

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 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
)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45
)	
Lifeline and Link-Up	)	WC Docket No. 03-109
)	
Universal Service Reform – Mobility Fund	)	WT Docket No. 10-208

COMMENTS

of

MOSS ADAMS LLP, 3 RIVERS TELEPHONE COOPERATIVE INC, ACCIPITER COMMUNICATIONS INC¹, ALASKA POWER & TELEPHONE COMPANY, ATC COMMUNICATIONS, BEAVER CREEK COOPERATIVE TELEPHONE COMPANY, BLUE VALLEY TELE-COMMUNICATIONS INC, CALAVERAS TELEPHONE COMPANY, CAMBRIDGE TELEPHONE COMPANY (NE), CAMBRIDGE TELEPHONE COMPANY INC (ID), CANBY TELCOM, CENTRAL TEXAS TELEPHONE COOPERATIVE INC, CLEAR CREEK COMMUNICATIONS, DAKOTA CENTRAL TELECOMMUNICATIONS COOPERATIVE, DELHI TELEPHONE COMPANY, DICKEY RURAL NETWORKS, DUCOR TELEPHONE COMPANY, EAGLE TELEPHONE SYSTEM, EAST OTTER TAIL TELEPHONE COMPANY,

¹ Accipiter Communications Inc. has unique concerns with the FNPRM in regard to eliminating support in areas with an unsubsidized competitor and limits on reimbursable costs for rate of return carriers. Accipiter has separately filed their own comments on these issues.

ENDEAVOR COMMUNICATIONS, ENMR TELEPHONE COOPERATIVE, FARMERS MUTUAL TELEPHONE COMPANY (ID), FILER MUTUAL TELEPHONE COMPANY, GUADALUPE VALLEY TELEPHONE COOPERATIVE, INTERBEL TELEPHONE COOPERATIVE, KALONA COOPERATIVE TELEPHONE COMPANY, LAVALLE TELEPHONE COOPERATIVE, LOGAN TELEPHONE COOPERATIVE INC, MADISON TELEPHONE LLC, MASHELL TELECOM INC (DBA RAINIER CONNECT), MIDVALE TELEPHONE EXCHANGE INC, MILLRY TELEPHONE COMPANY INC, MISSOURI VALLEY COMMUNICATIONS INC, MOAPA VALLEY TELEPHONE COMPANY, MOLALLA COMMUNICATIONS COMPANY, NEMONT TELEPHONE COOPERATIVE INC, NORTHERN TELEPHONE COOPERATIVE, NORTHWESTERN INDIANA TELEPHONE COMPANY, OSAKIS TELEPHONE COMPANY, PENASCO VALLEY TELEPHONE COOPERATIVE INC, PIGEON TELEPHONE COMPANY, PINNACLES TELEPHONE CO, PROJECT MUTUAL TELEPHONE COOPERATIVE ASSOCIATION INC, PROJECT TELEPHONE COMPANY, RICHLAND-GRANT TELEPHONE COOPERATIVE INC, RITTER COMMUNICATIONS, SACRED WIND COMMUNICATIONS INC, SANTA ROSA TELEPHONE COOPERATIVE, SCIO MUTUAL TELEPHONE ASSOCIATION, SOUTH PARK TELEPHONE COMPANY, THE CHILLICOTHE TELEPHONE COMPANY, THE PEOPLES TELEPHONE COMPANY OF BIGFORK, THE PIONEER TELEPHONE ASSOCIATION (DBA PIONEER COMMUNICATIONS), THE TOLEDO TELEPHONE COMPANY INC, TWIN VALLEY-ULEN TELEPHONE COMPANY, UBTA-UBET COMMUNICATIONS INC (DBA STRATA NETWORKS), VALLEY TELECOM GROUP, VOLCANO TELEPHONE COMPANY, WESTGATE COMMUNICATIONS LLC (DBA WEAVTEL), AND WHEAT STATE TELEPHONE COMPANY (THE MOSS ADAMS COMPANIES)

