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July 16, 2007

Ms. Marlene H. Dortch, Secretary
Federal Communications Commission
445 Twelfth Street, SW
Washington DC 20554

Re: WC Docket No 05-337, CC Docket No. 96-45 – *Ex Parte* Presentation

Dear Ms. Dortch:

On July 15 representatives of Consolidated Tel, Embarq, Windstream and Balhoff & Rowe held meetings with three members of the Federal-State Joint Board on Universal Service: Commissioner Larry Landis of Indiana, Commissioner Ray Baum of Oregon, and Commissioner John Burke of Vermont. Joint Board staff member Peter Bluhm (Vermont) also attended.

On July 15, representatives of Embarq and Windstream met with Joint Board staff member Jacob Williams of the Florida Public Service Commission.

On July 16, representatives of Embarq, Windstream and Balhoff & Rowe met with Joint Board Member and West Virginia Consumer Advocate Billy Jack Gregg.

In each meeting, the attached document was provided, in addition to the report, *Universal Service Funding: Realities of Serving Telecom Customers in High-Cost Regions* (Balhoff & Rowe, Summer 2007), which was filed with the Joint Board on July 12, 2007. The meetings concerned the details and methodology of the report, and explained how it is relevant to the Joint Board's current proceeding.

Sincerely,

Robert C. Rowe
Senior Partner

cc: Hon. Ray Baum, Hon. Larry Landis, Hon. John Burke, Billy Jack Gregg, Jacob Williams, Peter Bluhm

CenturyTel, Inc.
Consolidated Communications, Inc.
Embarq Corporation
Windstream Communications, Inc.
Balhoff & Rowe, LLC

Executive Summary

- Key messages
  - USF reform essential to ensure rural customers' access to affordable services
  - Competition *increases* the need for targeted, *explicit* support
  - Sustainable solutions must be grounded in financial realities

- Insights from Texas USF study
  - Signs that federal USF will fail to meet consumers' needs in high-cost areas
  - Competitor trends
    - Serve consumers in rural towns,
    - But not higher-cost outside of town regions
    - Pattern of targeted competition is unlikely to change
  - Incumbent local telephone companies have "Carrier of Last Resort" (COLR) responsibilities
    - Expected or compelled to serve uneconomic outside-of-town regions
    - Often at a *significant loss*
  - As competition impacts lower-cost rural towns, targeted explicit support mechanisms are vital for continued affordable, quality service to all rural customers
    - Traditional *implicit* support mechanisms eroding

Traditional (Monopoly) Model of Support

Urban Vertical

Long Distance Business

Local Residential

Rural Basic

Consolidated monopoly telecom

Lines of business

- Policymakers regulate carriers to ensure policy-based (as opposed to market-driven) ubiquitous/affordable services in exchange for economic viability of entire enterprise
- Historically, residential and high-cost rural consumers benefited from a system of enterprise-based internal cross-subsidies
  - Support included in access and long distance
  - Geographic rate averaging
  - Value-of-service pricing
  - Residual pricing of value added/"vertical" services
  - Rate differentials unrelated to cost differences
- System began to fail when certain sources (lines of business) of internal cross-subsidies became competitive
  - LD from approximately 1970
  - Business in the 1990s/2000s
  - Residential with VoIP in 2000s

