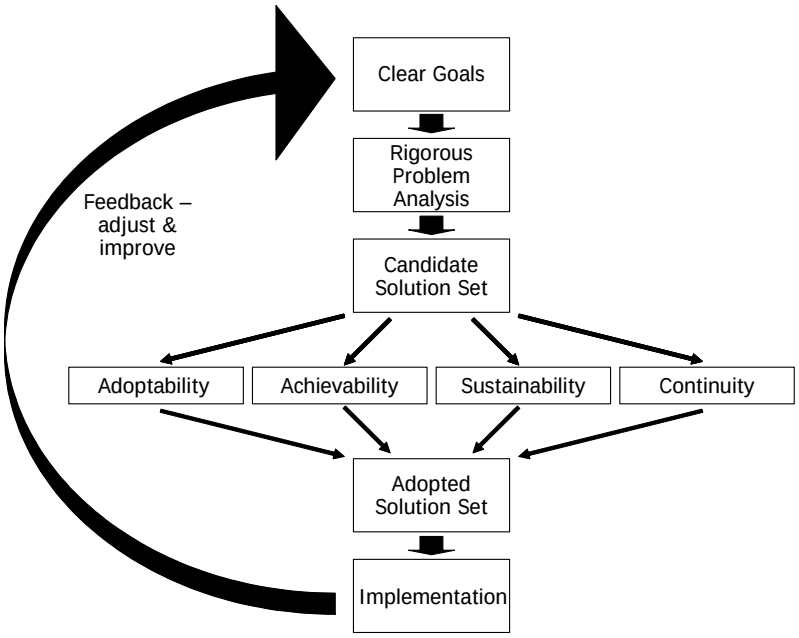
1. **Political adoptability.** There should be a reasonable probability that recommendations actually could be adopted in the administrative and political process and implemented.
2. **Achievability.** Recommendations should have a high likelihood of achieving the desired policy goals. Are the recommendations grounded in a clear analysis of the problem? Are the goals clear? Have probable and possible outcomes - including financial outcomes - been considered, so that there are not unintended negative outcomes?
3. **Taking into account the starting point for reform (continuity).** Rare are the opportunities to implement policy on a clean state, and rarer still are the attempts to do so which have succeeded. In the case of Universal Service funding, the slate is not clean, raising questions about, among other things, substantial risk of stranded investment.
4. **Sustainability over time.** Will policies continue to make sense on a going forward basis as facts-on-the-ground change?

Figure 9 below portrays this "framework for achievable reforms." The diagram expressly includes problem analysis as a prelude to developing a solution set which will be evaluated. The data and analysis provided in these Comments and in other documents filed in this record may constitute core inputs to the Joint Board's problem analysis.

The diagram also highlights implementation, leading to a control and feedback phase. One of the Joint Board's most useful contributions is to monitor developments

and recommend modifications based on analysis of those developments. The current docket presents an opportunity to accomplish further progress. In particular, the CETC regime appears to be in the monitoring and feedback phase when policymakers should consider seriously the need for meaningful modifications. This framework also suggests that, at the very least, targeted adjustments to the ILEC programs must occur to ensure support is sufficient and adapted to investment in advanced solutions or to restructuring of rural properties. In short, rigorous analysis of current facts leading to adoptable, achievable recommendations will be a tremendous contribution to sound and sustainable telecommunications policy.

Figure 9: Framework for achievable reforms

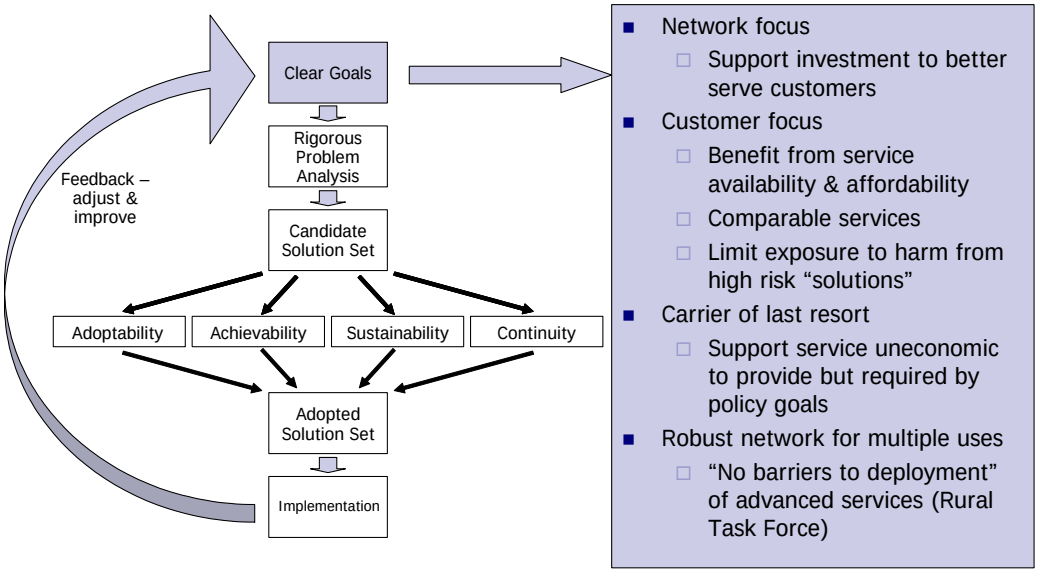


Source: Balhoff & Rowe, LLC

Figure 10 below populates the first element of the framework by suggesting policy goals that appear consistent with current program objectives. The Telecom Act

and the FCC's prior decisions suggest several relevant, strong programmatic goals. Others likely could be added.

