Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Connect America Fund	)	WC Docket No. 10-90
	)	
A National Broadband Plan for Our Future	)	GN Docket No. 09-51
	)	
Establishing Just and Reasonable Rates for Local Exchange Carriers	)	WC Docket No. 07-135
	)	
High-Cost Universal Service Support	)	WC Docket No. 05-337
	)	
Developing an Unified Intercarrier Compensation Regime	)	CC Docket No. 01-92
	)	

COMMENTS OF VIRGIN ISLANDS TELEPHONE CORPORATION D/B/A INNOVATIVE TELEPHONE

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COMMENTS OF VIRGIN ISLANDS TELEPHONE CORPORATION D/B/A INNOVATIVE TELEPHONE

Virgin Islands Telephone Corporation ("Vitelco") d/b/a Innovative Telephone, by its undersigned counsel, respectfully submits the following comments in response to the Commission's Notice of Proposed Rulemaking ("NPRM")[1] concerning reform of the High-Cost Fund program and the rules governing intercarrier compensation.

I. INTRODUCTION AND COMPANY BACKGROUND

A. Executive Summary

Vitelco generally supports the Commission's goal of reforming the high-cost support program to increase efficiency, provide better incentives for recipients of support, and to focus support on the areas of greatest need. The company particularly commends the FCC for its efforts to target waste, fraud, and abuse of universal service funding, and to eliminate support that results in duplicative investment and subsidized competition.

However, reform cannot be implemented successfully on the assumption that one size will fit all. Rural service territories are highly diverse, and a support structure that fails to take account of the unique needs and problems of particular areas will likely result in inadequate support and inadequate service in some areas, and excessive, wasteful support elsewhere. As explained in the following sections, the insular territories in general, and the U.S. Virgin Islands in particular, are unlike mainland rural telephone company service territories in many ways, and the Commission should take account of these differences in designing its new rules to provide support for these insular areas that will be predictable and sufficient to assure affordable access to advanced telecommunications and information services, as required by Section 254(b).

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[1] *Connect America Fund, A National Broadband Plan for Our Future, Establishing Just and Reasonable Rates for Local Exchange Carriers, High-Cost Universal Service Support, Developing a Unified Intercarrier Compensation System, et al.*, WC Docket Nos. 10-90, 07-135, 05-337, 03-109, GN Docket No. 09-51, CC Dockets No. 01-92, 96-45, FCC 11-13, Notice of Proposed Rulemaking and Further Notice of Proposed Rulemaking (rel. Feb. 8, 2011) ("NPRM").

Because of these issues unique to insular territories, the Commission should consider exempting rural telephone companies in these territories from its USF reforms, and continuing their existing support levels on a transitional basis, until it can further investigate these issues and develop a support mechanism that is tailored to the insular areas.[2] If it does implement its proposals in the insular areas, however, the Commission should at least take care that they do not result in abrupt "flash cuts" that injure smaller incumbent providers like Vitelco that have hired employees, invested in capital assets, and extended services to consumers in reliance on ongoing support from the high-cost fund. The transition from the existing rules to the new Connect America Fund (CAF) should be gradual and should take into account the critical need of smaller companies to recover the costs of existing investments and to maintain existing networks on a continuing basis.

In particular, Vitelco proposes that rural telephone companies serving insular territories should not be subject to the proposed changes in HCLS support percentages, nor to the proposed exclusion of support for corporate operations expense. Implementation of either of these proposals would have a severe, harmful impact on Vitelco's ability to maintain and modernize its network and bring broadband services to residents of the U.S. Virgin Islands at affordable prices. If the Commission were to apply either of these proposals to Vitelco, however, it should extend its proposed implementation schedule by several years to allow Vitelco, at a minimum, an opportunity to recover the costs of capital investments already made and committed to.

