141. Applying a similar approach to broadband may be more difficult, however. Many variables other than affordability affect penetration, including lack of necessary equipment such as a computer, a lack of digital literacy and a belief that broadband is not relevant.[227] Moreover, some of the metrics that we have used in the past for voice service—such as the relative stability of expenses over time—may not be readily available. We thus seek comment on appropriate ways to measure affordability of broadband service in the absence of longitudinal data regarding the pricing of such service.[228]

142. When the Commission initially implemented the 1996 Act, it noted that a variety of factors may affect affordability, including non-rate factors such as income levels, cost of living, population density, and the size of the customer's local calling area.[229] We seek comment on what factors are relevant in today's environment for determining affordability of broadband. To what extent should we take into account income levels in determining affordability,[230] how would that interplay with the statutory requirement that rates be reasonably comparable,[231] and what would be the implications of doing so for reforming our current programs to support broadband? Would it be feasible to implement a system where support is available only to subsidize the cost of serving customers under a specified income level? Should we establish a national benchmark for affordability?

143. We also seek comment on whether to adopt specific requirements to ensure that voice and broadband services supported by universal service are affordable.[232] Should we require recipients to offer a basic tier of broadband service at an affordable rate? If so, would we need to specify what an "affordable rate" is, or specify an upper bound for such a rate using a dollar figure, a percentage of the national average, or some other measure such as two standard deviations above the national average? Should there be different broadband performance requirements for such a tier? What role should our low-income programs play in ensuring the affordability of broadband services? Is affordability an issue best addressed outside the high-cost program?

144. *Reasonably Comparable.* Section 254(b) directs that universal service policies be designed to make services in rural areas available at rates that are "reasonably comparable" to rates in urban areas.[233] We seek comment on how to measure whether rates are reasonably comparable, and whether, for this purpose, we should look at rates for voice and broadband individually, or combined. For the purposes of high-cost support for non-rural carriers, the Commission has defined "reasonably

(Continued from previous page)
remained virtually unchanged over the past twenty years, despite major changes in the telephone industry and in telephone usage.").

[227] *See* National Broadband Plan at 168; Omnibus Broadband Initiative, *Broadband Adoption & Use in America; OBI Working Paper Series No. 1*, p. 24-33 (February 2010) (OBI, Broadband Adoption) (describing non-adopters and barriers to adoption).

[228] *See infra* para. 137 (proposing that recipients must offer voice and broadband (individually and together) in rural areas at rates that are affordable and reasonably comparable to rates in urban areas).

[229] *Universal Service First Report & Order*, 12 FCC Rcd at 8840-42, paras. 114-117. The Commission concluded that states, by virtue of their local ratemaking authority, should exercise primary responsibility for determining affordability of rates.

[230] We note that in its most recent recommended decision, the Joint Board highlighted several issues related to extending Lifeline universal service support to include broadband. *Joint Board 2010 Recommended Decision*, 24 FCC Rcd at 15625-26, para. 77.

[231] 47 U.S.C. § 254(b)(1).

[232] *See infra* para. 573 (proposing to adopt a rate benchmark that moves from a voice benchmark to a voice and broadband rate benchmark).

[233] *See supra* Section V.A (National Goals and Priorities for Universal Service).

comparable" in terms of a national rate benchmark.[234] The national rate benchmark for voice service is currently set at two standard deviations above the average urban rate as reported in the most recent annual rate survey published by the Wireline Competition Bureau.[235] Rates in rural areas that fall within the national rate benchmark are presumed to be reasonably comparable to rates in urban areas.[236] In practice, voice rates are often the same across a state to comply with state requirements.[237] Where there are differences, however, rural rates within most states tend to be *lower* than urban rates in those same states.[238]

145. We seek comment on whether to adopt a similar definition of "reasonably comparable" for voice and broadband rates, such that rural rates for voice and broadband together are deemed reasonably comparable if within two standard deviations of a national rate benchmark for voice and broadband. If we adopt the definition used for the provision of high-cost support to non-rural carriers for voice service, should we modify it so that we do not provide support to carriers whose combined voice and broadband rates in rural areas are *below* the average urban rate to ensure that we do not subsidize networks where the retail price of the service offering is significantly below a national benchmark? We also seek comment on how to compare voice and broadband offerings across regions that may include many pricing and service-quality variations.

146. Alternatively, should we adopt a different upper bound on the rates for broadband and voice services supported by our existing high-cost program or the CAF? For those carriers that receive support in only a portion of their service area, should we require that those recipients charge no more for broadband or voice in subsidized areas than they do in non-subsidized areas?[239] If so, how would we deal with recipients that are subsidized in all areas? Should we require that, in order to receive funding, rates for broadband in subsidized areas be no more than a certain percentage of the average urban rate?[240]

147. We also seek comment on whether the Commission should require recipients to file with the Commission rates that it will charge customers for a set period after receiving funding.[241]

c. Additional Considerations

148. *Joint Infrastructure Use*. Some commenters have suggested that we consider policies to encourage sharing of infrastructure, including by residential and anchor institution users.[242] We seek

---

[234] *Qwest II Remand Order*, 25 FCC Rcd at 4076, para. 8; *see* 47 C.F.R. §54.316(b); *Order on Remand*, 18 FCC Rcd at 22582-89, 22607-10, paras. 38-48, 80-82.

[235] *Qwest II Remand Order*, 25 FCC Rcd at 4076, para. 8; *see* 47 C.F.R. §54.316(b); 2008 Reference Book of Rates.

[236] *Qwest II Remand Order*, 25 FCC Rcd at 4076, para. 8.

[237] Such requirements typically apply to voice but not broadband as state commissions typically do not regulate broadband services.

[238] *Qwest II Remand Order*, 25 FCC Rcd at 4095-96, para. 43.

[239] Comments of the Regulatory Studies Program of the Mercatus Center at George Mason University (Mercatus Center), WC Docket Nos. 10-90, 05-337, GN Docket No. 09-51, at 12 (filed July 9, 2010).

[240] *See supra* para. 458 *et seq.* (proposing all recipients must report on deployment, adoption, and pricing data for voice and broadband).

[241] Mercatus Center July 9, 2010 Comments, at 10 ("It is difficult to see how the FCC could legally subsidize broadband without having the provider make some type of commitment on the price it will charge as a quid pro quo for universal service subsidies.").

[242] *See, e.g.*, Comments of COMPTEL, GC Docket No 09-51, at 9-10 (filed June 8, 2009) ("Any strategy for achieving maximum utilization of broadband infrastructure must include a requirement that incumbent LECs provide nondiscriminatory access to their broadband networks at wholesale rates to competing broadband service providers, competing Internet service providers and competing information service providers."); Reply Comments of Consumer Federation of America, Consumers Union, Free Press, Media Access Project, National Alliance for (continued....)

comment on the costs and benefits of such applying such policies in the universal service context. On the one hand, facilities-sharing arrangements could result in more efficient use of supported infrastructure.[243] Some parties, including PCIA – The Wireless Infrastructure Association, have suggested that providers share services or facilities with other providers.[244] Indeed, some, including AT&T and CTIA, have provided examples of successful sharing arrangements.[245] On the other hand, we recognize that mandating such policies could discourage participation in universal service programs or increase the costs to the Fund. We seek comment on the appropriate role of such policies in the USF context, if any, including how we might promote voluntary sharing arrangements.

149. We also seek comment on how USF can best achieve synergies with the connectivity objectives articulated for schools, libraries, and rural health care facilities in section 254.[246] Where build out is required to connect these particular types of community anchor institutions—for example, through the construction of lateral connections to regional fiber networks—should this construction be supported through the CAF, E-Rate, or Rural Health Care programs, individually or in combination? Would such a requirement complement or overlap any goals or requirements of those programs?[247] Should USF recipients have any obligations to serve anchor institutions, such as health care facilities or community centers, in the communities in which they serve residential customers?[248] On the one hand, we recognize

(Continued from previous page)

Media Arts + Culture, New America Foundation's Open Technolology Initiative, and Public Knowledge in re NBP Public Notice #30, GN Docket No. 09-51, at 4 (filed Jan. 27, 2010) (supporting "the reintroduction of some form of infrastructure sharing policies if competition does not emerge under current market trends."). *See Reply Comments Sought in Support of National Broadband Plan*, GN Docket Nos. 09-47, 09-51, 09-137, Public Notice, 25 FCC Rcd 241 (2010) (NBP PN #30).

[243] Health Network Group Organized by Internet2 Comments in re NBP PN #17, GN Docket No. 09-51, at 4-5 (filed Dec. 2, 2009). *See Comment Sought on Health Care Delivery Elements of National Broadband Plan*, GN Docket Nos. 09-47, 09-51, 09-137, WC Docket No. 02-60, 24 FCC Rcd 13728 (2009) (NBP PN #17)

[244] For example, in response to the *Mobility Fund NPRM*, PCIA recommended that the Commission encourage collocation of wireless antennas on existing infrastructure and require collocation opportunities on new structures constructed with Mobility Fund support "where feasible for the given deployment" to spur competitive entry in unserved markets. Comments of PCIA—The Wireless Infrastructure Association, WT Docket No. 10-208, at 4 (filed Dec. 16, 2010). Also in response to the *Mobility Fund NPRM*, MetroPCS Communications Inc. argued that Mobility Fund "recipients should be required to agree to provide data roaming over their Mobility Fund-enabled networks on just, reasonable and nondiscriminatory terms" and to "permit resale of their services on fair and reasonable prices." Comments of MetroPCS Communications Inc., WT Docket No. 10-208, at 14-15 (filed Dec. 16, 2010). *See also* Comments of Rural Internet and Broadband Policy Group, GN Docket No. 09-51, at 16 (filed June 8, 2009) (asserting that access, nondiscrimination, and infrastructure sharing "are especially important to boost competition in rural areas.").

[245] Comments of AT&T, GN Docket No. 09-51, at 45-46 (filed Nov. 4, 2009) (noting that "[t]here are many instances of competing or neighboring broadband service providers working together in consortia to lower their backhaul costs" and that "in many states ILECs have banded together in statewide consortia to construct and operate shared fiber rings"); Letter from Christopher Guttman-McCabe, Vice President, Regulatory Affairs, CTIA – The Wireless Association®, to Marlene H. Dortch, Secretary, FCC, GN Docket No. 09-51, at 18 (filed April 29, 2010) ("noting a strong trend of collocations involving multiple carriers sharing the same towers."); Comments of Sprint Nextel Corp., GN Docket Nos. 09-51, 157, at 43 (filed Sept. 30, 2009) (describing its own sharing arrangement and observing that "[s]haring the costly expenses associated with carrier-grade monitoring, diagnostic, and repair services reduces operating costs in rural, remote and underserved areas.").

[246] *See* 47 U.S.C. § 254(h); 47 C.F.R. §§ 54.501, 54.601.

[247] *See infra* para. 416 (seeking comment on whether to take into account the cumulative effect of the four USF disbursement programs).

[248] Community anchor institutions are large potential customers of broadband that could reduce broadband-related costs in unserved areas by aggregating demand, and could include institutions such as K-12 schools, community colleges, colleges and universities, town halls, federal and corporate research laboratories, libraries, museums, hospitals, and clinics. National Broadband Plan at 153-154. The American Telemedicine Association argues

(continued....)

the critical importance of ensuring adequate access to broadband infrastructure for community anchor institutions and recognize the value of specialized programs tailored to the unique needs of particular anchor institutions. On the other hand, splitting infrastructure and/or service funding among different programs that serve discrete types of institutions may forego potential efficiencies from aggregating funding for multi-use broadband networks.[249]

150. *Other Public Interest Obligations.* We seek comment on whether any additional public interest obligations should apply to USF recipients. To the extent broadband is not a supported service, should we nonetheless require recipients to market their broadband service, and if so, should we specify minimum requirements? Should recipients be required to provide customers with the option to subscribe to a basic broadband service on a stand-alone basis, without having to subscribe to voice or pay television services? Should the recipient be prohibited from requiring a term commitment or imposing an early termination penalty?[250]

151. We also seek comment on public interest requirements that should apply to carriers providing service on Tribal lands.[251] Should recipients be required to engage with Tribal governments to provide broadband to Tribal and Native community institutions? If so, should the requirements mirror those adopted in the general context? Should the Commission adopt tailored rules relating to broadband public interest obligations on Tribal lands, in consultation with Tribal governments, to ensure that broadband becomes widely available in ways that voice service has not? Are there additional requirements that should apply on Tribal lands?