Figure 10: Potential goals for High Cost Fund



Source: Balhoff & Rowe, LLC

The goals depicted in the graphic focus on four overarching policy matters.

1. **Customer focus.** "Reasonable comparability" of rates and service, together with other elements, makes clear the ultimate goal is service to *customers*. Customer services ride over integrated networks rather than over discrete or variable network elements.

2. **Network focus.** "Reasonably comparable service" requires robust rural as well as urban *networks*.[25] Economic vitality, public safety and security and social welfare continue to depend on ubiquitous and reliable core network "critical infrastructures." Importantly, new technologies and CMRS are dependent significantly on the landline networks, including those of the RLECs.

[25] *See* Balhoff and Rowe's High Cost Public Notice Comments at pp. 13-15.

3. **Carrier of Last Resort.** Although the Telecom Act does not use the term "*Carrier of Last Resort*," the ETC certification process sets out requirements for ETCs based on this concept.[26] State law imposes extensive service requirements on incumbent wireline carriers, going well beyond regulation of retail rates.[27] Both economic and financial models confirm that the costs of providing carrier-of-last-resort service to rural areas are exceptionally high, and the data continue to verify that such service would be uneconomic without support.[28]

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[26]Further, Section 214(a) of the Telecommunications Act of 1996 states that no carrier shall discontinue any telecommunications service until the Federal Communications Commission has certified that "neither the present nor future public convenience and necessity will be adversely affected" by such discontinuance. The FCC normally will authorize a discontinuance unless reasonable substitutes are unavailable or the public convenience and necessity is otherwise adversely affected. [47 C.F.R. § 63.17(a)(5)(ii), *In the Matter of Verizon Telephone Companies, Section 63.71 Application to Discontinue Expanded Interconnection Service Through Physical Collocation,* WC Docket No. 02-237, ___ FCCR ____ , para. 8 (released October 22, 2003) ("*Physical Collocation Order"*); *Southwestern Bell Tel. Co., U.S. West Communications, Bell Atlantic Tel Cos., BellSouth Tel Cos., Application for Authority Pursuant to Section 214 of the Communications Act of 1934 to Cease Providing Dark Fiber Service,* 8 FCCR 2589, 2601, para. 59 (1993) (*Dark Fiber Order*), *remanded on other grounds, Southwestern Bell v. FCC*, 19 F. 3d 1475 (D.C. Cir. 1994).] In determining whether to allow a carrier to discontinue service pursuant to Section 214, the Commission considers a number of factors in balancing the interests of the carrier seeking discontinuance and the affected user community. [*Physical Collocation Order* at para. 8.] These factors include:

1) the financial impact on the common carrier of continuing to provide the service;
2) the need for the service in general;
3) the need for the particular facilities in question;
4) the existence, availability and adequacy of alternatives;
5) increased charges for alternative services. [*Dark Fiber Order* at para. 54; *Physical Collocation Order* at para. 8.]

[27] The recipients of high cost support "are usually incumbents, since they are the ones with the carrier-of-last-resort obligations and thus the ones that normally serve these traditionally uncoveted customers." Jonathan E. Nuechterlein and Philip J. Weiser, *Digital Crossroads: American Telecommunications Policy in the Internet Age* (2005), p. 341. In California, for example, a Carrier of Last Resort must serve all residential and business customers who request service in its service territory until and unless the California CPUC designates another carrier as the COLR. *See* Final Decision and Order, *Universal Service and Compliance with the Mandates of Assembly Bill 3643,* 96-10-166, 68 CPUC 2d 524, (Cal. Pub. Utils. Comm'n, Oct. 25, 1996) ("CPUC COLR Order").

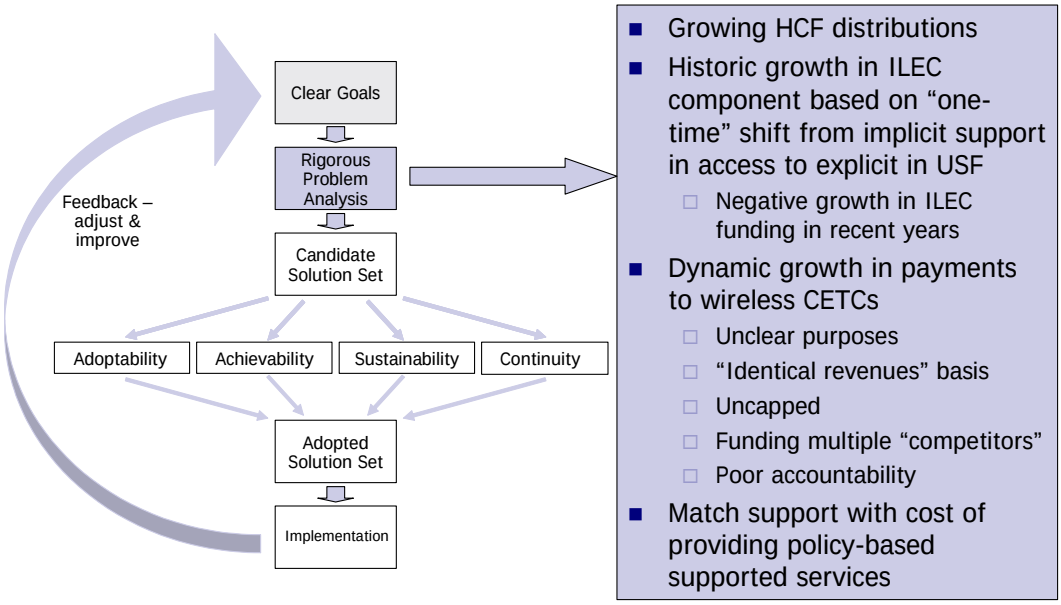
[28] A forthcoming Balhoff & Rowe report will focus on the cost differences between in-town and out-of-town rural areas, and the resultant financial implications on ability to meet Carrier of Last Resort obligations.