With respect to intercarrier compensation reform, the Commission should fashion a recovery mechanism for rural carriers that takes account of the unique difficulties of insular operating territories. A revenue-based recovery mechanism would be more consistent than a cost-based mechanism with the historical development of access charges and the need to maintain affordable rates for rural customers. Whichever approach the Commission adopts, however,

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[2] The exemption for insular areas would apply to American Samoa, Guam, the Northern Mariana Islands, and the U.S. Virgin Islands. Although Puerto Rico is also an insular territory, its incumbent provider is not a rural telephone company.

should provide sufficient funding to enable Vitelco and other rural incumbent LECs serving insular territories to continue to meet their Carrier of Last Resort obligations within their study areas, to continue to meet the high costs of operating in these territories and to be able to invest in their networks to bring affordable broadband services to residents of the territories. Vitelco proposes, as the preferred solution, a recovery mechanism that reimburses rural incumbents for the difference between pre-reform intercarrier compensation revenues, and the sum of (a) post-reform intercarrier revenues, and (b) revenues available from increases in end-user rates, to the extent those rates are currently below an affordability benchmark that takes into account local economic conditions.

B. Introduction to Vitelco

Vitelco is the incumbent local exchange carrier serving the territory of the United States Virgin Islands. In 2005, Vitelco served approximately 69,925 residential and business access lines. As of November 1, 2010, Vitelco served 58,069 residential and business access lines, which represents a decline of approximately 17 percent. Vitelco serves customers principally on the islands of St. Croix, St. John, and St. Thomas.

Prior to October 2010, Vitelco was a wholly owned subsidiary of Innovative Communication Corporation ("ICC"). ICC was placed into involuntary Chapter 11 bankruptcy by the United States District Court of the U.S. Virgin Islands, Division of St. Thomas and St. John, Bankruptcy Division, on July 5, 2007, after ICC defaulted on its debt obligations and its former chairman engaged in mismanagement and malfeasance associated with Company assets. On December 7, 2009, the Commission granted authority to transfer control of ICC's operating subsidiaries to the National Rural Utilities Cooperative Finance Corporation ("CFC"), finding that the proposed transaction would serve the public interest, convenience and necessity.[3] The transaction transferring control to CFC closed on October 6, 2010. Vitelco is now managed by a new management team appointed by CFC that has no relationship to the pre-bankruptcy owners.

[3] *See Stanford Springel as Chapter 11 Trustee for the Bankruptcy Estate of Innovative Communication Corporation*, 24 FCC Rcd 14360, ¶ 2 (2009).

The Virgin Islands Public Services Commission ("PSC") also reviewed the transfer of control of Vitelco to CFC through its subsidiary, Caribbean Asset Holdings, LLC., and approved the transaction subject to the terms and conditions of a Transfer of Control Agreement ("Agreement") dated May 5, 2010. Under the terms of the Agreement, CFC agreed to provide the PSC with a business plan capturing Vitelco's financial projections, network modernization plan, and planned capital expenditures. In accordance with this plan, Vitelco committed to make investments specific to plant, property, and equipment averaging $12 million annually during the first five (5) years following the consummation of the transfer of control.[4] The Agreement further required that these expenditures be targeted to modernizing, rehabilitating, and improving the Vitelco network. Vitelco also agreed to work with the PSC to establish and satisfy revised quality of service standards.

In addition, the Agreement freezes all of Vitelco's intrastate rates for approximately four years, by providing that neither the company nor the PSC may request or initiate a rate investigation prior to January 2014 so long as all parties are in substantial compliance with the Agreement. Because a rate investigation typically takes up to eight months under Virgin Islands law, 30 V.I. Code § 24, this provision effectively prevents any change in rates before September 2014. Vitelco also agreed to restrictions on paying dividends, and to conditions concerning its capital structure, which are designed to improve the company's overall financial condition.

C. Challenges facing Vitelco

The U.S. Virgin Islands, like other insular territories, is a difficult operating environment for telecommunications and broadband providers. The challenges include: (i) higher shipping-related costs, because all the supplies necessary for creating and maintaining a telecommunications infrastructure must be shipped and stored at considerable expense, and the company must

[4] This does not include capital commitments made by other PSC-regulated companies covered by the transfer of control agreement.

maintain higher inventories on-site due to shipping times;[5] (ii) higher operational costs associated with the topography of the U.S. Virgin Islands, such as the rocky, hilly terrain and heavy tropical vegetation in sparsely populated inland areas, that make the use of underground or buried cable expensive; (iii) higher operational costs associated with the warm tropical climate of the islands, which leads to enhanced need for environmental protection for telecommunications equipment and infrastructure; (iv) the frequent tropical storms and severe hurricanes in the Caribbean, which often cause extensive damage to existing telecommunications infrastructure; and (v) the high level of airborne salt from the ocean, which leads to accelerated corrosion and deterioration of telecommunications equipment and infrastructure.[6]

Compounding these physical obstacles are the serious economic challenges facing the U.S. Virgin Islands. These include a higher cost of living and greater levels of poverty as compared to the mainland.