TABLE OF CONTENTS

SUMMARYv

I. INTRODUCTION.....3

II. LIMITS ON REIMBURSABLE CAPITAL AND OPERATING COSTS FOR RATE-OF-RETURN CARRIERS 5

1. THE *REPORT AND ORDER AND FNPRM* LACKS CLARITY ON IMPLEMENTATION.....6

2. THE REGRESSION MODEL IS OVERLY COMPLEX AND UNPREDICTABLE THUS DISCOURAGING FUTURE INVESTMENT7

3. THE PROPOSED REGRESSION CAPS ARE BASED ON A MODEL WITH SERIOUS FAULTS8

4. THE REGRESSION ANALYSIS RELIES ON FLAWED DATA.....9

5. THE REGRESSION ANALYSIS UTILIZES FLAWED INDEPENDENT VARIABLES.....11

6. THE LIMITATIONS AS CALCULATED PRODUCE ANOMALIES AND DO NOT YIELD CONSISTENT RESULTS FOR SIMILARLY SITUATED COMPANIES14

7. THE LIMITATIONS ARE APPLIED INCORRECTLY TO THE HIGH COST LOOP SUPPORT ALGORITHM AND ARE MISSING CRITICAL COMPONENTS15

III.	CONNECT AMERICA FUND FOR RATE-OF-RETURN CARRIERS	18
	1. GIVEN THE FCC’S \$2 BILLION USF BUDGET, HOW CAN THE FCC BEST ACCOMMODATE THE RURAL ASSOCIATIONS’ PLAN?	19
	2. WHAT ARE THE BENEFITS AND THE COST OF PROVIDING SUPPORT FOR “MIDDLE MILE” FACILITIES AND ACCESS TO THE INTERNET BACKBONE UNDER THE RURAL ASSOCIATIONS’ PROPOSAL?	21
	3. THE RURAL ASSOCIATIONS PROPOSE THAT COSTS BE SHIFTED TO THE INTERSTATE JURISDICTION BASED ON AN INDIVIDUAL CARRIER’S “BROADBAND TAKE RATE”.	22
	4. THE CONNECT AMERICA FUND FOR RATE-OF-RETURN CARRIERS MUST BE FULLY FUNDED.....	23
IV.	RATE-OF-RETURN REPRESRIPTION.....	24
V.	ELIMINATING SUPPORT FOR AREAS WITH AN UNSUBSIDIZED COMPETITOR.....	26
VI.	REMOTE AREAS FUND	30
VII.	ANNUAL AUDIT REQUIREMENTS DUE BY APRIL 1ST EACH YEAR.....	31
VIII.	CONCLUSION	34

Summary

In these comments, the Moss Adams Companies urge the Commission to carefully consider the implications that its proposed reforms will have on rural rate-of-return carriers that are responsible for delivering universal voice, and now broadband, services to the most remote, sparsely populated and highest cost to serve areas of the country. Absent rate-of-return regulation and universal service funding, customers in these areas would not have access to the same telecommunications services that are available to their brethren in urban America.

Specifically, the Moss Adams Companies recommend that the FCC implement the following courses of action related to the limitation on capital and operating expenses:

- The capital and operating expense limitations should be delayed by at least one year to resolve the current flaws in the regression analysis.
- Underlying data and computations used in the capital and operating expense limitations must be made available to carriers in advance of implementation, and should be performed for a minimum of five years.
- The FCC must immediately clarify how and when the capital and operating expense limitations take effect.
- The FCC should not apply capital expense limitations to investment that has been made throughout the life of the company, but rather develop limitations based on the need for future expenditures.
- The FCC's regression model should be modified to incorporate more appropriate density measures as independent variables, such as subscribers per mile of loop plant. Such data could be submitted and certified annually by ETCs.
- The FCC's regression model should be modified to incorporate more appropriate terrain characteristics as independent variables.
- The limitations on capital and operating expenses should be applied to data lines, not algorithm lines, in the calculation of High Cost Loop Support.
- The limitation on capital and operating expenses must take into account the impact of accumulated depreciation and other accounts on the calculation of support.

- The limitation of depreciation expense must be modified to relate to the amount of associated investment that is limited.

The Moss Adams Companies recommend that the FCC implement the following courses of action related to the Connect America Fund for rate-of-return carriers:

- The FCC should utilize savings from other components of the CAF to increase funding for rate-of-return carriers to best achieve the broadband mandate in rural America.
- Establish reasonable limitations on capital and operating expenses, which cannot be based on the currently proposed regression analysis.
- The FCC should include the cost of 2nd Mile and Middle Mile Transport in the calculation of CAF support.
- The FCC should recognize that its broadband mandate requires support of broadband related costs through fully funded support mechanisms, regardless of where the support comes from.
- The Connect America Fund must be fully funded to accomplish both universal service, for voice and broadband, and intercarrier compensation reform.