4. **Robust networks for multiple uses.** Both Sections 254 and 706 of the Telecom Act emphasize the importance of deployment of, and access to, advanced services. The FCC has recognized consistently that supported networks may provide multiple services.[29] Specifically, the agency has embraced the Rural Task Force's "no barriers to advanced services recommendation."[30]

Figure 11 below suggests an initial problem analysis regarding the High Cost Fund: fund growth is a major concern; the ILEC changes are statutory and FCC-mandated one-time changes, while the real ongoing growth is related primarily to proliferating wireless CETCs. The import of this analysis appears that there needs to be a better systematic matching of support with a recipient's actual costs to achieve policy-based services.

[29] "The public switched telephone network is not a single-use network. Modern infrastructure can provide access not only to voice services, but also to data, graphics, video and other services." *In the Matter of Federal-State Joint Board on Universal Service; Multi-Association Group (MAG) Plan for Regulation of Interstate Access Service of Non Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, CC Dockets No. 96-45 and 00-256, 16 FCCR 11,244 (released May 23, 2001) at para. 200.
[30] *See Letter from William R. Gillis, Chair, Rural Task Force, to Magalie Roman Salas* dated Sept. 29, 2000, at p.21 ("RTF Recommendation") and Balhoff and Rowe's High Cost Public Notice Comments at pp. 25-26.

Figure 11: Problem analysis related to High Cost Fund



Source: Balhoff & Rowe, LLC

As these and other comments have made clear, on the disbursement side, today's difficult situation is driven by expanded USF obligations. Generally, the expansion has been caused by (i) a shift from implicit to explicit support that produces no direct increase in ILEC revenue, and (ii) the current dramatic growth in wireless support, for which purposes remain unclear and for which little accountability is required when compared to the rural ILEC program.

V. IN EXAMINING THE VIABILITY OF AUCTIONS, THE JOINT BOARD SHOULD CONSIDER SIGNIFICANT IMPLEMENTATION ISSUES. IF AUCTIONS ARE DETERMINED TO HAVE MERIT, IT IS HIGHLY UNLIKELY THEY COULD BE IMPLEMENTED IN THE NEAR-TERM.

The Joint Board and Chairman Martin have taken a bold step toward reform in focusing the industry's attention specifically on auctions, as well as on the underlying problems auctions are intended to address. These Comments have emphasized the importance of correctly identifying the problem to be resolved and matching the solution

to the problem. The analysis suggests that CETC funding is precipitating sharp increases in payments with no apparent controls for that growth. Second, the CETC "system" apparently is rationalized by the intent to create "competitive neutrality."[31] However, there are no other clearly mandated goals or mechanisms that ensure investment or levels of service quality as a result of support received. Further, the system has no effective methods for controlling organic CETC-driven fund growth.

Auctions and other mechanisms proposed by policymakers are meritorious in affirming the insight that there is a need to resolve equitably how to fund fewer rather than more eligible carriers. The insight of auctions is also correct that there should be mechanisms that focus carriers on more cost-efficient networks. Finally, auctions are attractive since they could theoretically (although not necessarily in practice) avoid tedious and complex wrangling about which cost methodology is most appropriate—embedded, forward-looking or some other approach.

At the same time, it is possible that the productive policy evaluation triggered by the auction proposal and this Public Notice can focus on the underlying values and could result in a different mechanism that achieves some or many of the same purposes articulated above. These Comments suggest prompt action on the several recommendations that could be implemented in the near-term, further assessment of auctions, and possible tests of auctions, for example, in currently unlicensed or abandoned areas, or for wireless CETC designation, if the Joint Board and FCC determine it is appropriate to have separate landline and wireless designations.

a. The previous history of auction proposals indicates that there are substantial implementation questions associated with auction

[31] *See infra*.

proposals, and suggests that more targeted use of auctions might be an appropriate initial step.

A substantial body of academic and professional literature exists concerning auctions.[32] The Joint Board and the FCC previously have considered auctions on at least five occasions, dating back to 1995.[33] The closest consideration occurred in the context of unserved Tribal lands, where the FCC tentatively concluded it should adopt a competitive bidding mechanism.[34] However, the proposal was never implemented.[35]

Generally, the path from academic theory to implementation is twisted and impaired by obstacles. Often what may make perfect sense on paper becomes unworkable, or difficult to apply in practice. Auction issues that must be resolved include the services to be bid, the temporal and geographic scope, how to initiate an auction, how to qualify the bidders, how many bids will be accepted, how many rounds of bidding to conduct, how to handle potential stranded investment, how to ensure a sufficiently long term such that investors are attracted, how to monitor ongoing fulfillment of obligations, and how to cope with failure to fulfill obligations. The history suggests that an arduous evaluation process related to auctions should not deter from

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[32] *See, e.g.* Paul Milgrom, "Procuring Universal Service: Putting Auction Theory to Work (Lecture at the Swedish Academy of Sciences, December 9, 1996); Dennis Weller, "Auctions for Universal Service Obligations," (12th Biennial ITS conference, Stockholm, June 1998); Frank Kelly and Richard Steinberg, "A Combinatorial Auction with Multiple Winners for Universal Service," (June, 1998); Valter Sorana, Auctions for Universal Service Subsidies," (November 24, 1998).

[33] *See Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board,* CC Docket No. 80-286, Notice of Proposed Rulemaking and Notice of Inquiry, 10 FCC Rcd 12309 (1995).