The need for policies that take into account the unique characteristics of the U.S. Virgin Islands and other U.S. territories is evident from the significant disparity between broadband deployment in these areas as compared to the rest of the United States. For example, the Commission has recognized that the U.S. Virgin Islands lags far behind the rest of the nation in broadband deployment. Indeed, the Commission's 2010 *Sixth Broadband Report* identifies all of the U.S. Virgin Islands as being unserved.[7]

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[5] In addition, because transporting equipment and personnel among the three main islands is more costly and time-consuming than covering similar distances on land, the company must effectively maintain three separate, smaller networks rather than one.

[6] *See also Federal-State Joint Board on Universal Service*, Report and Order, 12 FCC Rcd 8776, ¶¶ 112, 314, 414-415 (1997) (finding that carriers serving insular areas face formidable challenges because "insular areas generally have subscribership levels that are lower than the national average, largely as a result of income disparity, compounded by the unique challenges these areas face by virtue of their locations").

[7] *Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps to Accelerate Such Deployment Pursuant to Section 706 of the Telecommunications Act of 1996*, Sixth Broadband Deployment Report, GN Docket No. 09-137, FCC No. 10-129, at Appendix B, "Unserved Areas By State or U.S. Territory," and Appendix C, "Unserved Areas by County or County Equivalent"

The lack of broadband in the U.S. Virgin Islands is underscored by the recently launched National Broadband Map, which reflects that not a single household in the entirety of the U.S. Virgin Islands has broadband service of download speeds greater than 3 Mbps and upload speeds greater than 768 Kbps. Thus, the U.S. Virgin Islands has the dubious distinction of being ranked *last among all of the states and U.S. territories*.[8] As discussed above, Vitelco has entered into an agreement with the PSC to make increased investments in network rehabilitation and modernization, which will enable it to improve the territory's broadband availability over the next several years, as long as this Commission's actions do not jeopardize its ability to make those investments.

Of course, broadband providers in other insular areas face similar issues in trying to deploy broadband in their respective service areas. This likely explains why, according to the National Broadband Map, the three lowest ranked areas in the percentage of households with broadband service of download speeds greater than 3 Mbps and upload speeds greater than 768 Kbps are U.S. territories – Puerto Rico, American Samoa, and the U.S. Virgin Islands.

II. NEAR TERM USF REFORM PROPOSALS (NPRM SECTION VI)

A. Many Factual Predicates for Near-Term Reform Proposals Do Not Apply in the U.S. Virgin Islands

In Sections VI.A and B of the *NPRM*, the Commission proposes a series of near-term reforms in the high-cost support mechanisms for incumbent local exchange carriers, based on very generalized factual findings. Even though these findings may be true as a general matter, many of them are not valid in the U.S. Virgin Islands, highlighting again the danger of a one-size-fits-all approach. After all, while the height of the average American may be five feet seven inches, it

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(2010) (*Sixth Broadband Report*). The *Sixth Broadband Report* also highlights the lack of broadband in other U.S. Territories such as Puerto Rico, the Northern Mariana Islands and American Samoa.

[8] *See* National Broadband Map, "Rank Analysis" for the all states and territories, available at: http://www.broadbandmap.gov/rank/all/state/percent-population/within-nation/speed-download-greater-than-3mbps-upload-greater-than-0.768mbps/ascending/ (last visited March 2, 2011).

would not make sense to build doorways that are five feet eight inches high. The Commission's policies must account for variation within the population of incumbent carriers, not just for the typical case.