152. *Evolution.* Above, we seek comment on periodically re-evaluating the broadband performance metrics. Here, we propose that we periodically re-evaluate the broadband public interest

(Continued from previous page)
against using rural health care funds for broadband network construction because a "community's needs are best met through a common infrastructure." *See* ATA RHC NPRM Comments at 3-5; *see also* Health Network Group Organized by Internet2 Comments in re NBP PN #17, filed Dec. 2, 2009, at 4-5 (suggesting that "the creation of independent special purpose networks . . . does not encourage the aggregation of services" and "does not consider the community needs such as economic development"); Letter from John Windhausen, Jr., Telepoly, to Marlene H. Dortch, FCC, GN Docket Nos. 09-191, 10-127, WC Docket No. 07-52 (filed July 27, 2010) (supporting anchor institutions having at least a 1 gigabit per second connection); National Broadband Plan at 10.

[249] Several parties have recommended that CAF recipients connect to community anchors institutions and to the national Research and Education networks. *See* Comments of Communications Workers of America (CWA), WC Docket Nos. 10-90, 05-337, GN Docket No. 09-51, at 4 (filed July 12, 2010); Comments of Internet2, WC Docket Nos. 10-90, 05-337, GN Docket No. 09-51, at 1-2 (filed July 12, 2010); Comments of National LambdaRail, WC Docket Nos. 10-90, 05-337, GN Docket No. 09-51, at 4 (July 12, 2010) (all recommending that); Health Network Group Organized by Internet2 Comments in re NBP PN #17, GN Docket No. 09-51, at 4-5 (filed Dec. 2, 2009). *See Comment Sought on Health Care Delivery Elements of National Broadband Plan*, GN Docket Nos. 09-47, 09-51, 09-137, WC Docket No. 02-60, 24 FCC Rcd 13728 (2009) (NBP PN #17). *See also supra* Section V.C. We also note that section 254(h)(1)(A)-(B) requires telecommunications carriers to provide service to qualifying rural health care providers and schools and libraries for qualifying purposes at rates reasonably comparable to urban rates (in the case of health care providers) and at a discounted amount that is "appropriate and necessary to ensure affordable access to and use of such services by such entities" (in the case of schools and libraries). 47 U.S.C. § 254(h)(1)(A)-(B).

[250] ETCs would continue to be subject to other Commission rules, as applicable. *See, e.g.*, 47 C.F.R. §§ 1.20000, *et seq.* (Communications Assistance for Law Enforcement Act (CALEA)), 47 C.F.R. §§ 8.1, *et seq.* (Preserving the Open Internet), 47 C.F.R. §§ 64.601 *et seq.* (Telecommunications Relay Services), and 47 C.F.R. §§ 64.3000, et seq. (E-911). We note that some commenters have suggested that compliance with the Commission's open Internet rules should be spelled out as a public interest obligation for USF recipients, and seek comment on this suggestion. *See, e.g.*, Letter from Matthew F. Wood, Associate Director, Media Access Project, to Marlene H. Dortch, Secretary, FCC, GN Docket No. 09-51, WC Docket Nos. 10-90, 05-337, 03-109, and WT Docket No. 10-208 (filed Feb. 1, 2011).

[251] *See supra* note 208.

obligations. Should public interest obligations be re-evaluated at the same time the Commission re-evaluates its definition of broadband, or less frequently? We seek comment on the effect that changing the obligations would have on program administration and on funding recipients. In light of changing technological developments and marketplace conditions, how can the Commission best ensure that public interest obligations remain useful and up to date, with minimal disruption to recipients' deployment plans? We acknowledge that the evolution of obligations will affect the support levels necessary to meet these obligations. We therefore propose the Commission re-examine funding levels each time it re-evaluates the public interest obligations. Are there other ways that the Commission could ensure that its public interest obligations provide meaningful standards on an ongoing basis?

153. *Remedies for Non-Compliance.* We seek comment on remedies for failure to meet any public interest obligations, including but not limited to loss of universal service funding and repayment of funds already disbursed. Pursuant to Commission rules and directives, USAC already has the authority to recover funds through its established processes in instances where an audit or investigation finds that a recipient failed to comply with high-cost program rules and requirements. We propose that USAC also recover funds through its normal processes in instances where an audit or investigation finds that a recipient has failed to comply with certain CAF program rules and requirements.[252] We seek comment on this proposal. Should states or the Commission establish additional penalties to be imposed on a recipient that fails to fulfill its public interest obligations in a geographic area?

154. *Waiver Process.* We note that some recipients may require more time to come into compliance with the obligations proposed here, whether because their unserved customers exhibit certain costs characteristics or because support amounts are not sufficient to deploy broadband-capable facilities as widely within their service areas. We propose to allow those carriers that are unable to meet a deployment schedule that we may adopt in the future to seek a waiver of the requirement from the Commission. We seek comment on this proposal and ask what the criteria should be for such a waiver.

155. *Role of States and Tribal Governments.* We seek comment on the role of states and Tribal governments in enforcing compliance with these federally defined public interest obligations. Should states be responsible for enforcement? If so, in states where the public utility commission does not have jurisdiction over broadband providers, should a different state agency be responsible for enforcement? Where will funding for any additional administration and enforcement come from? Because Tribal governments are not political subdivisions of states but are, instead, sovereign nations that share a trust relationship with the federal government, should they be required to coordinate enforcement actions with the federal government? If a state or Tribal government declines to enforce these obligations, or lacks the legal authority to do so, should the Commission itself be responsible for enforcing the obligations?

156. We also seek comment on whether states or Tribal governments may impose additional obligations on funded providers. If so, should the state or Tribe bear the costs associated with those obligations? Does the Commission have the authority to direct states or Tribal governments to impose and enforce additional obligations under existing precedent?[253] As providers transition to all-IP networks, with voice as an application on such networks, what will be the role of state commissions generally in

[252] *See* Letter from Dana R. Shaffer, FCC, to Scott Barash, USAC (Oct. 13, 2010), *available at* http://www.fcc.gov/omd/usac-letters/2010/101310CPA-USAC.pdf (re independent CPA firm and USAC's procedures for follow-up on audit findings and recommendations in USF program engagements) (Oct. 13, 2010 USAC Letter); Letter from Steven Van Roekel, FCC, to Scott Barash, USAC (Feb. 12, 2010), *available at* http://www.fcc.gov/omd/usac-letters/2010/021210-ipia.pdf (re implementation of the Improper Payments Information Act of 2002 (IPIA) assessment program and companion audit program) (Feb. 12, 2010 USAC Letter).

[253] *See* United States Telecom Assoc. v. FCC, 359 F.3d 554, 565 (D.C. Cir. 2004) (finding the Commission may not delegate decision-making authority to outside entities, as opposed to subordinates, absent affirmative evidence of authority to do so).

such matters as determining and enforcing COLR obligations for voice carriers, designating ETCs and monitoring their compliance with ETC voice obligations?

VI. NEAR-TERM REFORMS

157. Over time, we propose to transform the existing high-cost fund into the Connect America Fund. In the near term, we seek comment on a set of proposals to eliminate waste and inefficiency, improve incentives for rational investment and operation by companies operating in rural areas, and set rate-of-return companies on the path to incentive-based regulation. These reforms will also help ensure that the size of USF is controlled as it transitions from supporting telephone service to broadband.

158. As discussed in detail below, we seek comment on: (a) modifying high-cost loop support reimbursement percentages and eliminating loop support known as "safety net"; (b) eliminating local switching support as a separate funding mechanism; (c) eliminating the reimbursement of corporate operations expenses; (d) imposing reasonable caps on reimbursable capital and operating costs; and (e) capping total high-cost support at $3,000 per line per year. These reforms would commence in 2012, although they could be phased in over a period of time. These proposals are intended to ensure incentives for rate-of-return carriers to invest in and operate modern networks capable of delivering broadband as well as voice services, while eliminating excessive spending that may ultimately limit funding available to enable the provision of affordable services to consumers in other rural communities that remain unserved.

159. We also seek to encourage small companies to explore opportunities for joint management and operation so that they can continue to serve their communities and offer innovative services to meet consumer demand. We seek comment on measures to remove barriers to achieving efficiencies, specifically to streamline the study area waiver process and revise the "parent trap" rule which limits support upon acquiring lines of another company so as to provide additional support when a company acquires lines in areas that are unserved. We propose to implement both of these reforms in 2012.

160. In addition, beginning in 2012, we propose to eliminate IAS over a few years and rationalize competitive ETC support over five years, eliminating the identical support rule no later than 2016. We propose to re-direct this funding in two ways. In 2012 and potentially again in 2014, we propose to disburse a specific amount of money from the Connect America Fund that will bring broadband to unserved Americans. Through this first phase of the CAF program, we will test an approach that will provide a fixed amount of funding through a competitive process to companies that commit to deploying broadband in the area within three years. During this period, existing ETCs will continue to receive ongoing funding under the existing high-cost programs, subject to any rule changes we may make, as proposed below. As discussed in more detail below, we also propose to use some of the reclaimed IAS and competitive ETC support as part of revenue or cost recovery to help offset reductions in intercarrier compensation rates, particularly interstate access charges, if necessary.[254] We seek comment on these proposals, including on ways to implement these immediate reforms in a technology-neutral manner.

161. We conclude this discussion of near term reforms by seeking comment on measures to encourage state action and how to target funding to areas of greatest need.

A. Rationalizing Loop Support, Local Switching Support, and Interstate Common Line Support

162. In this section we seek comment on a number of proposals to rationalize the universal service mechanisms for rural and rate-of-return carriers. These mechanisms – HCLS, LSS, and ICLS – often do not provide incentives for controlling capital and operating costs. Moreover, support is not

[254] *See infra* Section XIV.

distributed among high-cost carriers in a way that maximizes overall consumer benefits across communities. In some areas, more support is provided than a carrier needs to achieve the goal of reasonably comparable services at rates that are affordable and reasonably comparable to those in urban areas, while in other areas carriers cannot afford to deploy modern networks. The intent of the proposals below is to provide us with additional tools to target funding more effectively to support universal service in areas served by the smaller telephone companies, while we consider longer term proposals to provide appropriate amounts of ongoing support for areas that are uneconomic to serve through the Connect America Fund. Considering such reforms is desirable even without the national imperative to advance broadband. Many of these rules have not been comprehensively examined in more than a decade, and prioritize funding in ways that may no longer make sense in today's marketplace.

163. We invite commenters to offer additional or alternative solutions or proposals to reform universal service support for rural and rate-of-return carriers, and request that any comments include detailed supporting analysis and data. We seek comment on the intersection of these proposals, both with each other, and the proposals for intercarrier compensation reform, below.[255] We recognize that some of the proposed rule changes could impact firms that receive public funding from other governmental agencies, such as RUS. To the extent these proposals in the aggregate would impact company cash flow to repay outstanding loans, how should we take that into account, while balancing our commitment to fiscal responsibility?