[34] *Promoting Deployment and Subscribership in Unserved and Underserved Areas, Including Tribal and Insular Areas*, CC Docket No. 96-45, Further Notice of Proposed Rulemaking, 14 FCC Rcd 21177 (1999).

[35] Similarly, the California PUC adopted rules concerning withdrawal from COLR that included an auction process. *See CPUC COLR Order at* Appendix B, Rule 6.d.7. The CPUC Telecommunications Division held workshops in the spring and fall of 1997, and issued a report suggesting further investigation of legal issues with competitive bidding, whether a COLR can be relieved of interconnection responsibilities, and whether the commission can require an ILEC COLR to sell its facilities according to a specified pricing formula. Opinion 16(d) of D.96.10.066 as modified by D.97-01-020 (in R.95-01-020/021). An auction mechanism was never put in place. Auctions are again discussed in the CPUC's current review of the state high cost fund. See *Order Instituting Rulemaking Regarding California High Cost Fund-B Program,* 06-06-028, pp. 40-43 (Calif. Pub. Utils. Comm. mailed June 30, 2006).

more immediate action on proposals that are grounded in the problems identified and that are actionable in the near term.[36] It also suggests that initial use of auctions in a focused, relatively lower-risk context, such as a pilot program for allocating support for unlicensed or abandoned areas, could be a more appropriate initial step than widespread implementation. This would produce valuable feedback for any further program modifications.

b. Specific design questions must be answered for auctions to be implemented and to be effective.

The literature concerning the use of auctions for telephone service suggests a variety of auction designs. Much of the literature pre-dates outcomes of the U.S. spectrum auctions. Some of the literature appears to assume that auction would be for "POTS" landline service. More recent comparative literature provides an important additional set of perspectives concerning actual experience.[37]

Table 1 below outlines some of the complex implementation decisions related to auction design. But it is really only a starting point. The table highlights how challenging the issues are that should be resolved to ensure an effective public policy regime.

[36] According to Werner Heisenberg's "Uncertainty Principle," no treatment of any scientific experiment or measurement can be considered accurate without disclosing the nature of the probability distribution of the measurement. "Uncertainty" refers to the size of the distribution function applied to an observation. A "Public Policy Uncertainty Principle" might suggest that the closer to implementation, the greater the complexity of what might initially have appeared a straightforward proposal.

[37] *See* R.S. Jain, "Spectrum Auctions in India: lessons from experience," *Telecommunications Policy* 25 (2001), 671-688. Jain concludes that spectrum auctions may promote efficiency by allocating spectrum to users who value it most highly and also generate government revenue. Auctions also lead to unexpected outcomes, for example where regulators have inadequate information, where actual bidder behavior doesn't conform to expectations, or where the auction is poorly designed. There are significant opportunities for litigation, unpredictable regulatory and political interventions, and associated uncertainty and delay. U.S. experience is, of course, also instructive. It must be noted that spectrum auctions neither concern pre-existing COLR obligations to customers, nor affect pre-existing investments.

Table 1: Summary of some auction design issues

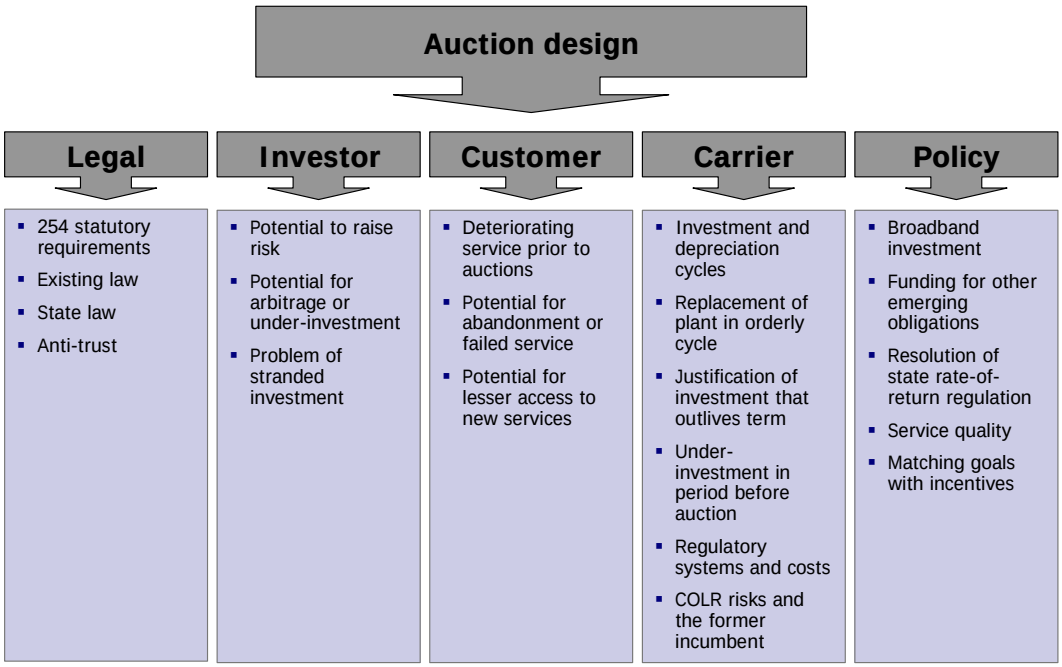
Subject	Questions	Comments
Service scope	1. Wireline only 2. Separate wireline and wireless 3. Combined 4. Functional approach 5. POTS or broadband-capable 6. Treatment of new regulatory and expectations	
Geographic scope	1. Narrow to allow targeting 2. Possibly limited to unlicensed areas 3. Broad to emphasize economies of scale/scope, COLR consistency 4. How to accommodate different wireline/wireless architectures? 5. Jurisdictional questions 6. Efficiency questions 7. Should specific areas be "nominated" for an auction by prospective (possibly pre-qualified) bidders?	
Temporal scope	1. Short period to encourage liquidity 2. Long period to facilitate investment	
Pre-qualification	1. Must bidders be pre-qualified 2. COLR suggests they should be pre-qualified 3. Do high standards limit number of bidders 4. Do low standards jeopardize customers or disadvantage high quality companies	Experience with other bids coupled with the importance of this service has lead to an emphasis on minimum requirements in order to bid.
Number of winners	1. One winner 2. Multiple winners	
Reserve pricing	1. Should a floor price be set either for competitive or service quality reasons? 2. Should a ceiling price be set? 3. If so, how? Would the HCPM need to be maintained for this purpose	In a sale auction, the reserve price is the minimum. In a procurement auction, it is the maximum acceptable. Reserve prices may or may not be disclosed, and may change.
Other bid practices	1. Open or sealed? 2. One or multiple rounds?	
Combinatorial bidding	1. Should combinatorial bidding be allowed? 2. Does it introduce too much complexity or disadvantage certain bidders? 3. Is it required to ensure a robust process and efficient outcomes?	Bids may be submitted for a collection of goods (sale auction) or to provide a collection of goods (procurement auction).
Selection	1. Price only? 2. How would non-price terms be accommodated? 3. Does subjectivity unacceptably complicate the process? 4. By whom will selection be made? 5. Standards for rejecting bids?	
Modification	1. How to accommodate policy/technology modifications, if at all? 2. Under what terms will bid winners be allowed to modify their proposals after acceptance or implementation, if at all?	
Enforcement	1. What are the penalties for non-performance or underperformance? 2. Are they sufficient to prevent non-performance 3. Is surety required? 4. Do enforcement requirements deter otherwise qualified bidders?	
Treatment of incumbent	1. How will costs incurred under prior regulatory regimes be required? 2. Will there be a transition period? 3. Will all federal and state obligations be removed? How? 4. Will the incumbent have any residual obligation to stand ready in the event the bid winner fails to perform?	