The Moss Adams Companies recommend that the FCC implement the following courses of action related to rate-of-return reprscription:

- Represcribe the rate-of-return utilizing the FCC's established procedures for doing so, without a predetermined result as proposed in previous comments in this proceeding.
- The FCC should not consider U.S. treasury yields as a surrogate for the cost of equity for rate-of-return carriers, but rather should consider the equity returns achieved by other telecommunications providers and then adjust for risk.

The Moss Adams Companies recommend that the FCC implement the following courses of action related to eliminating support for areas with an unsubsidized competitor:

- Calculate an individual company phase out of support for overlapped carriers based on the remaining depreciable life for existing assort loan term for existing loans, whichever is longer.
- The FCC should not eliminate any support for areas with less than 100% overlap by an unsubsidized competitor. If it chooses to do so, it should be done on an incremental cost basis.
- The FCC may not allow competitors to “cherry pick” support, by only serving the most densely populated, lowest cost to serve areas.
- The FCC must hold competitive providers to the same service standards of an ETC if an incumbent is to lose support as a result of an unsubsidized competitor. This would include the transfer of the Carrier of Last Resort obligation to the competitor.

The Moss Adams Companies recommend that the FCC implement the following courses of action related to Remote Areas Fund:

- The FCC must define the term “reasonable request” as it applies to a rate-of-return carrier’s provision of broadband service.
- The FCC should establish a process by which rural rate-of-return carriers, or their customers, can apply to have a service request move to an alternate provider for support through the Remote Areas Fund. This process could be administered by USAC.

The Moss Adams Companies recommend that the FCC implement the following courses of action related to annual financial statement audit requirements:

- The FCC should modify the annual reporting deadline to May 1st or later, which is more consistent with the reporting deadlines for lenders.
- The FCC should defer the effective date of the audit requirement to at least May 1, 2013 for audit reports on fiscal years ended during 2012.

Given these courses of action, we believe that the outcome of the *Report and Order and FNPRM* on these issues will more appropriately reflect the costs incurred by rate-of-return carriers and are more likely to produce support amounts that allow these carriers to continue to meet the universal service mandate for both voice and broadband service.

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 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

MOSS ADAMS LLP, 3 RIVERS TELEPHONE COOPERATIVE INC, ACCIPITER COMMUNICATIONS INC, ALASKA POWER & TELEPHONE COMPANY, ATC COMMUNICATIONS, BEAVER CREEK COOPERATIVE TELEPHONE COMPANY, BLUE VALLEY TELE-COMMUNICATIONS INC, CALAVERAS TELEPHONE COMPANY, CAMBRIDGE TELEPHONE COMPANY (NE), CAMBRIDGE TELEPHONE COMPANY INC (ID), CANBY TELCOM, CENTRAL TEXAS TELEPHONE COOPERATIVE INC, CLEAR CREEK COMMUNICATIONS, DAKOTA CENTRAL TELECOMMUNICATIONS COOPERATIVE, DELHI TELEPHONE COMPANY, DICKEY RURAL NETWORKS, DUCOR TELEPHONE COMPANY, EAGLE TELEPHONE SYSTEM, EAST OTTER TAIL TELEPHONE COMPANY, ENDEAVOR COMMUNICATIONS, ENMR TELEPHONE COOPERATIVE, FARMERS MUTUAL TELEPHONE COMPANY (ID), FILER MUTUAL TELEPHONE COMPANY, GUADALUPE VALLEY TELEPHONE COOPERATIVE, INTERBEL TELEPHONE COOPERATIVE, KALONA COOPERATIVE TELEPHONE COMPANY, LAVALLE TELEPHONE COOPERATIVE, LOGAN TELEPHONE COOPERATIVE INC, MADISON TELEPHONE LLC, MASHELL TELECOM INC (DBA RAINIER CONNECT), MIDVALE TELEPHONE EXCHANGE INC, MILLRY TELEPHONE COMPANY INC, MISSOURI VALLEY COMMUNICATIONS INC, MOAPA VALLEY TELEPHONE COMPANY, MOLALLA COMMUNICATIONS COMPANY, NEMONT TELEPHONE COOPERATIVE INC, NORTHERN TELEPHONE COOPERATIVE, NORTHWESTERN INDIANA TELEPHONE COMPANY, OSAKIS TELEPHONE COMPANY, PENASCO VALLEY TELEPHONE COOPERATIVE INC, PIGEON TELEPHONE COMPANY, PINNACLES TELEPHONE CO, PROJECT MUTUAL