First, the Commission's discussion of small rural telephone companies largely assumes that these companies are rate-of-return regulated. *See, e.g.*, *NPRM*, ¶¶ 162, 165, 166, 170. The Commission notes that some rate-of-return carriers, which it characterizes as "primarily mid-sized carriers," have converted to price caps in recent years. *Id.*, ¶ 165 n.260. Vitelco, which is by no means a mid-sized carrier, converted to price cap regulation in 2010.[9] The *NPRM* only notes in passing that a "small number of rural LECs" operate under price cap regulation, *id.*, and does not inquire whether the smallest of these companies might require a different approach to high-cost support than the vast majority that remain under rate-of-return regulation. The Commission also finds that high-cost support to those "price cap convert" companies has been declining under current rules, ¶ 166, so it is not a foregone conclusion that any reform of those rules is needed for this particular set of companies.

Second, the Commission expresses concern that some incumbents may have used high cost funding to support "imprudent investment decisions, bloated corporate overhead, or an inefficient operating structure." *NPRM*, ¶ 171. In effect, the Commission is concerned that rate-of-return incumbents may "gold plate" their networks in order to increase their reported costs and thereby garner more subsidies. This concern, however, is not applicable to price cap companies like Vitelco. High-cost support under existing rules covers *at most* 75 percent of any additional cost, and the price cap rules would prevent Vitelco from increasing interstate rates to recover the remaining 25 percent. Further, state regulatory policies (as described earlier) prevent any recovery of these costs through increases in local rates. Thus, Vitelco has no incentive to "gold plate" its network; to the contrary, Vitelco's network actually requires significant invest-

[9] *Petition of Virgin Islands Telephone Corporation, for Election of Price Cap Regulation and Limited Waiver of Pricing and Universal Service Rules*, 25 FCC Rcd 4824 (Wireline Comp. Bur. 2010).

ment simply to allow the company to offer services taken for granted on the mainland. Vitelco, under the commitments made to the PSC by its new owners, is undertaking to make necessary investments to improve its network and deploy enhanced broadband capabilities to its subscribers. The Commission should not penalize it for doing so, nor undercut its ability to make these investments by removing essential universal service support.

Third, the Commission believes that high-cost support "may subsidize excessively low rates for consumers served by rural and rate-of-return carriers." *NPRM*, ¶ 172. While this may be true in some cases, it certainly is not a valid concern for the U.S. Virgin Islands. Vitelco's local rates are well above nationwide averages, due largely to the high cost of serving its territory, as outlined earlier, and the need for additional investment to upgrade plant.

As the above examples illustrate, the Commission's near-term reform proposals are designed based on broad generalities and statistical averages. As a result, these proposals are likely to have unintended consequences for companies, like Vitelco, that are not in a typical situation.

B. The Commission Has Not Justified Its Proposal to Decrease Support Percentages for Incumbent LECs Operating 200,000 or Fewer Loops.

The *NPRM* proposes to reduce High Cost Loop Support (HCLS) payments to incumbents operating 200,000 or fewer loops. Support to those companies would be reduced from 75% to 65% for costs in excess of 150% of the adjusted national average cost per loop (NACPL), and from 65% to 55% for costs from 115% to 150% of the NACPL. *NPRM*, ¶ 180. Vitelco, which falls within this category, estimates that this proposal would cause a reduction in its annual HCLS funding of more than $560,000, or 15%.

The proposed reduction in support percentages is arbitrary and capricious. The Commission offers no rationale whatsoever for the particular figures of 55% and 65% it selected. It merely states that these reductions will "facilitate more equitable distribution of limited HLCS funds among rural carriers" and "increase incentives for carriers to operate efficiently …." *NPRM*, ¶ 180. Neither statement has any rational basis. The first statement seems to be based on the findings in ¶ 179 that HCLS support is increasingly "concentrate[d]" among a smaller

number of companies. The apparent concentration of support among a "smaller number of carriers" is misleading, however, because the total number of rural LECs receiving support has also declined due to consolidation and acquisitions (as shown in the third column of Figure 11 in the *NPRM*). And, to the extent there is greater concentration on a relative basis, the Commission made no findings as to *why* this concentration has occurred; it may be that these companies simply have the greatest need for support to preserve affordable basic rates, and therefore the existing formula is entirely equitable. The Commission's implicit reasoning that providing smaller amounts of support to a larger number of companies will result in a "more equitable" distribution of funds, and that this will promote the statutory goal of universal service, lacks both a factual basis and any logical consistency.