Source: Balhoff & Rowe, LLC.

c. Auction proposals should be evaluated from a variety of perspectives including legal, investor, customer, carrier, and policy.

This section suggests issues that the Joint Board should consider in evaluating auction proposals. Figure 12 below outlines a framework for questions that have implications for both program design and implementation. Given the interests at stake and the magnitude of the change under consideration, the Joint Board should assure itself of a high degree of confidence in the answers. The process begins with auction design (already discussed), suggesting that auctions generally will raise significant questions related to legal issues, investor concerns, customer values, carrier issues and public policy.

Figure 12: Some decision issues related to auctions



Source: Balhoff & Rowe, LLC

i. **Legal**. Any proposal should be weighed against the statutory objectives. Depending on how it is structured, an auction proposal could raise concerns under the following provisions:

1. Section 254(a) sets out statutory objectives, including:
    a. Quality services at affordable rates;
    b. Access to advanced telecommunications and information services in all regions;
    c. Reasonably comparable rural and urban rates and services;
    d. Specific, sufficient, predictable support; and
    e. Competitive neutrality.[38]
2. Coordination with existing law concerning state certification of ETCs/CETCs.
3. Reconciliation with state law concerning ILEC obligations, including rates, service levels and COLR.[39]
4. State law and anti-trust rules generally prohibit pricing below cost. Will this floor carry forward into auctions? If so, how will cost be determined?

[38] As discussed previously, competitive neutrality is a universal service principle authorized by Section 254(a) and implemented by the FCC and Joint Board. *See infra*.

[39] The Fifth Circuit has considered the relationship between FCC policy and state COLR policies: "The FCC suggests that GTE's problems stem not from bundling but from state-imposed 'carrier of last resort' ('COLR') requirements, which prohibit ILEC's such as GTE from disconnecting low-profit consumers and leave ILEC's vulnerable to outside competition. But the elimination of COLR requirements would only further undermine the goal of making basic services available to low income consumers and those in "rural, insular, and high cost areas." *See* 47 U.S.C. Sec. 254(b)(3). This again would violate the express intent of the universal service program. Without a better explanation for its unreasonable interpretation, we would be inclined to find the FCC's implementation "arbitrary and capricious and manifestly contrary to the statute." *See Chevron*, 467 U.S. at 844. *Texas Office of Public Utility Council v. FCC*, 183 F.3d 393(5th Cir. 1999).

ii. **<u>Investor/financial</u>.**

1. Possibility of raising risk, with the potential for increasing the cost of financing or even deterring investment. High Cost Fund USF support is a significant revenue stream for rural carriers and investors are very sensitive to uncertainty and disruption.
2. Potential for arbitrage and underinvestment raises rather than lowers the need for policymakers' scrutiny.
3. Complications related to how to handle stranded investment, which might be transferred to a new auction "winner," —how to establish sufficient valuations, or to treat "wasted" underlying investment. Creation of stranded investment also raises investors' concerns about policymakers' willingness to support a financially-sound future regime.

iii. **<u>Customer</u>.**

1. Risks associated with deteriorating service, especially in final years of the "bid" (these risks might be compared with the insufficient capital and expense budgets that typically unfold before a company – in any sector – is sold).