1. Background

164. *Regulatory Framework.* The current high-cost program consists of five separate primary funding mechanisms: (1) HCLS (with additional support available under safety net additive and safety valve), (2) high-cost model support (HCMS), (3) LSS, (4) ICLS, and (5) IAS. Companies receive support depending on whether they are classified as either "rural" or "non-rural" under the Commission's rules (rural companies receive high-cost loop support, while non-rural companies receive high-cost model support), how they are regulated at the interstate level (rate-of-return carriers receive ICLS, while price cap carriers receive IAS), and the size of the company's study area LSS.[256] In this section, we focus primarily on the three existing programs – HCLS, LSS and ICLS – that predominantly support rate-of-return carriers, but also price cap carriers to the extent that they receive HCLS or LSS.[257]

165. Rural carriers have fewer than 100,000 lines and serve predominantly rural areas.[258] Most, though not all, rural LECs are subject to rate-of-return regulation under Commission regulations. Our rules in practice provide a stable 11.25 percent return on certain expenditures by rate-of-return companies, regardless of their marketplace performance.[259] Rate-of-return carriers are, by total support, the largest category of high-cost universal service support recipients. In 2010, high-cost support was distributed to 1,150 rate-of-return study areas (owned by 754 holding companies) that received high-cost

[255] *See infra* Sections X-XIV.

[256] A small number of carriers that converted to price cap regulation relatively recently receive ICLS on a frozen, per-line basis, not IAS. *See, e.g., Windstream Petition for Conversion to Price Cap Regulation and for Limited Waiver Relief*, WC Docket No. 07-171, Order 23 FCC Rcd 5294, 5302-04, paras. 19-22 (2008) (*Windstream Price Cap Conversion Order*). The reforms proposed in this section apply to price cap carriers, including these recent price cap converts, only to the extent that they receive HCLS or LSS. For a discussion of proposed reforms to IAS and frozen ICLS for price cap carriers, *see infra* Sections VI.C and VI.D.

[257] *See supra* note 24. A small number of rural carriers that are price cap companies receive support through Interstate Access Support.

[258] 47. C.F.R. § 51.5 (adopting the 1996 Act's definition of "rural telephone company" for universal service purposes). Many rural areas are served by non-rural carriers – so classified because they serve too many lines to meet the definition of "rural carrier" – which often are also subject to price-cap regulation in the federal jurisdiction.

[259] In particular, rate-of-return companies have the opportunity to earn a rate of return of 11.25 percent on their regulated common line investment.

disbursements of approximately $2.0 billion for serving approximately 5.8 million lines.[260] As shown in Figure 6 below, on average, rate-of-return carriers received $348 in support per line annually, which is $29 in support per line per month.

Existing High-Cost Fund by Type of Regulation (2010 Actual Disbursements)

Regulation Type	Study Areas	Support (in millions)	Eligible Lines	Annual $ / Line	Monthly $ / line
Rate of Return	1,150	$2,016	5,783,801	$348.48	$29.04
Price-Cap Converts	105	387	4,536,242	$85.26	$7.11
Price-Cap	187	653	106,005,816	$6.16	$0.51
Total ILEC	1,442	$3,055	116,325,859	$26.26	$2.19
Price-Cap + Price-Cap Converts	292	$1,040	[illegible]	$5.40	$0.78

Source: USAC actual disbursements January – December 2010. Amounts shown reflect disbursements made on an accrual basis for all study areas for which USAC had line count information as of November 2011. Disbursements may include true-ups for earlier years, and disbursements for calendar year 2010 are subject to additional true-ups during future periods.
Note: "Price-Cap Converts" include several ILECs – primarily mid-size carriers – that chose to convert from rate-of-return regulation to price-cap regulation during the 2008 – 2010 time period.

Figure 6

166. Over time, aggregate high-cost support for rate-of-return carriers has increased, while such support for carriers that have chosen to move to price cap regulation has declined, as shown in the Figure 7 below.

[260] 2010 Disbursement Analysis (forthcoming); USAC High-Cost Disbursement Tool. This figure includes ICLS, HCLS, and LSS received by carriers that are subject to rate-of-return regulation. It does not include ICLS received by recent converts to price cap regulation or HCLS received by non-rural price cap carriers. A small number of rural LECs, and most larger carriers that do not meet the definition of a "rural telephone company," operate under price-cap regulation rather than rate-of return regulation. The price cap carriers (including several mid-size companies that recently converted from rate-of-return regulation) received approximately $1 billion for serving over 111 million eligible lines, or $0.78 per line per month. This includes $144 million in high-cost loop support received by rural price cap carriers.

Growth in High-Cost Fund by Type of Regulation 2006 – 2010 Actual
($ in millions)

Regulation Type	2006	2007	2008	2009	2010	Growth '06 - '10	CAGR '06 - '10
Rate of Return	$1,790	$1,834	$1,867	$1,931	$2,016	$226	
Growth		*2.5%*	*1.8%*	*3.4%*	*4.4%*	*12.6%*	*3.0%*
Price-Cap Converts	$489	$493	$414	$411	$387	($102)	
Growth		*0.7%*	*-16.1%*	*-0.6%*	*-5.9%*	*-20.9%*	*-5.7%*
Price Cap	$864	$785	$727	$676	$653	($212)	
Growth		*-9.2%*	*-7.4%*	*-7.0%*	*-3.4%*	*-24.5%*	*-6.8%*
Total ILEC	$3,143	$3,112	$3,008	$3,018	$3,055	($88)	
Growth		*-1.0%*	*-3.4%*	*0.3%*	*1.2%*	*-2.8%*	*-0.7%*

Note: "Price-Cap Converts" include several ILECs – primarily mid-size carriers – that recently converted from rate-of-return regulation to price-cap regulation during the 2008 – 2010 time period.
Source: 2006 – 2009 disbursements based on Universal Service Monitoring Report 2010. 2010 disbursement data based on USAC actual disbursements January – December 2010. Amounts shown may include true-ups for earlier years. Disbursements for calendar year 2010 are subject to additional true-ups during future periods.

Figure 7

167. HCLS helps offset the non-usage based costs associated with the local loop in areas where the cost to provide voice service exceeds 115% of the national average cost per line.[261] In effect, HCLS serves to shift some loop cost recovery from the intrastate jurisdiction, in which loop costs are recovered through local rates and intrastate access charges, to the interstate jurisdiction, to the federal universal service fund which provides explicit support for such costs.[262]

168. LSS allows incumbent LECs serving 50,000 access lines or fewer to allocate a higher portion of their switching costs to the interstate jurisdiction and recover those costs through the federal universal service fund.[263] Historically, the rationale for LSS was that mechanical switches were relatively expensive for the smallest of carriers because such switches were not easily scaled to the size of the

[261] "Loop costs" are the costs associated with providing the facilities between the carrier's switch, or central office, and the end user's premises. This includes not only the investment in copper loop or fiber cable, but the associated labor and maintenance costs and a share of overhead costs. Through the Commission's cost accounting rules, carriers assign costs to regulated and non-regulated activities, and the regulated costs are further assigned to functional categories, such as loop or switching. The regulated costs are further allocated between the intrastate and interstate jurisdictions. *See Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, Order, 25 FCC Rcd 6046, 6046-48, paras. 2-4 (2010). The terms "loop" and "common line" are often used interchangeably, but common line costs, as defined by Part 69 of the Commission's rules include other, non-loop costs such as general support facilities. *See, e.g.*, 47 C.F.R. § 69.307. As described in more detail below, *see infra* para. 176, carriers receive up to 75 percent of their loop costs above a certain cost threshold from HCLS. The remainder is recovered through the interstate jurisdiction and, specifically, ICLS to the extent their interstate common line revenue requirement exceeds their SLC revenues.

[262] *See* 47 C.F.R. §36.601(a).

[263] 47 C.F.R. § 36.125(f), (j). The precise amount of the extra allocation depends on a weighting factor determined by the number of access lines served by the incumbent LEC, with key thresholds established at 10,000, 20,000, and 50,000 lines. *See* 47 C.F.R. § 36.125(f).

carrier, and therefore required additional support from the federal jurisdiction. Smaller carriers continue to receive LSS even though modern switching technology is cheaper and more efficiently scaled to smaller service areas.[264] Qualification for LSS is solely based on the size of the incumbent LEC study area. For that reason, a large incumbent LEC holding company, such as CenturyLink, Frontier, Windstream, or Verizon, may receive LSS for a small study area.[265] Incumbent LECs do not have to meet a high-cost threshold to qualify for LSS.

169. ICLS helps rate-of return carriers, whether classified as "rural" or "non-rural," recover their interstate common line revenue requirements. The common line revenue requirements for carriers subject to rate-of-return regulation in the federal jurisdiction are equal to their regulated interstate-allocated expenses plus an 11.25 percent rate of return on investment. Carriers satisfy a portion of their common line revenue requirements by assessing customers a flat monthly fee called a SLC.[266] Because SLCs are capped, however, few if any rate-of-return carriers can recover sufficient revenues through SLCs alone. For this reason, rate-of-return carriers receive ICLS to recover any shortfall between their revenue requirement and their SLC revenues. Because ICLS is uncapped, increases in common line costs associated with upgrading and maintaining or operating modern networks, and declines in SLC revenues caused by line loss, both have the effect of increasing federal high-cost universal service support.

170. *Implications of our Regulatory Framework.* Rate-of-return carriers, on the whole, have made significant progress in extending high speed Internet access service in their territories, in part due to the operation of the Commission's "no barriers to advanced services" policy.[267] As shown in Figure 8 below, according to its 2010 survey, 75 percent of NTCA's predominantly rural member carriers reported offering Internet access service at speeds of 1.5 to 3.0 Mbps, up from 30 percent in 2005.[268]

[264] *See, e.g., 2008 Order and ICC/USF FNPRM*, 24 FCC Rcd at 6610-12, 6613-14 App. A, paras. 254-57, 260-61.

[265] *See* 2010 Disbursement Analysis (forthcoming); USAC High-Cost Disbursement Tool.

[266] Monthly SLCs are capped at the lesser of the average common line revenue requirement per line per month in a study area or $6.50 for residential and single line business customers (or $9.20 for multiline business customers).

[267] In the *Rural Task Force Order*, the Commission emphasized that modern telecommunications networks are not single-use networks and the Commission's universal service policies should not create barriers to the deployment of modern technology capable to providing access to advanced services. *Rural Task Force Order*, 16 FCC Rcd at 13211-12, paras. 199-200. As a result, carriers are permitted to recover high-cost universal service support for facilities capable of providing broadband data and video services when they are used to provide supported voice services. *Id.*

[268] NTCA 2010 Broadband/Internet Availability Survey Report, National Telecommunications Cooperative Association (Jan. 2011); NTCA 2009 Broadband/Internet Availability Survey Report, National Telecommunications Cooperative Association (November 2009); NTCA 2008 Broadband/Internet Availability Survey Report, National Telecommunications Cooperative Association (October 2008); NTCA 2007 Broadband/Internet Availability Survey Report, National Telecommunications Cooperative Association (September 2007); NTCA 2006 Broadband/Internet Availability Survey Report, National Telecommunications Cooperative Association (August 2006); NTCA 2005 Broadband/Internet Availability Survey Report, National Telecommunications Cooperative Association (September 2005) (NTCA broadband surveys available at http://www.ntca.org/index.php?option=com_content&view=article&id=3757&Itemid=240). We note that the NTCA survey refers only to service provided by NTCA members and does not reflect deployment of high speed Internet access by other providers serving the same areas as NTCA members. NTCA 2010 Broadband/Internet Availability Survey Report, National Telecommunications Cooperative Association (Jan. 2011).