The Commission's second explanation for reducing support percentages, namely increasing incentives for carriers to operate efficiently, is also flawed. The Commission is concerned that some companies may be using high-cost support funds to invest and upgrade their networks more than would be considered prudent for a company losing customers. *NPRM*, ¶ 178. It reviews data suggesting that some smaller companies have been increasing their net plant investment even while experiencing line losses.[10] *Id.* As in other examples discussed above, the Commission's focus on the average obscures the variation among this group of companies. In Vitelco's case, network investment has been declining at an even greater rate than its access line count, as shown in Figure 1 below. For companies in this position, the Commission's proposal to reduce the percentage of cost reimbursement will make it even more difficult to achieve the goal of broadband deployment.

[10] It should be noted that there is a logical fallacy in drawing any conclusions about whether investments by firms receiving subsidies are "prudent" by comparing them to investments made by firms not receiving the same benefits. The express purpose of the subsidies is to give companies an incentive to make investments that would not be financially prudent for a non-subsidized company, in order to achieve public policy goals (in this case, universal access to broadband in high-cost areas). Thus, the fact that the companies receiving the largest subsidies are investing more than other incumbents may simply be evidence that the subsidy is correctly targeted to those areas where the need for additional investment is greatest.

Growth Rate Analysis
Network Investment and Access Lines

	Annual Network Investment ($000s) 1/	Access Lines in Service 2/
2004	$ 11,623	73,005
2005	10,027	67,779
2006	10,023	65,900
2007	8,424	63,763
2008	6,582	61,307
2009	8,185	56,954
Annual Rate of Decline	-6.8%	-4.8%

1/ Source: Vitelco Schedule of Telephone Plant
2/ Source: Vitelco Report of Access Lines

Figure 1

There is, accordingly, no rational basis for the Commission's apparent belief that Vitelco needs to have its support reduced to prevent imprudent investment. The Commission should reject the proposal to reduce support percentages for small rural incumbents.

C. The Commission Has Not Justified its Proposal to Eliminate Support for Corporate Operations Expenses

The *NPRM* also proposes to reduce or eliminate universal service support for corporate operations expense. *NPRM*, ¶¶ 194-200. This proposal, if adopted, would have a devastating impact on Vitelco, as discussed in more detail in the following section. However, the Commission has provided no coherent rationale for its proposal, and it should either reject or drastically revise it.

The Commission suggests that corporate operations expenses "do not appear to result from costs inherent in providing telecommunications services, but may rather result from managerial priorities and discretionary spending." *NPRM*, ¶ 197. Even a cursory examination shows that this reasoning is, at a minimum, overbroad. Corporate operations expense includes such core business activities as corporate administration and planning, accounting and financial services (including payroll and disbursements), regulatory compliance, personnel management (including hiring, benefits, employee training and evaluation), procurement of material and supplies, and

insurance costs. 47 C.F.R. § 32.6720. It should be obvious that no organization can provide telecommunications services without hiring and paying employees; without providing training and supervision for those employees; without paying its bills; without filing tariffs and reports required by regulatory agencies; without paying for insurance to cover liability, casualties, and employee injuries; or without performing many of the other functions classified as corporate operations expense. The suggestion that these costs are not "inherent in providing telecommunications services" is ridiculous on its face. To the contrary, it would be impossible to achieve the statutory universal service goals without incurring expenses of this nature, and carriers will not be able to sustain these expenses if they are unable to recover their costs through customer revenues or universal service support.

Perhaps what the Commission meant to say is that *some* corporate operations expenses of *some* companies may reflect managerial priorities and discretionary spending, rather than expenses inherent in providing telecommunications service. That more limited statement may be more credible, but it does not justify eliminating all support for this category of expenses.

The Commission also expresses concern that holding companies with multiple operating companies in different study areas may allocate their overhead costs arbitrarily among study areas, with the goal of maximizing universal service support. *NPRM*, ¶ 197. Even if this is so, it provides no rational basis for withholding support for the expenses of a company like Vitelco that serves only one study area and cannot possibly engage in this type of cost allocation.[11]

In short, the *NPRM* at most presents a rational argument for limiting the amount of corporate operations expense eligible for support, but not for eliminating it entirely. The Commission already limits corporate operations expense as a component of HCLS. 47 C.F.R. § 36.621(a)(4). Vitelco submits that the Commission should reject its proposal to eliminate support for this