2. Possibility of abandonment or failure of the auction "winner" – again, which party stands ready to assume COLR obligations in such a case? Why should customers who receive service from the supported entity be faced with the potential of forced change of service providers every set number of years? Is that service provider uncertainty a form of discrimination against customers in rural areas?
3. Possibility of no access to new services unless an enforceable framework is included related to new services that are somehow factored into the bidding – presumably a corresponding bid price adjustment would have to be allowed as well.

iv. **Carrier.**

1. Poor correlation between investment and depreciation cycles. Longer term is better than shorter for investment, but longer may not be as attractive in terms of policy and consumer expectations for the deployment of new features and services.
2. Plant is typically replaced on an orderly cycle, not all at once.

3. A rational bid winner could not justify investment that outlived the auction term, without at least express transition mechanisms.
4. Incumbent carrier could not justify investment in the period before an auction was to occur (and this may be a problem even with the Joint Board's Discussion Proposal).
5. Incumbent landline carriers have built networks and incurred ongoing costs to meet a defined set of regulatory mandates, including COLR,[40] network capacity, network reliability, customer service, and others. They have also been required to develop and maintain complicated cost allocation, rate design, and reporting systems. None of these may be shed easily. Much as in the electric industry, this creates a set of costs that were incurred in order to achieve legal and regulatory requirements, but which likely put the incumbent at a significant disadvantage at the outset of the auction. Further, losing the auction while retaining the cost-overhang could exacerbate the incumbent's disadvantage. There is also potential for significant

[40] *See infra,* fn. 16.

confusion about policy support for carriers that have or will be fulfilling public purposes.

6. Must the incumbent stand ready to assume COLR duties in the event the successful bidder produces unacceptably low levels of service or abandons? If so, how will this cost be compensated? What are the questions of equitable and competitive-fairness if an incumbent loses the USF support, but must stand ready to provide service in uneconomic regions?

v. **Policy.**

1. Must reconcile auctioning of support monies with broadband emphasis.
2. How to accommodate new and emerging regulatory expectations that did not exist at the time of the auction, such as CALEA, E-911, and Local Number Portability?
3. How to reconcile with state regulation, including rate-of-return which is still commonly used for small incumbent wireline companies?
4. It may be difficult to account for soft factors such as service expectations in an auction, especially where products are not entirely standardized or they are evolving such as those related to broadband.

5. Adding more specific requirements, plus monitoring and strong penalties likely limits the number of bidders, makes the process less market-like, and may tend to produce less “efficient” results or benefits of auctions over other approaches.
6. Generally, seek to match dominant incentives with primary regulatory goals, which is more conducive to reduced and efficient regulation. If incentives and goals are not well aligned, auctions will require much more effective oversight, enforcement or penalty regimes. For example, support that is based on investment costs has proved to be conducive to high quality service and technology deployment. However, it appears that the current CETC support mechanism misaligns incentives—by providing for “competitively-neutral” duplicative payouts without clear obligations—precipitating confusion about achievable policy goals, and apparently causing wasteful fund growth. Auctions likely would require an even higher level of monitoring and penalties, given the incentives to minimize costs and potentially supply services that are below acceptable levels.

These considerations are summarized at a high level in Figure 12 above. It must be emphasized that auction design and legal, investor, customer, carrier, and policy effects are closely and reciprocally related.

d. The "Discussion Proposal" attached to the Auctions Public Notice may merit careful consideration as a longer-term approach.

Appended to the Joint Board's notice is an auction example provided "for the sole purpose of encouraging a constructive dialogue"[41] and not endorsed by the Joint Board or any individual Joint Board member. The Discussion Proposal is intended to introduce market forces, limit the number of supported networks in each area, select the most cost-effective proposal, and thereby minimize the burden on customers providing support.

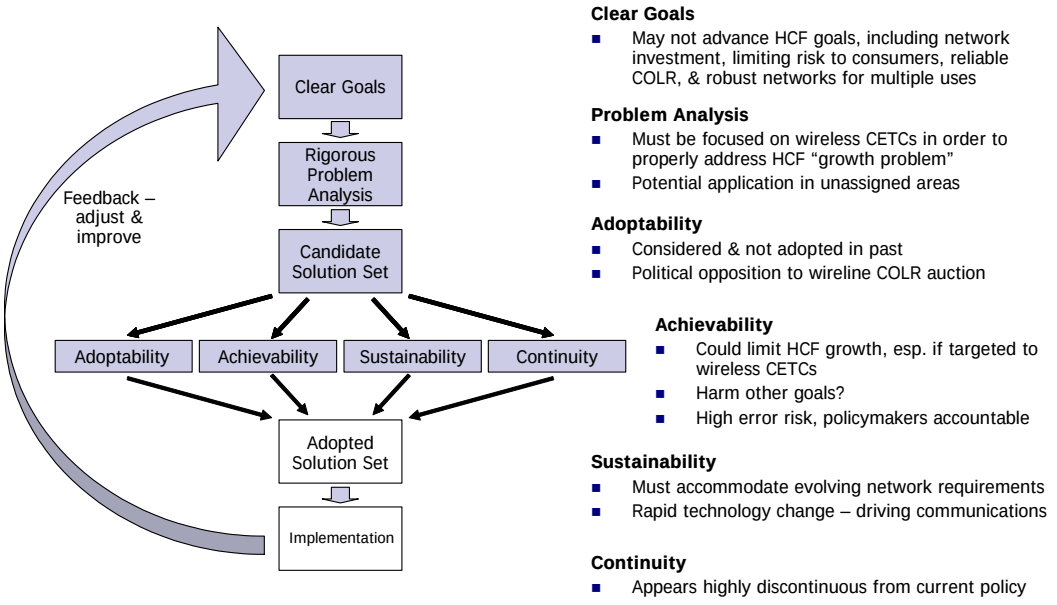
The Joint Board is to be commended for its effort to encourage constructive dialogue. At a very high level, the discussion proposal has several positive features including limiting the number of supported networks in order to control costs, distinguishing wireline and wireless networks as complementary and suggesting distinct standards for each, requiring broad build-out of network facilities, evaluation based on multiple criteria not limited to price, and allowing a transition period for the current ILEC COLR obligations. Recognizing these positive aspects, the Discussion Proposal should still be evaluated through a process similar to the structure suggested in these Comments, and the auction-specific questions listed above should be considered. Problematic features on the Discussion Proposal's face include the effect on ILEC COLR investment in the period proximate to the auction, complexity in the bidding process along county lines, and harmonization of the auction with state roles under federal and state law. It

[41] Auctions Public Notice at p. 8.

should also be noted that it may be possible to achieve many of the benefits posited for the Discussion Proposal without its risk and complexity.