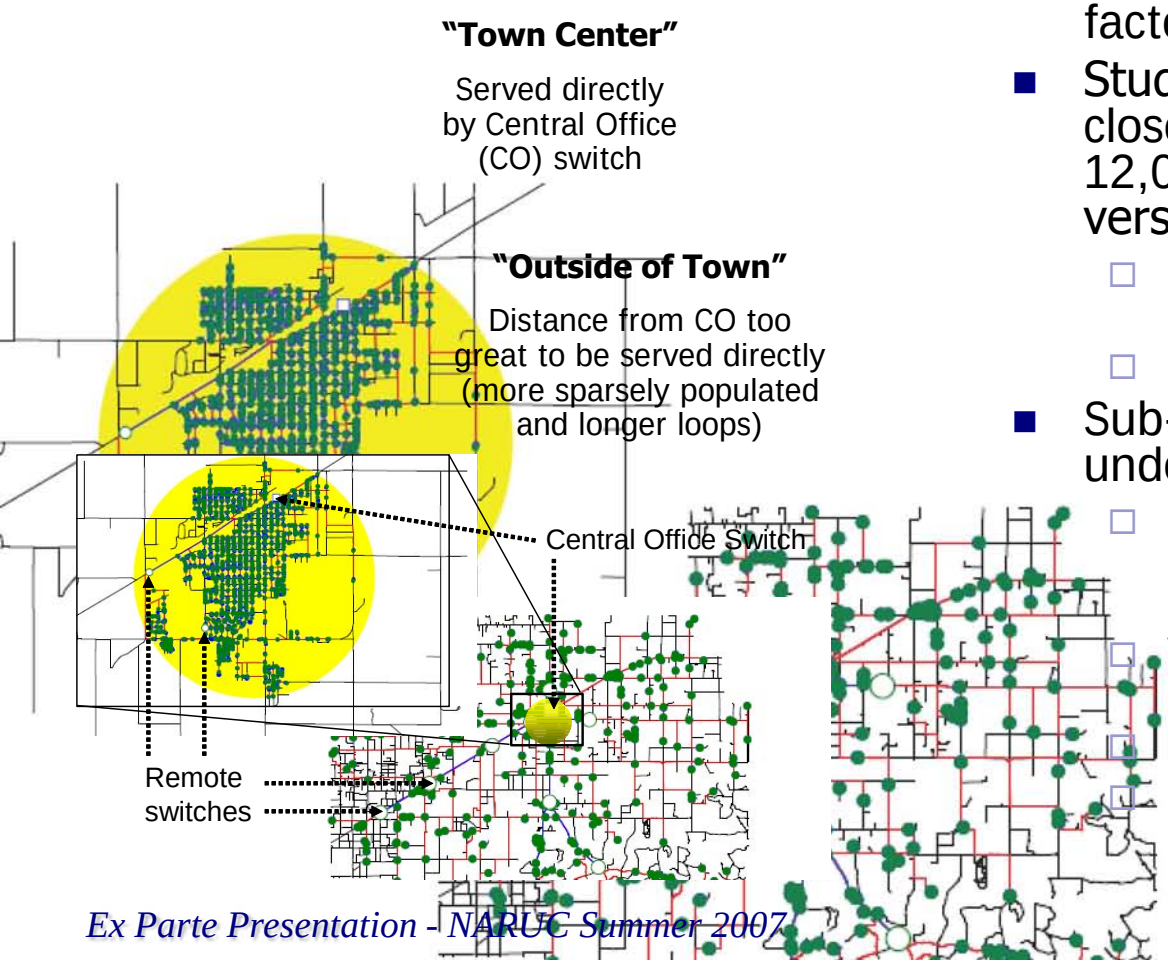
Slide 3

Rural Financial Problem

- Competitive line losses are concentrated in townships, not outside
- Companies/B&R note findings are consistent with data in other states
- B&R Texas study focused on cost patterns and competitive activity
  - Methodology involving financial data study based on . . .
    - "Supported services" only (revenues, costs, investment)
    - Actual revenues received for provision of these services
    - Forward-looking costs (12 kft loops – no costs for broadband-capable plant)
  - Data set
    - Over 100 Texas wire centers
    - Approximately 375,000 lines
    - Approximately $250 million in revenue (including USF receipts)
    - ~$850 million in gross loop investment (~$450 million net R1/B1 investment)
  - Analyzed financial characteristics/performance of wire centers in data set
    - Segmented into ROI groups (negative, 0%-10%, >10%)
    - Sub-wire center analyses of financial performance
  - Using geo-coded information, studied the geographic coverage of the cable operators (only in towns) & characteristics of service areas

NOTE: "Supported services" revenue streams included in analysis consist of Basic Area Local Revenue, End User Common Line (excluding USF surcharges), Carrier Common Line, Switched Access (including CALLS support), IntraLATA Toll, and High Cost USF where indicated. Costs and investment reflect what is required to provide R1/B1 services (including Loop, Transport & Switching), with returns calculated based on net investment (after accumulated depreciation).