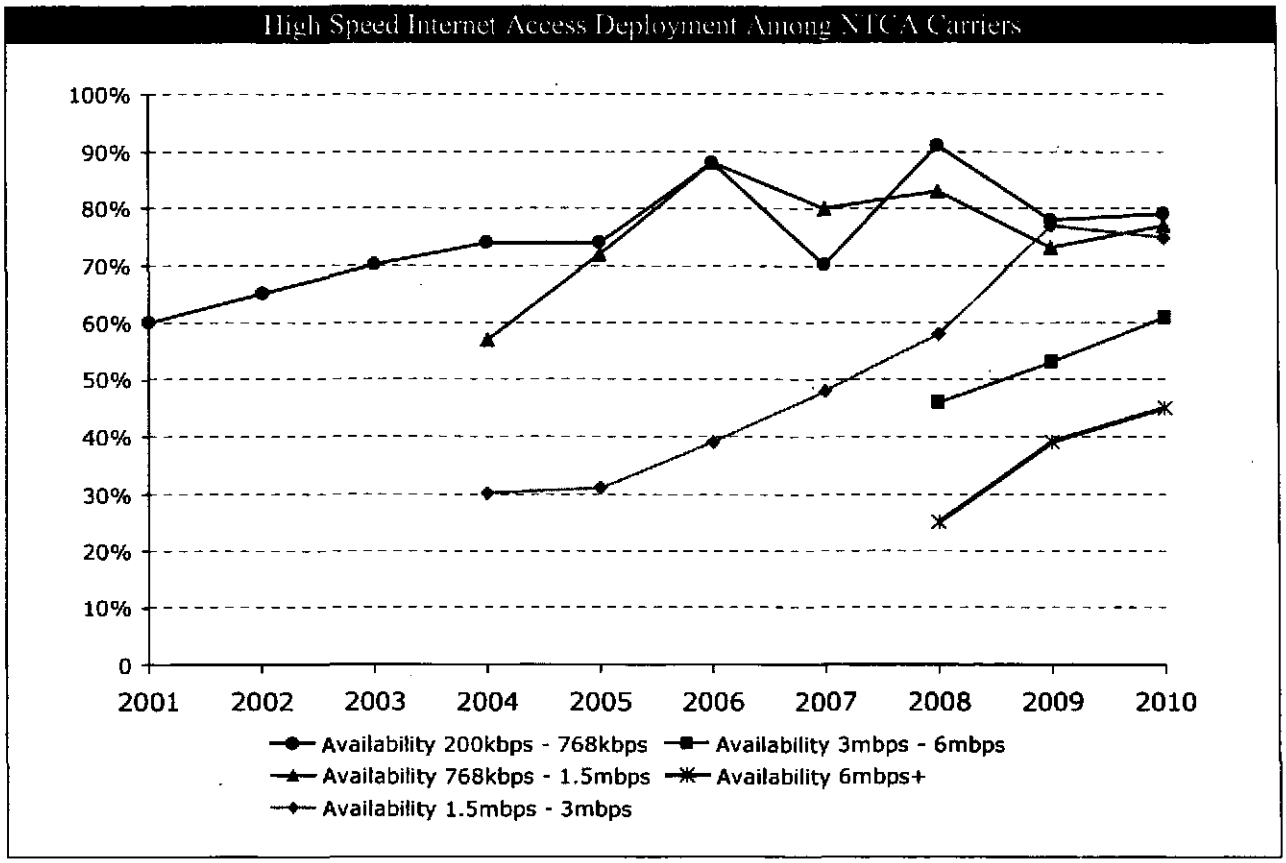

Figure 8

171. At the same time, our current high-cost universal service rules – combined with potential lack of clarity regarding what costs should be reimbursable for universal service purposes – may have the unintended effect of providing some carriers more support than is necessary to ensure reasonably comparable local voice service at reasonably comparable rates.[269] Moreover, our current "no barriers to advanced services" policy imposes no practical limits on the type or extent of network upgrades, so long as such networks continue to provide access to voice service. As such, incumbent companies are free to use high-cost support to deploy broadband networks to areas where there is an unsubsidized competitor, such as a cable company, as well as to areas where satellite service would be a significantly less expensive option. Companies also are free to accelerate network upgrades even where a more measured approach to capital investment might be appropriate, given the demographics of the customer base and rate of consumer adoption for new services. Absent any limits, the rate-of-return regulatory framework provides universal service support to both a well-run company operating as efficiently as possible given the geography and demography of its service area, and a company with high costs due to or exacerbated by imprudent investment decisions, bloated corporate overhead, or an inefficient operating structure.

172. In addition, our high-cost universal service rules may subsidize excessively low rates for consumers served by rural and rate-of-return carriers. One commenter notes that roughly 20 percent of the residential lines of small rate-of-return companies have monthly rates of $12 or less and another 22 percent have local rates between $12 and $15 per month, while the nationwide average urban rate is

[269] We discuss measures to strengthen oversight, including reporting requirements and internal controls, *infra* Section VIII.

$15.47 according to the most recent reference book of rates published by the FCC.[270] While individual consumers in those areas may benefit from such low rates, when a carrier uses universal service support to subsidize local rates well below those required by the Act, the carrier is spending universal service funds that could potentially be better deployed to the benefit of consumers elsewhere.

173. Although the costs of universal service are spread approximately equally among consumers across the nation, our current rules may not create the right incentives for individual companies. Given our current regulatory framework, those stakeholders who stand to benefit the most may, without realizing it, unfairly increase costs for other consumers. Though those carriers are often acting in the best interests of their customers and communities – and in a manner consistent with or even encouraged by our current rules – excessive spending in any one community may have the unintended consequence of limiting opportunities for consumers in other communities and therefore not be in the best interests of the country as a whole.

174. Below we propose several measures to control the total amount of support, including, among other things, eliminating or capping local switching support and capping total high-cost support on a per-line basis. We believe we have authority to impose such limits. Courts have consistently upheld Commission measures taken to control universal service costs, including caps on support.[271] Our "'broad discretion to provide sufficient universal service funding includes the decision to impose cost controls to avoid excessive expenditures that will detract from universal service.'"[272] We also have broad authority to adopt transitional rules as we move high-cost support to the CAF.[273] It is particularly appropriate for the Commission to craft a transition plan in this context, where we are acting to reconcile the "implicit tension between" the Act's goals of "moving toward cost-based rates and protecting universal service."[274] We seek comment on this issue.

2. Modification of High-Cost Loop Support

175. We propose to reduce the reimbursement percentages for high-cost loop support to promote more equitable distribution of limited HCLS funds. We also propose to eliminate the safety net additive component of high-cost loop support. We seek comment on these proposals.

176. As shown in Figure 9 below, HCLS is calculated, in part, based on a formula that allows carriers to recover a higher percentage of their costs from the interstate jurisdiction as their total (interstate and intrastate) study area cost per loop (SACPL) increases relative to the national average cost per loop (NACPL).[275]

---

[270] Letter from Brian J. Benison, AT&T, to Marlene H. Dortch, FCC, dated Feb. 23, 2010, CC Docket No. 01-92, WC Docket No. 05-337, GN Docket No. 09-51, at Attachment; 2008 Reference Book of Rates, at Table 1.1 (showing urban rates as of Oct. 15, 2007). In 2006, Verizon submitted rate data in the Qwest II Remand proceeding to support the argument that rural carriers charge, on average, 90 percent of the average urban rate and that many rural carriers charge less than that. Comments of Verizon, CC Docket No. 96-45, WC Docket No. 05-337, Declaration at 5 & Attachment B (filed Mar. 27, 2006).

[271] *See Rural Cellular*, 588 F.3d at 1108 ("the Commission acted reasonably by adopting a prophylactic tool it has used numerous times before to control USF growth"); *Alenco*, 201 F.3d at 620 (cap on high cost growth "reflects a reasonable balance between the Commission's mandate to ensure sufficient support for universal service and the need to combat wasteful spending").

[272] *Rural Cellular*, 588 F.3d at 1103 (quoting *Alenco*, 201 F.3d at 620-21).

[273] *See supra* Section IV.

[274] *Southwestern Bell Tel Co. v. FCC*, 153 F.3d 523, 538 (8th Cir. 1998).

[275] For example, most rural carriers receive support equal to 65 percent of costs in excess of 115 percent of the NACPL. If the NACPL is $100 and a carrier's costs are $120, it receives $3.25 in support: ($120 – ($100 * 115%)) * 65%. Those carriers receive support equal to 75 percent of their total costs in excess of the next threshold, (continued....)

High-Cost Loop Fund Formulas		
Study Area Size	**Cost Range as % of National Average**	**% Expense Adjustment Within Range**
< 200,000 loops	0 – 115%	0%
	115 – 150%	65%
	150% and above	75%
>200,000 loops	0 – 115%	0%
	115% - 160%	10%
	160% - 200%	30%
	200% - 250%	60%
	250% and above	75%

Figure 9

177. Total HCLS for incumbent LECs is subject to a cap, which is indexed to inflation plus line growth (or minus line loss, which has been the case in recent years). For 2008, 2009, 2010, and 2011, the indexed cap on high-cost loop support was $1.03 billion, $1.01 billion, $962 million, and $906 million, respectively. The cap operates by adjusting the NACPL used in calculating HCLS upward until the formula yields a total support amount for all incumbent rural carriers equal to the cap amount. As a result, even though the 2009 actual NACPL calculated based on data filed by all incumbent LECs is $423.15, an NACPL of $458.36 is used to calculate HCLS for 2011 because that is the level necessary to constrain HCLS within the cap.[276] This "ratcheting up" of the NACPL has the effect of concentrating HCLS among the carriers with the highest costs per loop, at the expense of carriers with high loop costs that nonetheless are relatively lower when compared to these highest cost carriers.

178. As discussed above, the current structure may provide inadequate incentive for high-cost loop support recipients, especially those operating 200,000 or fewer loops, to operate as efficiently as possible.[277] For example, as illustrated in Figure 10 below, data compiled by NECA shows that for most companies, total net plant has declined with access line loss. However, the investment trends for companies that in 2009 had a study area cost per loop (SACPL) greater than 150% of the NACPL were different from what may be expected.[278] Even as these companies experienced increasing rates of access line loss, their investment in net plant continued to increase. This may suggest that these companies continue to invest and upgrade their networks more than otherwise would be considered prudent for a company that is losing customers.

(Continued from previous page)
150 percent of the NACPL. HCLS is calculated based on the size and cost characteristics of an incumbent LEC's study area, not at the holding or operating company level. *See* 47 C.F.R. §§ 36.621, 631; *infra* para. 218.

[276] *See* National Exchange Carrier Assoc., Inc., NECA's Overview of Universal Service Fund, Submission of 2009 Study Results USF Filing Overview at 6 (filed Sep. 30, 2010) (NECA 2010 USF Overview Filing), *available at* http://www.fcc.gov/wcb/iatd/neca.html. Actual costs incurred during 2009 are used to calculate 2011 HCLS payments. In addition, the *Rural Task Force Order* "froze" the NACPL (notwithstanding the operation of the cap) at $240 per loop. *See Rural Task Force Order*, 16 FCC Rcd at 11268, para. 55. Due to the operation of the cap, however, the $240 frozen NACPL has never been used to actually calculate support.

[277] *See supra* paras. 171 and 176.

[278] *See* National Exchange Carrier Assoc., Inc., Universal Service Fund Data: NECA Study Results, 1999 Report through 2008 Report, http://www.fcc.gov/wcb/iatd/neca.html. Staff analysis based on trends in Net Plant and Total Loops using NECA Universal Service Fund Data Reports from 1999-2008. Analysis is limited to cost company study areas in existence throughout the entire 10 year period, excluding study areas owned by Regional Bell Operating Companies, and does not fully account for changes in study areas due to mergers and acquisitions. Study areas are grouped based on their SACPL relative to the NACPL as reported in the 2008 Report.