[11] The Commission also appears to believe that smaller companies could reduce their overhead expenses by combining study areas or merging their operations. *NPRM*, ¶ 159. While this may be the case for some mainland companies, the geographic isolation of the U.S. Virgin Islands eliminates any possibility that Vitelco could pursue this option.

expense category, and instead should adjust the expense limitation formula to address its concerns about managerial discretion and holding company cost allocation. In particular, the Commission should limit corporate expense support at the holding company, rather than the study area, level, and should update the expense cap formula to reflect more current data on the overhead expenses of efficiently-operated rural carriers. It should also adjust the formula to address anomalies such as those pointed out in footnote 314 of the *NPRM*, whereby very small companies may be able to recover excessive overhead support.[12]

D. The Proposed Reductions in Support Would Have a Devastating Effect on Vitelco and Its Customers

If the Commission were to adopt its proposals to reduce HCLS support percentages and eliminate all support for corporate operations expense, Vitelco would suffer an immediate, substantial reduction in support. The precise amount is impossible to determine due to the interrelating effects of the indexed HCLS cap with the changes in the support formulas, but Vitelco has developed rough estimates based on NECA data, as shown in Figure 2, below.[13]

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[12] Vitelco opposes the Commission's proposal to limit support for corporate operations expense in ICLS, at least for companies like Vitelco that receive frozen per-line ICLS pursuant to recently granted waivers. Vitelco addresses this issue in separate comments that it is submitting jointly with other similarly-situated carriers. *See* Comments of the Recently Converted Price Cap Carriersin the above-captioned dockets, to be filed April 18, 2011.

[13] All estimates are based on 2009 cost data, as noted. Column (b) assumes that the NACPL will remain unchanged, as ¶ 179 of the *NPRM* states that the reduction in support percentages is not expected to change the overall fund size. For purposes of columns (c) and (d), Vitelco assumes that the NACPL would be 13% lower if corporate operations expenses were disallowed, based on the statement in ¶ 196 that approximately 13% of high cost support is attributable to these expenses. Vitelco estimates that the recalculated actual NACPL, excluding corporate operations expenses, would equal approximately $366.73. The NACPL adjusted for the indexed cap would equal $415.47. Also note that columns (c) and (d) reflect the overall effect on support after the proposed three-year phase-out of corporate operations expense recovery. Finally, as stated in the previous footnote, these estimates exclude any impacts of the proposals on Vitelco's frozen per-line ICLS support.

Innovative Telephone Projected 2011 High Cost Funding under USF/ICC Reform Proposals - Potential Impact

	High Cost Loop Support ("HCLS")	Current Parameters	Support Algorithm Percentages Proposal	Corporate Operations Exp. Proposal	Both Proposals
A.	Study Area Cost per Loop 2009 ("SACPL")	(a)	(b)	(c)	(d)
B.	National Average Cost per Loop 2009 ("NACPL")	$ 634.43	$ 634.43	$ 551.12	$ 551.12
C.	Minimum Loop Cost for Support [L.B x 1.15]	$ 468.46	$ 468.46	$ 415.47	$ 415.47
D.	Category 1.3 Loops [VITELCO as of 12/31/09]	$ 538.73	$ 538.73	$ 477.79	$ 477.79
E.	2011 Monthly Funding [USF Algorithm - Current and Proposed]	58,156	58,156	58,156	58,156
F.	Projected 2011 Annual Funding	**$ 301,469**	**$ 255,089**	**$ 230,992**	**$ 195,455**
G.	Variation from Current Funding	**$ 3,617,632**	**$ 3,061,073**	**$ 2,771,909**	**$ 2,345,461**
H.	Percentage Impact	N/A	**$ (556,559)**	**$ (845,723)**	**$ (1,272,171)**

Figure 2

A reduction in support of $ 1.27 million would be the equivalent of $3.13 per month for each of Vitelco's 33,835 residential lines (projected total for 2011). That is, Vitelco would have to charge $3.13 per month more for residential service just to break even under these proposals.