Figure 13 below suggests for discussion a possible application of the evaluation framework to auctions, potentially including the Discussion Proposal. The analysis at each step would depend on the specific elements of the proposal (e.g., separate wireless and wireline auctions or a combined auction, supported services including broadband or not, how is COLR addressed, etc.).

Figure 13: Policy assessment of wireless auction



Source: Balhoff & Rowe, LLC

If based on the comments received, the Joint Board determines that auctions should be explored further, such an analysis could be productive. In the meantime, the Joint Board is encouraged strongly to move ahead on recommendations discussed in these Comments that are developed fully and actionable now.

VI. VARIOUS CONSTRUCTIVE PROPOSALS TO HELP CONTROL GROWTH HAVE BEEN IDENTIFIED FOR ACTION, AND SHOULD BE RECOMMENDED TO THE FCC FOR IMPLEMENTATION.

a. The Joint Board should clarify that high cost support is "network support" and should be tied to the costs of deploying network infrastructure.

As described in these Comments and more extensively in previous comments, significant uncertainty and waste has been caused by not clearly identifying High Cost Fund support as "network support" and by the failure to craft objectives and standards consistent with this goal. Although in part outside the scope of this Auctions Public Notice, this goal has positive implications for investment and service levels, and suggests the desirability of geographically targeting support.

b. Payments to CETCs, like support for incumbent ETCs, should be based on their own costs.

An ample record already exists in this and the previous docket to support this recommendation. This simple step will help shift the CETC program toward an investment-driven model, and begin linking support with the provision of service.[42]

c. Current advisory guidelines for CETC support should be strengthened, and should be made mandatory.

Based on an earlier Joint Board recommendation, the FCC promulgated ETC certification guidelines ("Guidelines") that are advisory to the states and binding on the FCC in those cases where it makes the ETC certification determination.[43] Several states have conducted worthwhile implementation efforts, or have thoughtfully applied the guidelines in specific determinations. The National Association of Regulatory Utility

[42] *See* Balhoff and Rowe's High Cost Public Notice Comments at pp. 34-36.
[43] Report and Order, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, FCC 05-46 (rel. March 17, 2005) (*ETC Designation Order*).

Commissioners ("NARUC") convened an ETC Task Force which did commendable and helpful work.[44] Nonetheless, as described in these Comments, growth in CETC funding has accelerated since the Guidelines were adopted.

A Petition for Reconsideration of the *ETC Designation Order* was filed in June 2005.[45] To the Commenters' best information, the *ETC Petition* remains pending and actionable. The Petition made four recommendations:

1. **Service Area Coverage.** The FCC insist upon unambiguous and complete compliance with Section 214(e)(1), requiring that ETCs "shall" offer and advertise supported services "throughout the service area" in which they are designated, as required by the Telecom Act.

2. **Impact on the Fund.** Clarify that the aggregate impact of ETC designations should be considered in evaluating specific applications.

3. **Guidelines for State ETC Designation.** The Guidelines should be made mandatory.

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[44] *See NARUC's ETC Task Force Final Report,* released February 2006. *Several* states have convened workshops, adopted rules, or issued orders intended to effectuate the FCC Guidelines' purposes. The Regulatory Commission of Alaska denied a petition for ETC designation and study area redefinition, based on a rigorous public interest analysis. Order Denying Petition for Study Area Designation as an Eligible Telecommunications Carrier, Denying Request to Redefine Study Area, and Affirming Electronic Ruling, In the Matter of the Petition Filed by Alaska Wireless Communications, LLC for Designation as an Eligible Telecommunications Carrier Eligible to Receive Federal Universal Services Support under the Telecommunications Act of 1996 and the Request for Redefinition of the Study Area Served by Interior Telephone Company, U-04-62, Order No. 9 (June 27, 2006). Most recently, on October 6th the Iowa Utilities Board adopted rules implementing Iowa law and 47 U.S.C. Sec. 214(e). Order Adopting Amendments and Scheduling Workshops, In re: Eligibility, Certification, and Reporting Requirements for Eligible Telecommunications Carriers, Docket No. RMU-06-1.

[45] ITTA/WTA/TDS Petition for Reconsideration of ETC Designation Order (filed June 25, 2005) (*"ETC Petition").*

4. **<u>Pending Petitions</u>.** Pending applications should not be grandfathered.

Based on one-and-one half years' experience, these recommendations continue to deserve close consideration by the Joint Board and adoption by the FCC.[46] Accordingly, the Joint Board should explore the issues raised in the ETC Petition and encourage the FCC to act on it.

d. Longer-term, a separate wireless component of USF should be considered.