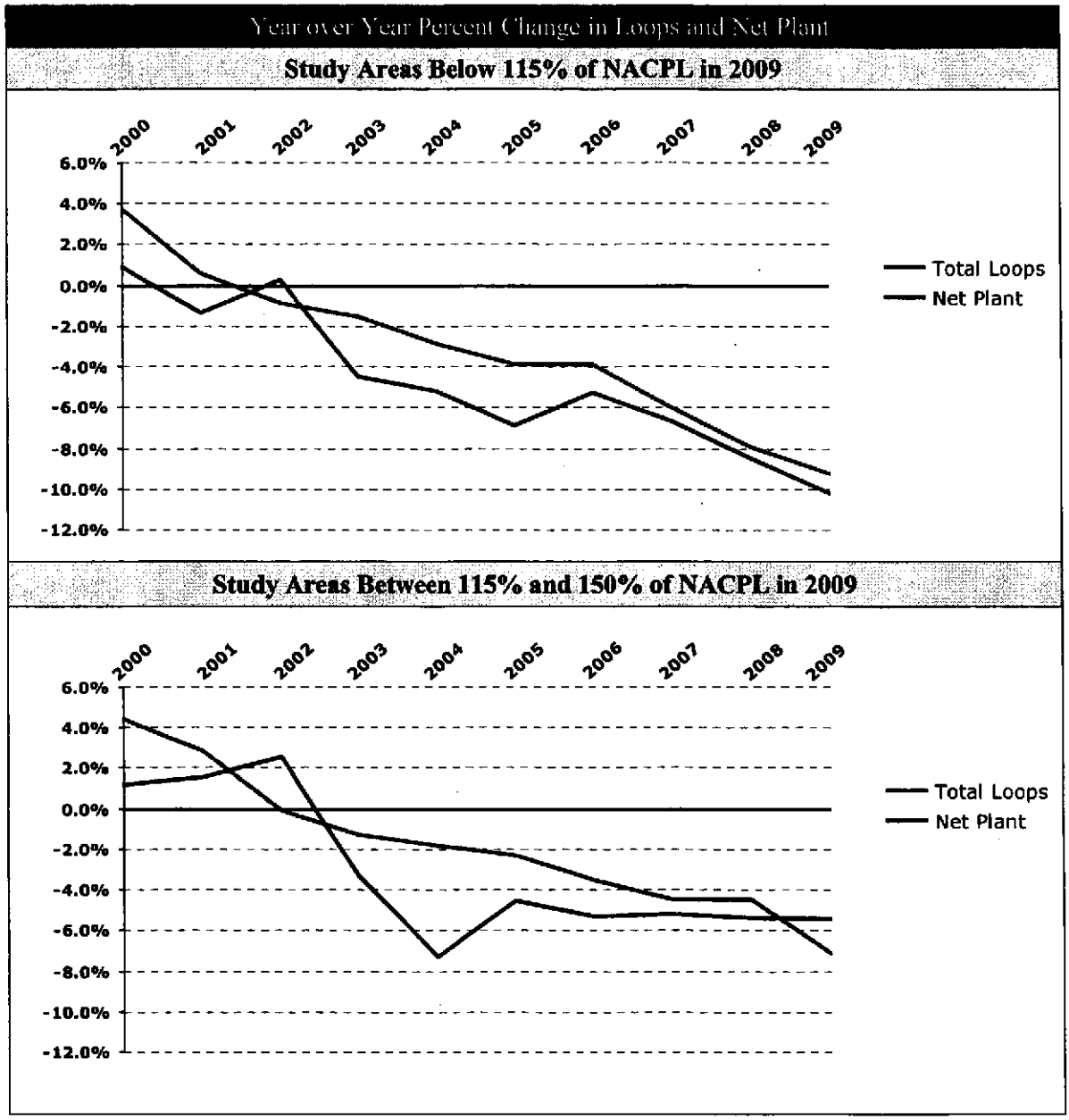
Year over Year Percent Change in Loops and Net Plant
Study Areas Below 115% of NACPL in 2009
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
-10.0%
-12.0%
Total Loops
Net Plant
Study Areas Between 115% and 150% of NACPL in 2009
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
-10.0%
-12.0%
Total Loops
Net Plant

Figure 10

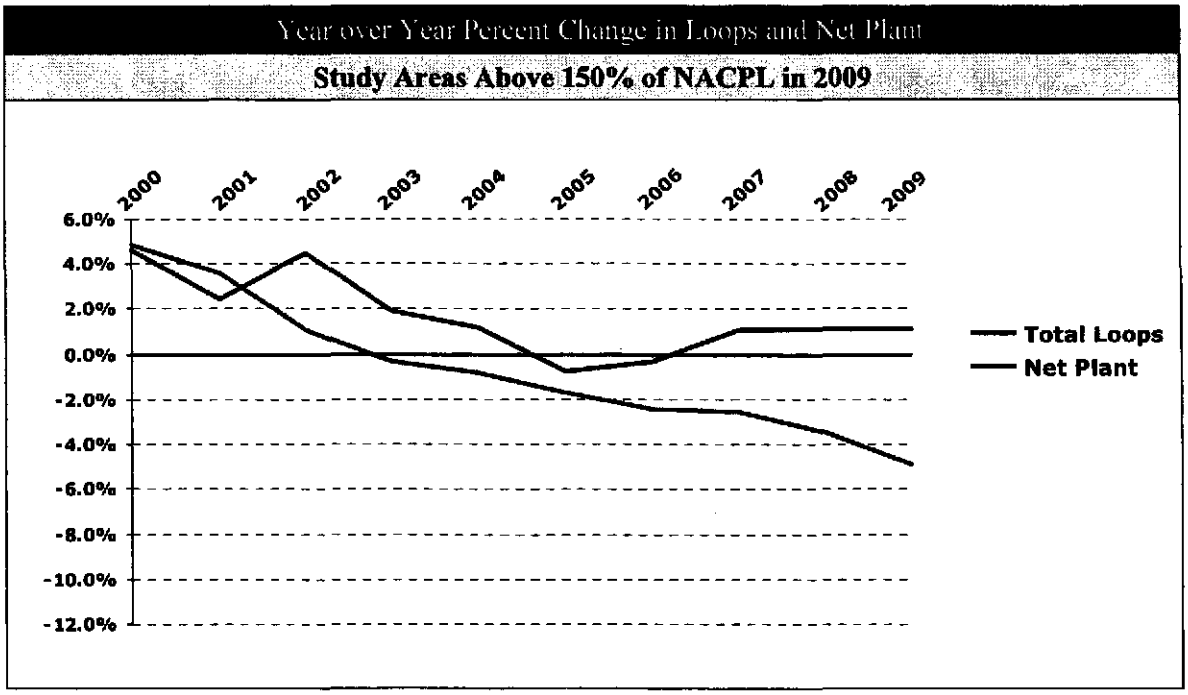

Figure 10 (cont.)

179. As noted above, because of the operation of an indexed cap on HCLS, total available HCLS support has decreased in recent years due to the decline in access lines.[279] As a result, each year, lesser total support must be spread among the qualifying carriers. The existing cap on HCLS and rules for determining support has been sometimes referred to as a "race to the top," i.e., giving some carriers an incentive to outspend their neighbors to maintain high-cost support. The net result of our existing HCLS rules is to concentrate support among a subset of rural carriers with very high costs and to reduce support to other rural carriers whose costs may be only modestly lower. For instance, in 2007, the cap-adjusted NACPL was $344 and 1,115 rate-of-return companies qualified for HCLS, with 725 companies having costs in excess of the 150 percent benchmark.[280] By 2010, the NACPL had grown to $424 and only 1,066 rate-of-return companies qualified for HCLS, with 581 companies having costs in excess of the 150 percent benchmark.[281] Moreover, in 2007, 50 percent of HCLS was claimed by the 340 incumbent LECs with the highest costs per loop, but for 2010, 50 percent of HCLS is concentrated among only 288 incumbent LECs with the highest costs per loop.[282] Figure 11 below depicts how HCLS has been

[279] Total rural high-cost loop support each year is limited to the previous year's support increased by the sum of Gross Domestic Product-Chained Price Index plus the percentage change in the total number of rural incumbent local exchange carrier working loops during the previous calendar year. *See* 47 C.F.R. §§ 36.603(a), 36.604. *See* NECA 2010 USF Overview Filing); NECA 2009 USF-Overview; NECA 2008 USF Overview.

[280] *See* National Exchange Carrier Assoc., Inc., Universal Service Fund Data: NECA Study Results, 2009 Report (filed Sept. 30, 2010) (NECA 2010 USF Data Filing), http://www.fcc.gov/wcb/iatd/neca.html. 2011 support is based on 2009 cost data, filed on October 1, 2010. This submission includes data for the current year plus the previous four years.

[281] *See* NECA 2010 USF Data Filing.

[282] *See id.*

concentrated among fewer incumbent LECs from 2007 to 2010 and that because of the escalating NACPL, a smaller number of carriers have costs per loop in excess of 150% of the NACPL.[283]

Concentration of Declining High-Cost Loop Support Among Fewer Incumbent Carriers, 2007 to 2010				
Payment Year	HCLS Cap (in millions)	No. of LECs receiving HCLS	No. of LECs with highest costs receiving half of available HCLS support	No. of LECs with costs per loop greater than 150% of NACPL
2007	$1,050	1,115	340	725
2008	$1,034	1,112	324	701
2009	$1,007	1,106	308	614
2010	$962	1,066	288	581

Figure 11

180. To facilitate more equitable distribution of limited HCLS funds among rural carriers and to increase incentives for carriers to operate efficiently, we propose to decrease the current 65% and 75% support percentages, for incumbent LECs operating 200,000 or fewer loops, to 55% and 65%, respectively. Such incumbent LECs would be eligible for 55% reimbursement at 115% of the NACPL and support would increase to 65% when the average cost per loop is 150% or higher than the NACPL. Because rural LECs also recover 25% of their loop costs from the federal jurisdiction (through SLCs and ICLS), rural LECs would still receive between 80% and 90% reimbursement of costs in excess of 115% of the NACPL from the federal jurisdiction with this modification to high-cost loop support.[284] A reduction in the reimbursement percentages, even a modest reduction as proposed, may encourage incumbent LECs to invest and expend funds more efficiently and effectively, without jeopardizing universal service. We seek comment on this proposal.

181. For those rural carriers that have more than 200,000 working loops, the current reimbursement percentages are 10% when the carrier's cost per loop exceeds 115% of the NACPL, 30% at 160%, 60% at 200%, and 75% at 250%.[285] We note, however, that no rural incumbent LEC with more than 200,000 working loops currently qualifies to receive HCLS based on actual costs.[286] We also propose that the Commission's rule for providing HCLS to carriers with more than 200,000 working loops be eliminated because there are only five rural incumbent LECs with more than 200,000 working loops and all five incumbent LECs have costs per loop that are well below the NACPL.[287] We seek comment on this proposal. We also seek comment on whether the 200,000 threshold for providing support to rural incumbent study areas should be lower and, if so, what the appropriate threshold should be.

[283] Staff analysis of NECA 2010 USF Data Filing. This analysis includes both cost-based and average schedule incumbent LECs.

[284] Carriers would receive between 80% and 90% reimbursement of costs by the combination of recovering 55% or 65% from HCLS and the 25% assignment of loop costs to the federal jurisdiction by jurisdictional separation process. *See* 47 C.F.R. § 36.154(c).

[285] 47 C.F.R. § 36.631(d).

[286] Windstream Communications, a rural incumbent LEC that operates in Texas, receives frozen per-line HCLS support pursuant to section 54.305 of the Commission's rules due to a purchase of former GTE lines in Texas. *See* NECA 2010 USF Data Filing.

[287] *See* NECA 2010 USF Data Filing.