It is important to stress, however, that Vitelco could *not* actually increase residential rates, or any other rates, to offset these proposed reductions. The company cannot increase its interstate end user charges, as these are capped by Commission rule. It also cannot increase its interstate carrier access charges, because it recently converted to price cap regulation and those rules provide no opportunity for rate increases due to reduced earnings (unless the Commission were to permit price cap rural LECs to treat these proposed rule changes as an exogenous event). Further, it cannot increase its basic local exchange rates or any other intrastate rates to offset the lost revenues, because those rates are frozen until 2014 under the transfer of control agreement the company reached with the Public Services Commission. Moreover, even if that agreement did not exist, it would not be in the public interest for the Commission to force Vitelco to pass through increased costs to its ratepayers, who already pay monthly rates above the nationwide

average for basic service. The goal of Section 254 is to reduce the burden on ratepayers in high-cost areas, not to exacerbate it.

Accordingly, the Commission should either reject entirely the proposed reductions in HCLS support discussed in the two preceding sections, or else should exempt rural LECs serving insular territories from these reductions. If, however, the Commission does subject Vitelco to either or both of these proposed reductions in support, it should at least phase them in more gradually than it has proposed. The Commission has proposed to introduce the lower HCLS support percentages effective January 1, 2012, and to phase in the elimination of corporate operations expenses over three years (2012-2014). These proposals provide inadequate transition time for companies that are making capital investments in assets with useful lives well in excess of three years. Immediate support reductions would impair Vitelco's ability to recover the costs of capital investments it has already made, and therefore potentially raise Fifth Amendment takings concerns. To provide a reasonable opportunity for small LECs to adjust their investment plans to take account of changes in support flows, the Commission should not make any changes effective earlier than Jan. 1, 2014, and then should phase in the reductions over a minimum of seven years after that date.

III. INTERCARRIER COMPENSATION RECOVERY MECHANISM (NPRM SECTION XIV)

A. A Sufficient Cost Recovery Mechanism is Essential to Permit Vitelco to Meet Carrier of Last Resort Obligations in its Insular Operating Territory

The intercarrier compensation sections of the *NPRM* propose a long-term goal of eliminating per-minute switched access charges. As the Commission acknowledges, this will mean a substantial loss of revenue for many incumbent local exchange carriers, including Vitelco, which have relied on this source of revenue to earn an adequate return on investment without increasing end-user charges to unaffordable levels. *NPRM*, ¶ 559. Vitelco agrees that the current system is not ideal, and is not opposed to the general direction of reform that the Commission proposes, but is concerned that the impacts of reform on rural incumbents, particularly those facing the

unique difficulties of insular operating territories, will be taken into account fully in designing a recovery mechanism.

In Section I.C, above, Vitelco has described the difficult combination of circumstances, including high operating costs, need for major network upgrades, above-average end user rates, and a low-income population, that uniquely impact it and a handful of other insular operating companies. This makes it particularly difficult for Vitelco to replace any revenues that may be lost due to access charge reform. An increase in end-user charges (such as an increased Subscriber Line Charge) would place an unreasonable burden on subscribers who already have difficulty affording Vitelco's rates, and most likely would exacerbate the trend of declining access lines. As already noted, intrastate rates are subject to a five-year freeze, and could not be increased to recover lost revenues. There are very few opportunities for cost reduction, especially since Vitelco has already cut its expenses while its former owner was in Chapter 11 reorganization, and in light of the need to maintain and upgrade its network plant.

Accordingly, any recovery mechanism must provide sufficient funding to enable Vitelco and other rural incumbent LECs serving insular territories to continue to meet their Carrier of Last Resort obligations within their study areas, to continue to meet the high costs of operating in these territories and to be able to invest in their networks to bring affordable broadband services to residents of the territories. Whether this recovery mechanism is revenue-based or cost-based, *NPRM*, ¶ 564, it must consider the specific operating conditions of companies such as Vitelco that serve insular areas.

B. A Cost Recovery Approach Must Consider the Actual Characteristics of Operating in an Insular Area

In ¶¶ 564-566 of the *NPRM*, the Commission requests comments regarding possible cost-based recovery mechanisms for intercarrier compensation reductions. As an initial matter, Vitelco is skeptical that this approach can be productive. Historically, as the Commission recounts in sections III and X of the *NPRM*, access charges were designed to generate a targeted revenue requirement, not to cover incremental costs in an economic sense. In other words, the

rate design was always top-down, not bottom-up. Although access charges for price cap carriers have since been untethered from revenue requirements studies, they were initialized on this top-down basis. It is therefore unlikely that a bottoms-up approach will be successful in protecting incumbent LECs' ability to maintain quality service at affordable rates.