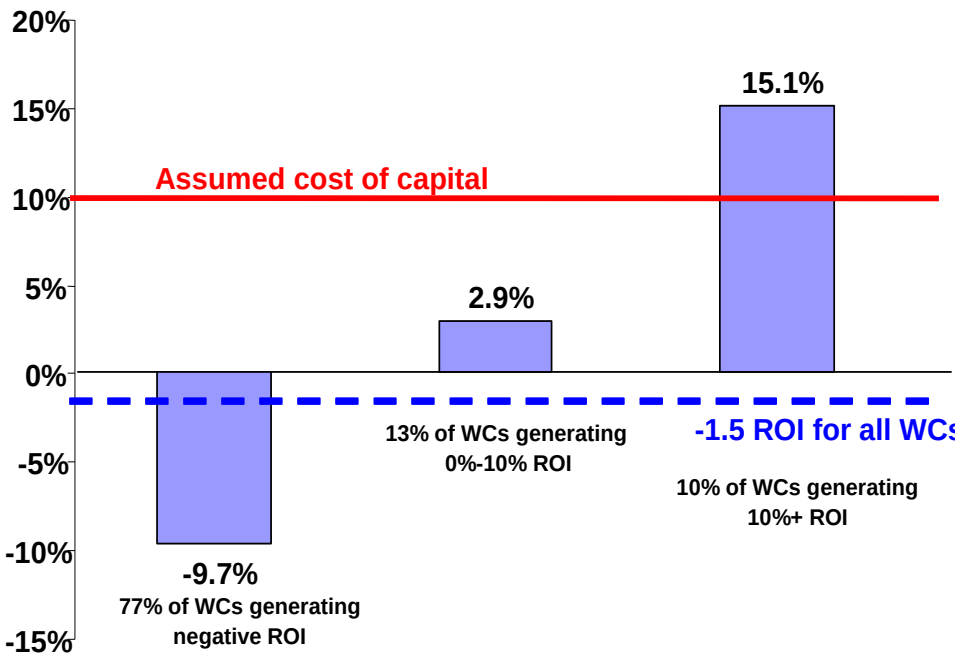
Town Center vs. Outside of Town



- Fundamental goal – better understand challenges in serving rural customers based on sub-wire center financial & competitive factors
- Studied "Town Center" regions, close enough to the CO (less than 12,000 feet) to be served directly, versus "Outside of Town" areas
  - CO typically placed in population centers
  - Higher density, lower cost areas
- Sub-wire center data are key to understanding . . .
  - Economics of serving differing geographic regions (in terms of density, costs, investment, etc.)
  - Why and where wireline competition is occurring, and where it is not
  - Role of explicit support mechanisms
  - Future pressures on mechanisms

Without USF, Rural Service At Risk

- Excluding USF receipts, ROI for all wire centers studied would be negative (excluding non-supported services)
- Wire centers generating returns below assumed 10% cost of capital represent a large percentage of WCs, lines and investment
- Uneconomic Outside-of-Town regions are unlikely to attract incremental investment from rational competitors
- Quality/availability of service for customers put at risk without sufficient support



Source: Sampled Texas companies; Balhoff & Rowe, LLC.

Without USF

Wire Centers with negative returns	Wire Centers with returns of 0%-10%	Wire Centers with returns greater than 10%	All Wire Centers
38% of total lines	20% of total lines	42% of total lines	100.0% of total lines
77% of total wire centers	13% of toal wire centers	10% of total wire centers	100.0% of total wire centers
60% of total investment	15% of total investment	25% of total investment	100.0% of total investment
-9.7% return on investment	2.9% return on investment	15.1% return on investment	-1.5% return on investment

- Outside of town operations all generate sub-10% ROIs
- 75% of investment for 58% of lines that generate sub-10% ROIs
- Import is that loss of town cluster is loss of major source of profits

Wire Centers with negative returns

Town Center
- 49% of WC revenues
- 48% of WC lines
- 27% of WC investment
- -1% return on inv.

Outside of Town
- 51% of WC revenues
- 52% of WC lines
- 73% of WC investment
- -13% return on inv.

Wire Centers with returns of 0%-10%

Town Center
- 46% of WC revenues
- 47% of WC lines
- 34% of WC investment
- 12% return on inv.

Outside of Town
- 54% of WC revenues
- 53% of WC lines
- 66% of WC investment
- -2% return on inv.

Wire Centers with returns greater than 10%

Town Center
- 50% of WC revenues
- 49% of WC lines
- 40% of WC investment
- 24% return on inv.

Outside of Town
- 50% of WC revenues
- 51% of WC lines
- 60% of WC investment
- 9% return on inv.

All Wire Centers

Town Center
- 49% of WC revenues
- 48% of WC lines
- 31% of WC investment
- 10% return on inv.

Outside of Town
- 51% of WC revenues
- 52% of WC lines
- 69% of WC investment
- -7% return on inv.