182. Finally, we note that these proposals would not affect the relative balance of cost recovery from the interstate and intrastate jurisdictions at an aggregate level as we expect the effect to spread federal support from a smaller number of carriers to a larger number of carriers. However, to the extent federal support would be lower for some carriers in particular instances, that could create the need for increased state support or higher intrastate rates. Any increased intrastate rates may have to be addressed in connection with our intercarrier compensation reforms discussed later in this Notice.[288] We invite parties to comment on the extent of this potential shift, the effect it will have on the evaluation of the transition and revenue recovery mechanisms identified in connection with intercarrier compensation reform, and any measures that might be available to mitigate those effects.

183. In 2001, as part of the Rural Task Force proceeding, the Commission adopted a rule known as the "safety net additive" with the intent of providing additional support to rural incumbent LECs who make additional significant investments in years where high-cost loop support is capped.[289] The safety net additive provides additional loop support if the incumbent LEC realizes growth in year-end telecommunications plant in service (TPIS) (as prescribed in section 32.2001 of the Commission's rules) on a per-line basis of at least 14 percent more than the study area's TPIS per-line investment at the end of the prior period.[290] Essentially, the safety net additive was designed for an incumbent LEC to receive support above its capped support amount for incremental additional investment.[291] Once an incumbent LEC qualifies for such support, it receives such support for the qualifying year plus the four subsequent years.[292]

184. From 2003 to 2010, the safety net additive has increased significantly from $9.1 million to $78.9 million.[293] It is projected to be $90.1 million for 2011, an increase of almost ten-fold in nine years.[294] Aggregate safety net additive support is not capped. We are concerned that this rule may provide inadequate incentives for rural incumbent LECs to operate efficiently and that the rule's design leads to additional support in situations where no additional investment is occurring. Specifically, some incumbent LECs that qualify for the safety net additive are not qualifying as a result of significant increases in investment. To qualify for the safety net additive, an incumbent LECs year-over-year TPIS, *on a per-line basis*, must increase by a minimum of 14 percent. If an incumbent LEC loses a significant number of lines, however, its per-line TPIS may meet the 14 percent threshold because of the loss of lines

[288] *See infra* para. 490.

[289] 47 C.F.R. § 36.605. The safety net additive was adopted based on the recommendation of the Rural Task Force. *See Rural Task Force Order*, 16 FCC Rcd at 11276-81, paras. 77-90.

[290] *See* 47 C.F.R. §§ 36.605(c) and 32.2001.

[291] Specifically, the safety net additive is equal to the amount of capped high-cost loop support in the qualifying year minus the amount of support in the year prior to qualifying for support subtracted from the difference between the uncapped expense adjustment for the study area in the qualifying year minus the uncapped expense adjustment in the year prior to qualifying for support as shown in the by the following equation: Safety net additive support = (Uncapped support in the qualifying year–Uncapped support in the base year)–(Capped support in the qualifying year–Amount of support received in the base year). 47 C.F.R. § 36.605(b).

[292] For the four subsequent years, the safety net additive is the lesser of the sum of capped support and the safety net additive support received in the qualifying year or the rural telephone company's uncapped support. *See* 47 C.F.R. § 36.605(c)(3)(ii).

[293] *See* 2010 Universal Service Monitoring Report at Table 3.7.

[294] *See* Universal Service Administrative Company, Quarterly Administrative Filings for 2011, Second Quarter (2Q), Appendices at HC01 (filed Jan. 31, 2011) (USAC 2Q 2011 Filing), http://www.usac.org/about/governance/fcc-filings/2011/.

and not because of significant increases in investment, contrary to the original intent of the rule to provide additional funding only for new investment.[295]

185. For these reasons, we propose to eliminate the safety net additive. We seek comment on this proposal. Should we eliminate the safety net additive immediately, or implement a phase-down over a period of years, such as three years?

3. Local Switching Support

186. We propose to eliminate local switching support,[296] or in the alternative, to combine this program with high-cost loop support.

187. Historically, the rationale for LSS was that traditional circuit switches, which were based on specialized hardware, were relatively expensive for the smallest of carriers because such switches were not easily scaled to the size of the carrier, and therefore required additional support from the federal jurisdiction. LSS was created to ensure that small companies would be able to buy large, expensive hardware-based switches. In recent years, however, telecommunications technology has been evolving from circuit-switched to an IP-based environment and many smaller rate-of-return carriers are purchasing soft switches.[297] Soft switches and routers tend to be cheaper and more efficiently scaled to smaller operating sizes than the specialized hardware-based switches that predominated when LSS was created.[298] For that reason, the size-based eligibility for LSS may be inappropriate in an IP-based environment where switching platforms may be shared among non-contiguous properties.

188. LSS provides funding for study areas with 50,000 or fewer access lines, but in some instances, the incumbent LECs that receive LSS serve multiple study areas and much more than 50,000 access lines in total. There are 94 telephone holding companies today that receive local switching support for more than one study area in a given state.[299] For example, in Wisconsin, one carrier provides telephone service to approximately 137,000 lines in 21 separate study areas. The line counts for those 21 study areas range from a low of 1,073 to a high of 30,430 and received disbursements totaling $2.6 million in LSS for 2010.[300] Similarly, another carrier in Wisconsin serves 17 study areas, 14 of which have less than 50,000 lines each, with approximately 174,000 of its lines in those 14 separate study areas. The line counts for those 14 study areas range from a low of 1,042 to a high of 45,374 and received disbursements totaling $2.8 million in LSS for 2010.[301] In each instance, because the company chooses to

---

[295] For example, we are aware of an incumbent LEC that will receive approximately $6.4 million in safety net additive during 2011 (the highest among any incumbent LEC), even though its total annual year-end TPIS has increased only in the range of between 5% and 9% over the past five years. That carrier, however, has lost approximately 8% of its lines in each of the past two years and 18% of its lines over the past five years. Additionally, its cost per loop is well below the HCLS qualifying threshold and therefore does not qualify for HCLS. *See* USAC 2Q 2011 filing, Appendices at HC01; NECA 2010 USF Data Filing.

[296] *See* 47 C.F.R. § 54.301.

[297] *See, e.g., 2008 Order and ICC/USF FNPRM*, 24 FCC Rcd at 6610-12, 6613-14 App. A, paras. 254-57, 260-61.

[298] *Id.* A soft switch connects calls by means of software running on a computer system. In such configurations the "switching" is virtual because the actual path through the electronics is based on signaling and database information rather than a physical pair of wires. Soft switches are economically desirable because they offer significant savings in procurement, development, and maintenance. Such devices feature vastly improved economies of scale compared to switches based on specialized hardware. *Id.*; *see also infra* para. 506 (noting that the current intercarrier compensation regime creates the perverse incentive to maintain and invest in legacy, circuit-switched-based networks).

[299] Staff analysis of Universal Service Administrative Company, Quarterly Administrative Filings for 2011, First Quarter (1Q) (filed Nov. 2, 2010) (USAC 1Q 2011 Filing), Appendices at HC08; NECA 2010 USF Data Filing.

[300] 2010 Disbursement Analysis (forthcoming); USAC High-Cost Disbursement Tool.

[301] *Id.*

operate through multiple study areas in the state, it is eligible for LSS; if it were required to report its costs at the holding company level in a given state, it would not be eligible for LSS at all.

189. The LSS rule provides support without any high-cost qualifying threshold, i.e., the only qualification is that incumbent LEC study areas have less than 50,000 lines, even when those companies are using scalable switching technology and/or are part of a much bigger holding company. As a result, in 2010, four of the largest carriers in the country received millions (and in some cases tens of millions) of dollars in local switching support because they have some small study areas. These four carriers received $16.2 million (7.3 million lines), $14 million (6.6 million lines), $12.6 million (557,847 lines), and $9.4 million (2.9 million lines) each in local switching support during 2010.[302]

190. LSS in its current form may not appropriately target funding to high-cost areas, nor does it target funding to areas that are unserved with broadband. For these reasons, we propose to eliminate LSS and utilize those savings to direct support through the CAF to areas that are unserved. We seek comment on this proposal. Should we eliminate LSS immediately, in one year, or implement a transition over a period of years, such as three years? Should we eliminate LSS more quickly, i.e., immediately in 2012, for companies that have more than a specified number of lines, such as 50,000, at the holding company level? What impact would this proposal have on interstate access charges (if we make no changes to our access charge rules) or local rates? If we were to eliminate LSS, do we need to allow existing recipients an opportunity to recover sunk costs associated with their past investment in switches? In this regard, we request that current local switching support recipients provide information on the types of switching equipment currently employed, including dates placed in service, and information on the remaining depreciable life of such equipment.

191. Alternatively, we propose to combine LSS and HCLS into one high-cost mechanism that recognizes support should flow to areas with above-average costs. Merging these two support mechanisms into one may be more appropriate as telecommunications network architecture evolves toward an all-IP environment; indeed, the distinction between certain switching and loop equipment has blurred over the years due to the evolution of telecommunications technology. Combining these two high-cost mechanisms could reduce the incentives for carriers to design network architecture or to classify equipment in a particular way merely to maximize high-cost support.[303] This distinction is important because a remote switch is eligible for support under the LSS rules, while a remote terminal of a concentrator is eligible for support under the HCLS rules.[304]

192. Finally, merging of LSS and HCLS into one program may also remove the incentive for carriers not to merge study areas within the same state. The current LSS rules reward incumbent LECs for maintaining small study areas in a state, even in situations where they have other operations in the state, by allowing additional recovery of costs from the interstate jurisdiction. Combining LSS with HCLS may encourage carriers to gain the efficiencies of scale by merging operations with other small

[302] Sept. 2010 Trends in Telephone Service, at Table 7.3.

[303] In 1992, the Bureau issued a Responsible Accounting Officer Letter 21 (RAO 21) to define how to differentiate between remote switching equipment and remote terminals of a concentrator. *See Responsible Accounting Officer Letter 21*, Classification of Remote Central Office Equipment for Accounting Purposes, 7 FCC Rcd 6075 (1992) (*RAO 21*); *see also* Letter from Albert M. Lewis, Chief, Pricing Policy Division, Wireline Competition Bureau to John T. Nakahata, Counsel for Aztek Network, 24 FCC Rcd 2945 (2009) (clarifying that "the installation of emergency standalone routing capability at a terminal classified as a remote concentrator prior to installation of such capability shall not alter the classification of that terminal or location as a remote terminal of a concentrator, provided that the router does not routinely perform the interconnection function locally.").

[304] The Bureau issued RAO 21 in part to address a concern that some carriers were improperly classifying remote switches as loop circuit equipment rather than as switching equipment, which would result in greater amounts of HCLS. *See RAO 21* at 1.

rural study areas, because there no longer would be an advantage to keeping the two study areas separate to maximize LSS receipts.[305]

193. Under this alternative proposal to revise the Commission's rules to combine local switching costs with loop costs into one high-cost loop and switching support mechanism known as local high-cost support (LHCS), LHCS would be calculated in a similar manner to HCLS, where incumbent LECs would qualify if their LHCS cost per loop exceeds the national average cost per loop by 115%. HCLS is currently capped, while LSS is not capped. We propose to establish a cap for the new LHCS as the sum of the current cap on HCLS in the year of implementation of the proposed rule change, plus total LSS support paid during the calendar year prior to the implementation of LHCS. In the alternative, should the new LHCS cap be the sum of the current cap on HCLS in the year of implementation of the proposed rule change and the amount of LSS received in the prior year by companies with 50,000 or fewer lines at the holding company level, with the remaining funds, not incorporated into LHCS, folded into the CAF? This reformed support mechanism would be subject to whatever other rule changes we adopt as proposed in this Notice, such as the proposal to impose benchmarks on allowable expenses, the proposal to reduce the reimbursement percentages, and the overall limitation on total support per line. We propose to index the LHCS cap using the rural growth factor as is currently used for HCLS.[306] We seek comment on these proposals. What impact, if any, would these proposals have on rates for local service or interstate access charges?[307]

4. Corporate Operations Expenses

194. We propose to reduce or eliminate universal service support for corporate overhead expenses.

195. Corporate operations expenses are general and administrative expenses, sometimes referred to as overhead expense.[308] More specifically, corporate operations expense includes expenses for overall administration and management, accounting and financial services, legal services, and public relations.