If the Commission does pursue this approach, however, it should not begin with a transport and termination reciprocal compensation framework with a focus on the Section 252(d)(2) "additional costs" standard, as suggested in ¶ 566, as this would not provide a sufficient basis for the appropriate recovery of joint and common costs that currently are legitimate components of intercarrier connection services. If these joint and common costs cannot be recovered through intercarrier compensation, then they must either be recovered from end users (who are already paying rates above the national average, as noted earlier) or through the CAF. Indeed, as Vitelco understands it, the goal of intercarrier compensation reform is that LECs should be able to recover the "additional costs" of switching and transport through charges to other carriers; the entire point of a recovery mechanism, therefore, must be to focus on those joint and common costs that would *not* be included in intercarrier payments.

Further, Vitelco cautions that a cost-based recovery mechanism would have to take into account carriers' actual costs based on their specific operating conditions. Economic modeling reflective of industry average operational parameters, as the Commission has used in other contexts to determine "TELRIC" pricing and non-rural universal service support, may not appropriately incorporate the unique operating conditions of insular areas such as the U.S. Virgin Islands. Instead, the Commission should prefer approaches that more closely reflect actual operating costs and conditions rather than abstract models.

C. Revenue-Based Recovery Mechanisms Must Consider the Specific Competitive and Regulatory Characteristics of the Carrier's Operating Territory

As suggested in the previous section, Vitelco urges the Commission to give serious consideration to a revenue-based recovery mechanism to offset intercarrier compensation reductions.

In this process, the Commission must seek to ensure that rural incumbent LECs operating in insular areas will be able to earn sufficient revenues to cover the costs of doing business in these specific operating territories, given the existing regulatory constraints, economic conditions, and related conditions described earlier in these comments, and will not be forced to raise rates above affordable levels.

The issues faced by the Commission in this process are not unlike those it has faced in past Universal Service decisions. In determining whether rates are "affordable," the Commission should compare current local rates to those charged by other companies nationwide, but it should also take account of local demographic conditions. A rate that is "affordable" in Manhattan or Jackson Hole, Wyoming, may not be affordable to the much lower-income population of the United State Virgin Islands. Thus, the affordability benchmark should be adjusted based on per-capita income and other economic characteristics of a particular operating territory.[14]

Also, the Commission should take account of the ability (or lack of ability) of an incumbent LEC to increase its rates. As already described, Vitelco's pricing flexibility is tightly circumscribed both by regulatory considerations and by market conditions. If Vitelco could increase its end-user rates, it would likely lose market share as a result and might not realize any increase in total revenues at all. The Commission should take account of these competitive realities, including the presence of subsidized operations such as the U.S. Virgin Islands Government's Middle Mile Broadband Initiative (which was funded by an NTIA grant), which further limits Vitelco's ability to increase end-user prices.

Vitelco suggests that the Commission determine a revenue benchmark for each rural telephone company study area, based upon pre-reform intercarrier compensation revenues, and a rate affordability level for that study area based on economic conditions, as described above. It should then determine how much of that benchmark can be recouped through (a) post-reform

[14] The Commission has previously concluded that consumer income and cost of living are relevant factors in assessing affordability for purposes of Section 254. *Federal-State Joint Board on Universal Service*, 12 FCC Rcd. 8776, ¶¶ 110, 116 (1997) (subsequent history omitted).

intercarrier revenues, and (b) increases in end-user rates that are currently below the affordability level. Any balance remaining after these two adjustments should be provided to the company through the recovery mechanism.

IV. CONCLUSION

For the foregoing reasons, Vitelco urges the Commission (a) to reject the proposed reduction in HCLS support percentages for incumbent carriers with fewer than 200,000 loops, (b) to reject the proposed disallowance of corporate operations expenses for rural incumbent carriers, (c) to modify its proposed rules to take account of the special circumstances faced by carriers serving insular territories; and (d) to adopt a recovery mechanism to offset revenues that rural incumbent carriers will lose due to reform of access charges and other intercarrier compensation.

Respectfully submitted,

/electronically signed/

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