There appears to be growing interest in a separate wireless "mobility" program within the USF. Such a program specifically could identify and support mobility-targeted objectives including, for example, ubiquity of coverage, capacity, and reliability of service. Notably, the investment, monitoring and other distinctive policy objectives could be specified in a manner more appropriate to mobility technologies, which have characteristics very different from those of wireline carriers. Importantly, just as other Universal Service elements are part of the overall Fund, supported by a common contribution mechanism, so would be such a mobility fund. However, the disbursement of the USF monies to wireless carriers would be consistent with the goals of a specific, well-defined mobility program. Several elements of the Discussion Proposal could be incorporated into such a program, including, for example, limiting the number of supported wireless carriers. A mobility or wireless program with wireless-appropriate goals and requirements could also correct logical detours in the current CETC regime, where mobility and long distance service ("fewer toll calls") are cited as benefits helping

[46] *See* Balhoff & Rowe's High Cost Public Notice Comments at pp. 29-33.

to justify wireless CETC certification, even though mobility and long distance service are not "covered services."[47]

While some form of a separate wireless program is certainly worth close exploration, such an undertaking should not defer the critical steps that are actionable now to provide greater discipline, accountability and customer value to the existing CETC regime. The Joint Board and the FCC must cauterize the hemorrhage or risk losing the patient. And the Joint Board and the FCC should employ mechanisms that properly target the source of the underlying, organic CETC-based growth problem lest the treatment harm other functioning and healthy organisms.

VII. THE PROGRAM SUPPORTING SERVICE TO RURAL INCUMBENT CARRIERS NEEDS SPECIFIC MODIFICATIONS TO ENSURE SUPPORT IS SUFFICIENT.

There are several modifications to the rural portion of the High Cost program that should be addressed immediately. Five concerns are particularly appropriate for Joint Board action: (a) modifying the Rural Growth Factor, (b) not consolidating study areas for USF receipts, (c) distinguishing future access replacement funds from USF, (d) the need for ongoing evaluation of the contribution mechanism, and (e) modifying the Parent Trap rule. Each of these concerns is discussed in more detail below.

a. The Rural Growth Factor for determining loop support for rural carriers should be modified so that support does not decline more precipitously than do costs.

As described in these Comments and elsewhere in the record, the current Rural Growth Factor for high cost loop support has produced a large and growing gap between the actual cost of providing service and the amount of support received. Further, the

[47] *See* 47 C.F.R. § 54.101 for a list of services eligible for USF support.

formula operates to reduce year-over-year the number of high-cost rural study areas that are eligible for support. The Joint Board should act favorably on recommendations to modify the formulae to ensure that support better follows costs.[48]

b. Rural study areas should not be consolidated.

Medium-sized rural companies that serve more than one study area within a state are achieving efficiencies that exist by nature of serving multiple study areas while at the same time are working to achieve higher levels of service. As demonstrated in these Comments, rural incumbents are not the source of Fund growth; CETCs are the source. Consolidating ILEC study areas for purposes of determining support is unrelated to the foundational problem causing USF growth (organically increasing disbursements to wireless CETCs) and would be a movement away from targeting support to the highest cost areas. Such study area consolidation would also have the unintended effect of discouraging combinations that could be beneficial to customers and likely would be supported by policymakers.[49]

c. Future access charge replacement mechanisms should be distinguished from High Cost Fund support.

The amount of implicit support included in access charges before the CALLS and MAG reforms may be disputed. There is relatively less dispute that all or the great majority of implicit support was moved out of access charges as a result of past access charge reductions. As is seen in this docket, there remains substantial confusion about the relationship between access charge payments, access charge replacement, and explicit universal service support. Therefore, the Joint Board should recommend that any future access charge replacement funds expressly be designated by the FCC under 47 U.S.C. §

[48] *See* Balhoff & Rowe High Cost Public Notice Comments at pp. 46-47.
[49] *See* Balhoff & Rowe's High Cost Public Notice Comments at pp. 42-43.

201 which establishes the duty to connect to other carriers and authorizes the federal agency to set rates.

d. The Joint Board should support the FCC's ongoing effort to reform the contribution mechanism.

Contribution reform is the necessary counterpart to disbursement reform. The FCC has been focused on this effort, and has taken several constructive actions while continuing to work on long-term approaches to contribution reform. Reforms should emphasize both broadening and stabilizing the support base. As it has in the past, the Joint Board should continue to support and constructively contribute to this effort.[50]

e. Rules concerning transferred exchanges must be addressed.

While this Auctions Public Notice is concerned with other matters related to growth in Universal Service funding, rules concerning transferred exchanges are an important forward-looking aspect of this docket. The FCC's current "Parent Trap" rule limits a purchaser of telecom property to the amount of USF that was previously received by the selling company. The record includes information about the deleterious and likely unintended effects of this rule. The record also includes recommendations to modify current practice in order to facilitate actual investment in and improvement of often severely depreciated acquired telecommunications property.[51]

VIII. CONCLUSION.

This proceeding has afforded the Joint Board and stakeholders a valuable forum to consider foundational matters, to "think outside the box" by exploring the most creative approaches to meeting universal service objectives, and to develop and act upon specific

[50] *See* Balhoff & Rowe High Cost Public Notice Comments at pp 52-55.
[51] See Balhoff & Rowe Comments, September 30, 2005, pages 39-42.

and well-developed proposals that are actionable now. These should be complementary, not mutually exclusive, projects. The insight that appears to have informed this Public Notice is correct: the fund is growing overall, driven by organic growth in CETC support; CETC support continues to be poorly disciplined, and appears insufficiently connected to defensible public purposes. At the same time, support for rural incumbent carriers in several respects appears less than optimal. These Comments have offered data as inputs; suggested an analytical structure; discussed policy and implementation issues associated with auctions; and have urged that the Joint Board now recommend specific steps, which are both achievable and related to the problems at hand. The Joint Board should proceed accordingly on these recommendations.

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