196. Corporate operations expenses are currently eligible for recovery through HCLS, LSS, and ICLS,[309] although for many years the Commission has limited the amount of recovery for these expenses through HCLS (but not through LSS and ICLS).[310] We estimate that approximately $117 million or 13% of HCLS support during 2011 is for corporate operations expenses.[311]

197. In the *Universal Service First Report and Order*, the Commission agreed with commenters that these expenses do not appear to result from costs inherent in providing telecommunications services, but rather may result from managerial priorities and discretionary spending.[312] As a result, the Commission limited the amount of corporate operations expense that could be recovered from HCLS to help ensure that carriers use such support only to offer better service to their customers through prudent facility investment and maintenance consistent with their obligations under section 254(k).[313] Section 36.621(a)(4) of the Commission's current rules specifies the limits on the

[305] *See supra* para. 189.

[306] 47 C.F.R. § 36.604.

[307] *See infra* para. 557 (seeking comment on the need to cap interstate access rates).

[308] 47 C.F.R. § 32.6720.

[309] 47 C.F.R. §§ 36.611(e), 54.301, and 54.901.

[310] 47 C.F.R. § 36.611(e).

[311] Staff analysis of NECA 2010 USF Data Filing.

[312] *See Universal Service First Report and Order*, 12 FCC Rcd at 8930, para. 283.

[313] *See id.* at 12 FCC Rcd at 8930, para. 283.

amount of corporate operations expense that may be recovered from HCLS.[314] Holding companies with multiple operating companies in different study areas allocate their overhead costs among their study areas. This creates incentives for such holding companies to arbitrarily allocate overhead to avoid the corporate operations expense limitations for HCLS.

198. To focus finite universal service funds more directly on investments in network build-out, maintenance, and upgrades, we propose to eliminate the eligibility for recovery of corporate operations expenses through HCLS, LSS, and ICLS. We seek comment on this proposal. We also seek comment on alternatives to outright elimination of corporate operations expense as eligible for recovery, such as limiting the amount of corporate operations expenses eligible for recovery at the holding company level, rather than at the study area level. Such a proposal could eliminate potential gamesmanship in the allocation of such expenses among commonly-owned study areas. We also seek comment on whether there is any basis to permit recovery of such expenses for one program as opposed to another.

199. Through operation of the indexed cap on HCLS, the overall amount of HCLS available to carriers has decreased in recent years from $1.01 billion in 2009 to $906 million for 2011 due to the decline in access lines.[315] As a result, each year, fewer dollars must be spread among qualifying carriers. Reduction or elimination of corporate operations expense as an eligible expense for purposes of high-cost loop support would enable more targeted and efficient use of these limited funds. First, it would reduce the overall pressure for high-cost loop funds at the indexed cap. Second, it would result in more funds being made available under the cap for direct support of investment and maintenance of facilities, without changing the overall amount of HCLS.[316]

200. With respect to LSS, we seek comment on the effect of reducing or eliminating corporate operations expense as an eligible expense and whether that would have a material effect on current recipients. Regarding ICLS, we seek comment on the effect on interstate rates or carriers' opportunity to earn the authorized interstate rate-of-return if corporate operations expense is reduced or eliminated as an eligible expense for ICLS. Finally, should we reduce or eliminate the recovery of corporate operations expense in one year, or implement a transition over a period of years, such as three years?

5. Limits on Reimbursable Operating and Capital Costs

201. We propose to establish benchmarks for reimbursable operating and capital costs for rate-of-return companies. Our proposal is based significantly on analysis submitted by the Nebraska Rural Independent Companies.[317]

202. Currently, rural rate-of-return carriers with high loop costs may have up to 100 percent of their marginal loop costs above a certain threshold reimbursed from the federal universal service fund. This produces two interrelated effects. First, carriers with high costs may further increase their loop costs

[314] The Commission's rules limit corporate operations expense to a monthly per-line amount developed from a statistical study of data submitted by NECA in its annual filing. 47 C.F.R § 36.621(a)(4). Incumbent LECs with less than 6,000 lines are allowed monthly corporate operations expense as much as $50,000 divided by the number of access lines. 47 C.F.R § 36.621(a)(4)(ii)(A). For example, for 2009 operating results, one incumbent telephone company with only 19 access lines, will be claiming $587 in corporate operations expense per-line per month for purposes of calculating 2011 high-cost loop support. *See* NECA 2010 USF Data Filing. In other words, USF is subsidizing the majority of the nearly $600 dollars in overhead per customer every month.

[315] *See* Universal Service Fund, 2008 Submission of 2007 Data Collection Study Results by the National Exchange Carrier Association, Inc. (Sep. 30, 2008); NECA 2010 USF Data Filing.

[316] Even though our proposal eliminates the eligibility of corporate operations expense for high-cost loop support, it is unlikely that, due to the operation of the indexed cap, total high-cost loop support would decrease.

[317] *See* Letter from Thomas Moorman, Counsel to Nebraska Rural Independent Companies, to Marlene H. Dortch, FCC, WC Docket Nos. 10-90, 05-337, GN Docket No. 09-51, Attachment (dated Jan. 7, 2011) (Nebraska Rural Independent Companies Study).

and recover the marginal amount entirely from USF, rather than from their customers. Second, carriers that take measures to cut their costs to operate more efficiently may actually lose support to carriers that increase their costs. These two effects may lessen incentives for some carriers to control costs and invest rationally. It also shifts the responsibility of supporting these high-cost carriers to the federal jurisdiction, and ultimately to consumers across the country.

203. We propose to address these shortcomings in our current rules by capping the amount of operating expenses (opex) and capital expenses (capex) that are reimbursable for universal service purposes at specified levels that will allow ongoing, reasonable investment consistent with section 254. Opex and capex amounts above the cap would be ineligible for reimbursement through universal service. Because opex and capex have different drivers of cost, caps on each would need to be based on separate analyses.[318] Specifically, we propose to use regression analyses to estimate appropriate levels of opex and capex for each incumbent study area. Drivers of capex likely include factors such as density (area density, e.g., homes per square mile; or linear density, e.g., homes per linear road mile), topography, and soil type.[319] Drivers of opex could include such line items as staff salaries, rent, and power costs. From a modeling perspective, we could parameterize these costs in terms of quantities more easily modeled or captured in data, such as plant investment (more plant investment being indicative of, for example, more employees to operate and maintain operations) or the number of subscribers (e.g., as an indicator of billing and customer care costs). In each case, the actual variables used and their weights would be determined by standard statistical techniques. Given sufficient source data, we could potentially create different regressions for operators of different size to capture scale effects.[320]

204. Under this proposal, a carrier would only be eligible for reimbursement from the HCLS and ICLS mechanisms for capex and opex at or below a specified threshold. This proposal would establish clear standards that could be evaluated in the context of compliance audits and other ongoing Commission oversight.[321] We seek comment on this proposal. It would also provide regulatory clarity regarding appropriate expenses and investment, and enable companies to plan ahead for longer-term investment. We note that under such a proposal, the Commission would retain the authority to conclude

[318] *See* Omnibus Broadband Initiative, The Broadband Availability Gap: OBI Technical Paper No. 1, at 96 (April 2010) (OBI, Broadband Availability Gap); OBI; Broadband Assessment Model, Documentation, at 22-34; *both available at* http://www.broadband.gov/plan/broadband-working-reports-technical-papers.html; *see also* Nebraska Rural Independent Companies Study.

[319] *See* Nebraska Rural Independent Companies Study. We note that Nebraska has successfully implemented a state universal service fund that relies significantly on household density to determine support. *See* Nebraska Rural Independent Companies July 12, 2010 Comments, at Attachment B.

[320] Indeed, many rate-of-return carriers already effectively receive support based on a similar regression analysis under the Commission's average schedule rules, although we do not propose to use that methodology here. The National Exchange Carrier Association (NECA) is an association that allows rate-of-return carriers to pool costs and revenues for the purpose of filing common tariffs. Pursuant to sections 36.611, 36.612, and 36.613 of the Commission's rules, NECA also has responsibility for collecting loop cost data from all LECs and calculating HCLS. 47 C.F.R. §§ 36.611-613.Some carriers, called average schedule carriers, do not routinely file their cost data for either tariff settlement or universal service purposes. Instead, NECA annually proposes formulas to determine settlements and HCLS. These formulas are derived from a regression analysis performed on cost data filed by non-average schedule companies and a sample of average schedule companies. *See National Exchange Carrier Association, Inc. and Universal Service Administrative Company; 2010 Modification of Average Schedule Universal Service Support Formulas*; *High-Cost Universal Service Support*, WC Docket No. 05-337, Order, DA 10-2350 (rel. Dec. 20, 2010); 2011 National Exchange Carrier Inc.'s Association Modification of the Average Schedule Universal Service High-Cost Loop Support Formula, Docket No. 05-337 (filed August 24, 2010); National Exchange Carrier Association Inc.'s 2010 Modification of Average Schedule Formulas, WC Docket No. 09-221 (filed December 23, 2009).

[321] For a discussion of proposals related to oversight of high-cost universal service, *see infra* Section VIII.

investment in a particular instance is not appropriate, even though within the benchmark. We seek comment on this proposal.

205. To follow such an approach, the Commission would need access to a source data set for each analysis that is both reasonably representative of the carriers to whom we would apply its results, and indicative of reasonable levels of costs. We seek comment on sources of availability of such data to the Commission. In particular, we seek comment on the potential use of cost data from rate-of-return carriers and/or the Rural Utilities Service for such an analysis, and whether such data would be sufficiently representative. In addition, because we anticipate benefits from public input to any such data collection and related analysis, we seek comment on ways to solicit and incorporate input from the public in a way that is consistent with the timeline laid out for these reforms.

206. We seek comment regarding the implementation details of such caps. What cost data should be used in the regression analysis, and how often should it be updated? What cost drivers should be considered for inclusion in the regression analysis? Are there benefits to a simpler formula, with fewer variables (perhaps even one relying solely on density) over a more complex formula using more variables? Would a cap of 110 percent of the estimated cost and investment provide a reasonable buffer for carriers that have higher costs for reasons not captured in the formulas? Should the allowable percentage above the benchmark be set higher or lower? We also seek comment regarding whether a process should be created to permit carriers with higher costs to receive a greater amount of support notwithstanding the cap based on a showing that their costs are justified for reasons not captured in the formula. We also seek comment regarding whether additional allowances should be made for carriers that have existing loans or other commitments that would make immediate implementation of the caps unduly burdensome. Alternatively, we seek comment regarding whether some alternative means of cost recovery should be permitted when a carrier's expenses exceed the relevant benchmarks and how this proposal would impact rates. We also seek comment on whether this proposal should be applied only to a limited subset of expenses, such as corporate operations expenses, as opposed to all accounts.

207. Finally, we seek comment on whether this proposal would be an effective method for limiting the growth of ICLS and better distributing HCLS among rural carriers. We recognize that this proposal to cap reimbursable expenses, in its application to ICLS, may affect some carriers' opportunities to recover the amounts that they currently do through interstate rates. Would such a change result in a carrier receiving an amount from interstate access charges that would produce an inadequate return on its interstate net investment? We seek comment on whether this proposal could be implemented solely by modifying the Commission's universal service rules, or whether the rate-of-return rules should be amended as well to implement this proposal.

