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Marlene H. Dortch, Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Re: Connect America Fund, WC Docket No. 10-90; A National Broadband Plan for Our Future, GN Docket No. 09-51; High-Cost Universal Service Support, WC Docket No. 05-337

Dear Ms. Dortch:

On August 20, 2010, Thomas Strait and I, on behalf of the National Telecommunications Cooperative Association, met with Lisa Gelb, Al Lewis, Katie King, and Elise Kohn. Gary Seigel participated in the discussion by telephone. We discussed questions relating to telecommunications cooperatives relevant to the above referenced proceedings. In particular we explained the principles under which cooperatives are formed and operate, their financial structure and the basis for universal service support. The attached document was distributed to the Commission participants.

Please contact me if there are any questions regarding this matter.

Sincerely yours,

David Cosson

Attachment

Cc: Lisa Gelb
Al Lewis
Katie King
Elise Kohn
Gary Seigel

ORGANIZATION AND FINANCING OF TELEPHONE COOPERATIVES

I HISTORY AND STRUCTURE

A. Cooperative Principles

The modern concepts of cooperative business organization were developed over 150 years ago. Today the essential characteristics of a cooperative are generally recognized as:

> (1) *Subordination of capital* -- the members' investment is not paid a "rate of return". Instead, distributions of a cooperative's margins (income) are determined on the basis of the members' participation in the cooperative endeavor;
> (2) *Democratic control by the members* -- typically exercised on a "one-member, one-vote" basis at all meetings of the members; and
> (3) *Allocation of margins on the basis of patronage* -- operation at cost is accomplished by the charges for expenses being allocated among the members based on their participation and excess margin collected allocated to the members as capital credits (i.e., patronage dividends) to be returned eventually.[1]

In even more condensed form:

> The principal difference between the cooperative form of doing business and the ordinary corporate form is that the shareholders of a cooperative share in the cooperative's income in proportion to their purchases from the cooperative rather than to the number of shares they own.[2]

B. Telephone cooperatives

Telephone cooperatives were first organized in the late 19th-early 20th Century to provide telephone service in rural areas that Bell and other investor-owned companies had no interest in serving. The majority of today's approximately 270 cooperatives trace their origin to the beginning of REA (now RUS) funding in 1949.

Telephone cooperatives are corporate entities, usually organized under state statutes for telephone, telephone and electric, or general cooperatives. Some may be organized under general state corporation statutes, with cooperative articles and bylaws.

The bylaws of telephone cooperatives, *inter alia,* typically specify:

> **…** all patrons will, through their patronage, furnish capital for the Cooperative…. In order to induce patronage and to insure that the Cooperative will be operated on a non-profit basis, the Cooperative is obligated to account on a patronage basis to all its patrons for all amounts received and receivable from the furnishing of telecommunications, communications and information services in excess of operating

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1 *Puget Sound Plywood, Inc. v. Commissioner,* 44 T.C. 305, 308 (1965), 1966-2 C.B. 6.

2 *CF Industries v. Commissioner,* 995 F.2d 101 (7th Cir. 1993).

costs and expenses properly chargeable against the furnishing of such services. All such amounts in excess of operating costs and expenses for telecommunications, communications and information services at the moment of receipt by the Cooperative are received with the understanding that they are furnished by the patrons as capital.

The Cooperative is obligated to pay by credits to a capital account for each patron all such amounts in excess of operating costs and expenses derived from telecommunications, communications and information services.…

If, at any time prior to dissolution or liquidation, the Board shall determine that the financial condition of the Cooperative will not be impaired thereby, the capital then credited to patrons' accounts may be retired in full or in part. [3]

> The obligation of the cooperative to account for and make allocations of capital furnished by patrons as established in this Section and Section 8.3, following shall apply only to the furnishing of retail services to end user patrons.

C. Tax Status of Telephone Cooperatives

Exemption of telephone cooperatives from federal income tax was first made explicit in the 1916 Code. The current Section 501(c)(12) requirement that exempt coops derive 85% of their income from members originated in the 1924 Code. That section now excludes income from other telephone companies from the 85% calculation. Rural Telephone cooperatives not qualifying for this exemption exclude capital allocations to patrons from income.

II TELEPHONE COOPERATIVES' RECOVERY OF COST OF ORIGINATINGAND TERMINATING LONG DISTANCE SERVICE

A. Telephone Cooperatives Historically Have Been Treated the Same as All other Rural ILECs.

In the early 20th Century, the Bell System interconnected with rural independent telephone companies, including cooperatives, to jointly provide long distance service. The independent companies' share of the toll revenues they billed and collected was determined by an "average schedule" in which the settlement per message varied with the average revenue per message. In the 1960s, the Bell System began to agree to "cost-based" settlements with independents, with cost being determined in accordance with the FCC/NARUC Separations Manual plus the rate of return earned by the joint enterprise (separately for inter- and intra-state).

The mid-1980s saw major industry upheaval flowing from the introduction of long distance competition: the conversion of settlements to access charges, the splitting of access revenues into access and Universal Service Fund, the breakup of the Bell System and the creation of NECA. When the dust settled, independents, including cooperatives, continued to determine their cost of interstate service based on the jurisdictional allocation rules (which were

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3 Periodic retirement of capital credits promotes generational equity of capital contribution.

then codified into 47 CFR) plus the return on net investment prescribed for the Bell Operating Companies.

That revenue requirement is used by NECA (or the coop if it files its own tariff) prospectively to develop tariffed rates and retrospectively by USAC to determine USF disbursements. The share of each pool member, including cooperatives, in the pooled revenues is determined by multiplying the members' net investment by the earnings of the pool as a whole. There is no readily apparent or justifiable mechanism to adjust this process to account for different costs of capital of pool members, either cooperative or closely held corporation

B. Telephone Cooperatives Require an Appropriate Amount of Equity in Their Capital Structure, as do all LECs

Any business, especially a capital-intensive business such as a facilities based telecommunications carrier, requires sufficient capital on its balance sheet to be able to operate. As carriers subject to the Communications Act to the same degree as all other rural LECs,[4] telephone cooperates have specific federal (and often state) obligations to provide their service to all who request it. In an industry with rapidly changing technology, increasing subscriber expectations and evolving and expanding regulatory requirements (e.g. CALEA, E911, local number portability), telephone cooperatives have a constant need to make new capital investments.

This capital comes from a combination of the cooperative's margins of revenue over expense and debt financing. Lenders, including the Rural Utilities Service, require that cooperatives have an appropriate level of equity. Indeed, lenders have become especially strict about this requirement in recent years because of the significantly increased risk faced by telephone cooperatives as a result of the combination of increased competition and regulatory uncertainty. Determining the precise proportion of equity required, and the cost of that equity, is of course difficult. But those numbers are equally difficult to determine for the hundreds of small, closely held ILECs that have also historically used the Bell System either earned or prescribed rate of return. For both cooperatives and non-publicly traded LECs, the historical answer has been that the cost of individual determinations would undoubtedly exceed the benefits of such determinations, and that the benefits of a single tariff and pool settlements based on shared risk would be destroyed if differences in equity costs were required to be recognized.

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4 Except as provided in Section 224(a)(1).