Financial Drivers Highlight Risks

- ROI driven by high-density & low-capital intensity in Town Centers
- Town Center regions vs. Outside of Town areas
  - 4x the line density
  - Approx. 50% the per-line investment
  - Lower maintenance & operating costs
- Systemic vulnerability to targeted competitive entry will put policy goals at risk
  - Competitors target concentrated profits/returns
  - Economically unattractive outlying areas make ongoing capital allocation problematic
  - Quality, affordable service less available – consumers lose

"Town Center"

- $769 avg. invest./line
- 4x OoT density
- 10% ROI

"Outside of Town"

- $1,581 avg. invest./line
- 2.1x Town Center per line investment
- -7% ROI

Wireline Competition Not Ubiqitous

- Large percentage of rural customers are not cable-served
- ILEC is sole service provider for highest-cost customers
- Rural cable service area metrics consistent with Town Centers
  - 31x more dense than areas without cable service
  - Approx. 45% of per-line investment vs. areas with no cable (assume ratios of investment are similar to telco investment in and out of towns)
- Reflects rational business decision by unregulated competitors
  - Attack areas of concentrated ILEC profitability
  - Serve only where opportunity for return on investment is economically rational (unlikely to change)

"Cable-served"

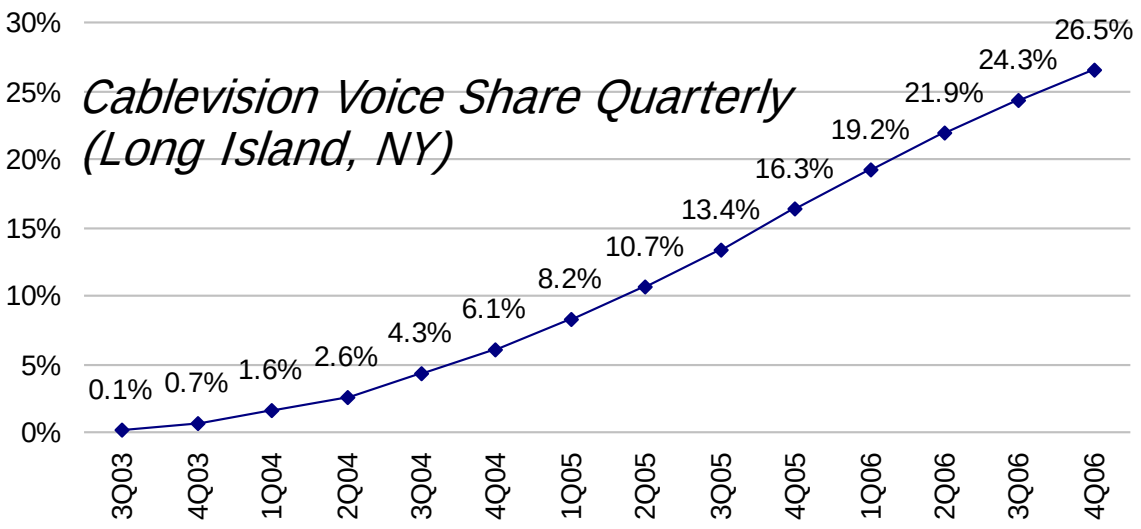
- 44 lines/sq. mi.
- ~$1,900 avg. telco invest./line

"No Cable Service"

- < 2 lines/sq. mile
- ~$4,300 avg. telco invest./line

Impact of Targeted Entry

- In the past, little/no competition possible in rural regions
- VoIP makes it possible to target the most profitable rural areas
- Effect of current system is to make possible an arbitrage
  - Competitor can focus on profitable cluster
  - COLR carrier burdened with support of unprofitable, outside of town areas
  - USF systems not targeted enough to support specific and isolated regions
  - VoIP speeds disruption of current system



As an illustration of share loss to VoIP in a concentrated market . . .

Rural operators are reporting similar losses in targeted regions

Conclusions

- Joint Board's interim solution is a good beginning
- Need more specific understanding of emerging financial challenges
- Recognize pressures on regulatory systems – implicit supports unsustainable
  - Facts have changed or are about to change
  - Financial realities will force a change in the system
- Insufficient explicit support puts significant numbers of customers at risk
- Need sustainable, complementary competitive business & regulatory models
- Implications for . . .
  - Retail rate and service regulation
  - Carrier-of-Last-Resort requirements
  - Competition policy
  - Universal service
  - Intercarrier compensation