6. Limits on Total per Line High-cost Support

208. We propose to adopt a cap on total support per line for all companies operating in the continental United States.

209. Although the current HCLS mechanism is capped in the aggregate, there is no cap on the amount of high-cost loop support an individual incumbent LEC may receive. Further, there is no limit on support either in the aggregate or for an individual incumbent LEC for ICLS and LSS. As shown in Figure 12 below, for calendar year 2010, out of a total of approximately 1,442 incumbent LECs receiving support, less than 20 incumbent LECs received more than $3,000 per line annually (i.e., more than $250 monthly) in high-cost universal service support.[322]

[322] 2010 Disbursement Analysis (forthcoming); USAC High-Cost Disbursement Tool.

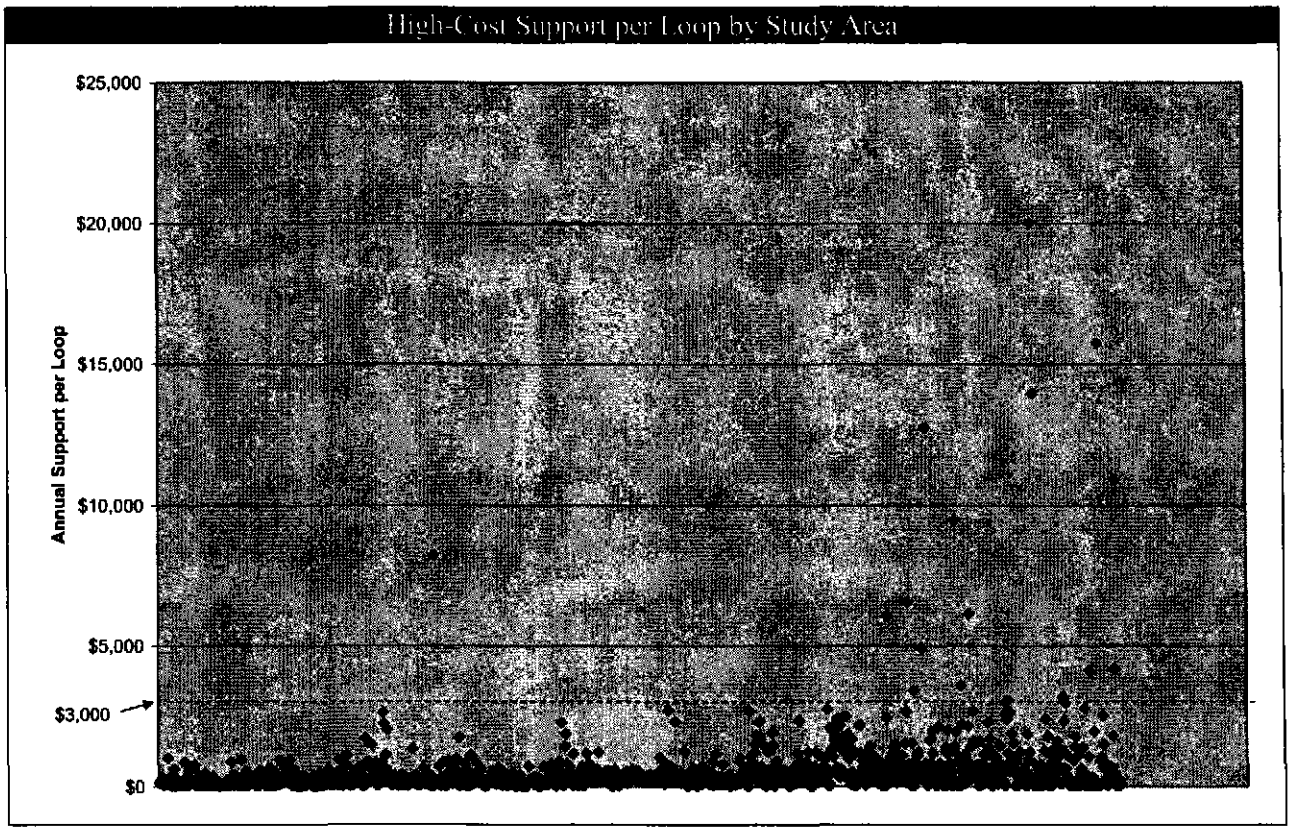

Figure 12

210. We recognize that the cost of providing terrestrial phone service in some rural areas is significant, and we reaffirm that universal service must truly be universal. But some companies with fewer than 500 lines have received USF support for line, switching, and other costs in the last several years ranging between $8,000 to over $23,000 per year per line, which translates into subsidies for local phone service ranging from roughly $700 to nearly $2,000 per line per month.[323] We recognize that there may be unique circumstances in very high-cost areas justifying higher levels of support, and that not all areas may be reachable by satellite offerings because of geographic or topographic limitations. But we seek comment on whether requiring American consumers and small businesses, whose contributions support universal service, to pay more than $3,000 annually or more than $250 per month for a single home phone line is consistent with fiscally responsible universal service reform.

211. As we move forward to transform the existing high-cost fund into the Connect America Fund, it may be prudent to adopt as an interim step a cap on total annual support per line. When universal service support for a carrier exceeds the cap, there would be a rebuttable presumption that the costs associated with the support above the cap are ineligible for recovery through universal service. We seek comment on this proposal and the level of the total per line cap amount (e.g., $3,000 per line annually). In setting the level of the cap in total support per line, should we take into account the equivalent cost of satellite voice and/or broadband service? We also seek comment on what would be a reasonable transition period from the current unlimited per-line support to the limited per-line support. For instance, should we implement this proposal in one year, or implement a transition over a period of years, such as three years? Should there be an exception for carriers serving Tribal lands in addition to carriers operating outside of the continental United States?

[323] *Id.* On average, incumbent LECs operating less than 500 lines receive approximately $1,148 per-line in high-cost support annually.

212. We also seek comment on the application of a total per-line cap to each universal service mechanism. For example, if the per-line cap is $3,000 and an incumbent LEC would have received, prior to the application of a cap, $2,400, $1,000, and $600 ($4,000 total) in HCLS, LSS (or combined LHCS), and ICLS, respectively, how would the reduction in support be applied to each high-cost support mechanism? Should each mechanism be reduced by its relative percentage to the total pre-cap high-cost support?[324] Alternatively, should an order of precedence for reducing support be established, e.g., first HCLS would be reduced, then LSS, and then ICLS until the necessary reduction is attained?

213. We also seek comment on whether we should develop separate per-line caps for each universal service mechanism. Because 25 percent of total common line costs are allocated to the interstate jurisdiction and recovered through SLCs and ICLS, while carriers with costs per loop exceeding 150 percent of the NACPL qualify for the 75 percent recovery rate under the HCLS formula, the federal fund bears most of the burden to ensure these carriers satisfy their revenue requirements.[325] We are concerned that, absent some limit in federal support, carriers lack adequate incentives to curb costs. Should we impose per-line caps on LSS and HCLS to limit the amount of costs that can be shifted to the interstate jurisdiction through these mechanisms? If we were to take such action, how would companies recover such costs?

214. We seek comment on whether an incumbent LEC whose current per-line support is above the cap should be able to make a showing that additional support is in the public interest. Specifically we seek comment on what criteria should be applied when considering the request and whether the availability of less costly satellite voice service (or voice and broadband service) is a sufficient criterion to establish that additional support is not in the public interest. We also seek comment on whether such a showing should include the following additional information about that carrier:

- Density characteristics of the study area including total square miles, subscribers per square mile, route miles, subscribers per route mile, or any other characteristics that contribute to the study area's high costs. We propose to include this information because physical attributes of a study area are likely a primary driver of costs per line.[326]
- How unused or spare equipment or facilities is accounted for by providing the Part 32 account and Part 36 separations category this equipment is assigned to. We propose to include this information because plant held for future use is not eligible for support.[327]
- Specific details on the make-up of corporate operations expenses such as corporate salaries, the number of employees, the nature of any overhead expenses allocated from affiliated or parent companies, or other expenses. We propose include this information because corporate operations expense is highly discretionary.[328]
- All local rate plans including local, long distance, Internet, video, and wireless package plans. We propose to include this information because rural rates should be comparable and not significantly less than urban rates if the incumbent LEC is eligible for support.
- A list of services other than traditional telephone services provided by the universal service supported plant, e.g., video, Internet, and the percentage of the study area's telephone

[324] Using this methodology, HCLS, LSS and ICLS would each absorb 60%, 25% and 15%, respectively, of the $1,000 in excess of the per-line cap of $3,000.

[325] When costs per loop exceed 150% of the NACPL, carriers currently receive 100% recovery of incremental costs from the combination of jurisdictional separations (25% of costs) and high-cost loop support (75% of costs). 47 C.F.R. §§ 36.154(c) and 36.631(c)(2).

[326] *See supra* para. 203 (discussing cost drivers).

[327] 47 C.F.R. § 36.611.

[328] *See supra* para. 197.

subscribers that take these additional services. We propose to include this information to determine the extent of cross-subsidization to competitive services, if any.

- Procedures for allocating shared or common costs between incumbent LEC regulated operations and competitive operations. We propose to include this information to verify that competitive operations are allocated a fair share of shared or common costs.
- Audited financial statements and notes to the financial statements, if available, and otherwise unaudited financial statements for the most recent three fiscal years. Specifically, the cash flow statement, income statement and balance sheets. We propose to include this information to verify that rates of return, cash flow and net income are sufficient to service any outstanding debt.

215. We also seek comment on the effect on interstate rates or the incumbent LEC's ability to earn the authorized interstate rate-of-return should ICLS support be reduced because of an application of a cap on total support. Should we re-examine the 11.25 percent rate-of-return for any company over that cap to determine whether the imposition of such a cap would prevent it from earning its authorized rate-of-return? Should we lower the authorized rate of return for any such carrier?

B. Reducing Barriers to Operating Efficiencies

216. We propose specific changes to our current processes and rules to remove obstacles to increasing the operational efficiencies of incumbent LECs. Specifically, we propose to streamline the study area waiver process to facilitate the transfer and acquisition of exchanges and consider in our public interest inquiry whether granting such a waiver would result in beneficial consolidation. We also propose to revise section 54.305 to strike a better balance between discouraging carriers from acquiring exchanges solely to increase universal service support and encouraging carriers to invest in modern communications networks. We seek comment on these proposals.

217. Our current universal service rules may have the unintended consequence of discouraging beneficial consolidation of small carriers by subsidizing inefficient operating structures and limiting the ability of small companies to acquire and upgrade lines from other providers that have little interest in serving rural markets. As noted above, in 2010, there were 1,150 incumbent rate-of-return operating companies (owned by 754 incumbent telephone holding companies), the vast majority of which are also rural carriers eligible to receive HCLS.[329] Although we recognize the benefits of local firms serving local markets, it may not serve the public interest for consumers across the country to subsidize the cost of operations for so many very small companies, when those companies could realize cost savings through implementation of efficiencies of scale in corporate operations that would have little impact on the customer experience.

1. Study Area Waiver Process

218. A study area is the geographic territory of an incumbent LEC's telephone operations. The Commission froze all study area boundaries effective November 15, 1984.[330] The Commission took this action to prevent incumbent LECs from establishing separate study areas made up only of high-cost exchanges to maximize their receipt of high-cost universal service support. A carrier must therefore apply to the Commission for a waiver of the study area boundary freeze if it wishes to transfer or acquire additional exchanges.[331]

---

[329] 2010 Disbursement Analysis (forthcoming); USAC High-Cost Disbursement Tool.

[330] *See MTS and WATS Market Structure, Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board*, CC Docket Nos. 78-72, 80-286, Decision and Order, 50 Fed. Reg. 939 (1985) (*Part 67 Order*). *See also* 47 C.F.R. Part 36, App.

[331] *Part 67 Order* at para. 1.