TELEPHONE COOPERATIVE ASSOCIATION INC, PROJECT TELEPHONE COMPANY, RICHLAND-GRANT TELEPHONE COOPERATIVE INC, RITTER COMMUNICATIONS, SACRED WIND COMMUNICATIONS INC, SANTA ROSA TELEPHONE COOPERATIVE, SCIO MUTUAL TELEPHONE ASSOCIATION, SOUTH PARK TELEPHONE COMPANY, THE CHILLICOTHE TELEPHONE COMPANY, THE PEOPLES TELEPHONE COMPANY OF BIGFORK, THE PIONEER TELEPHONE ASSOCIATION (DBA PIONEER COMMUNICATIONS), THE TOLEDO TELEPHONE COMPANY INC, TWIN VALLEY-ULEN TELEPHONE COMPANY, UBTA-UBET COMMUNICATIONS INC (DBA STRATA NETWORKS), VALLEY TELECOM GROUP, VOLCANO TELEPHONE COMPANY, WESTGATE COMMUNICATIONS LLC (DBA WEAVTEL), AND WHEAT STATE TELEPHONE COMPANY (THE MOSS ADAMS COMPANIES)

The Federal Communications Commission's (Commission or FCC) *Report and Order and FNPRM*² in the above captioned proceeding requests comment on proposed changes to the existing Universal Service Fund (USF) and Intercarrier Compensation (ICC) mechanisms for rural rate-of-return carriers, among other issues. Specifically, the FCC requests comments on Sections XVII.A-K of the *FNPRM*, which address a wide variety of USF related issues. The Moss Adams Companies do not comment on all of these issues, but reserve the right to provide Reply Comments on any of the issues identified in the *Report and Order and FNPRM*.

Following are the issues that we focus on in these comments:

- Proposed limitations on capital and operating expenses for High Cost Loop Support and Interstate Common Line Support using a regression based analysis of costs.
- Development of the budget for the Connect America Fund and various approaches to reestablishing or maintaining this budget for rural rate-of-return carriers.

² *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, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, *Lifeline and Link-Up*, WC Docket No. 03-109, *Universal Service Reform – Mobility Fund*, WT Docket No. 10-208, *Report and Order and Further Notice of Proposed Rulemaking and Further Notice of Proposed Rulemaking*, FCC 11-161 (rel. November 18, 2011) (*Report and Order and FNPRM*).

- Represcription of the authorized rate-of-return and weigh in with thoughts on how the FCC should handle this process.
- Elimination of universal service support for rural rate-of-return carriers that are fully, or partially, overlapped by a facilities-based terrestrial provider of broadband services.
- Development of the Remote Areas Fund and the proper means for defining customers eligible for support.
- Establishment of the interstate portion of the revenue baseline for rate-of-return carriers as the forecasted amount used in a company's latest tariff filing.
- Requirement for privately held rate-of-return carriers to submit audited financial statements by April 1 of each year, beginning in 2012.

The Moss Adams Companies³ submit these comments based on our analysis of the *Report and Order and FNPRM*, and the impacts of certain aspects of the *Report and Order and FNPRM* on rural rate-of-return carriers throughout the U.S.

I. Introduction

The Moss Adams Companies provide both voice and broadband services in some of the most rural areas of the country, and range in size from less than 100 voice access lines to more than 37,000 voice access lines. The following characteristics are true of each of the Moss Adams Companies:

³ Moss Adams LLP (Moss Adams) is the 11th largest accounting and consulting firm in the United States, with more than 225 partners and 1,800 staff. Moss Adams' Telecom Group has served the telecommunications industry since 1957. Today, we provide audit, tax, and consulting services to more than 100 small and mid-sized telecommunications carriers throughout the United States and its territories. The fact that Moss Adams serves primarily rural carriers provides us a unique perspective on the financial ramifications on the impacts of the *Report and Order and FNPRM* on these companies and access to financial data that allow us to perform company specific analyses of the financial impacts.

- Each company is the Carrier of Last Resort designated by the relevant state public utilities commission, which legally obligates the company to provide telecommunications services to all requesting customers within its service territory.
- Each company is the Eligible Telecommunications Carrier determined by the relevant state public utilities commission and/or the FCC to provide universal service within the company's designated service territory.
- Each company receives High Cost Support⁴ from the Federal Universal Service Fund, which represents a significant revenue stream for each of these companies.
- Each company generates substantial revenues from providing intrastate switched access and reciprocal compensation services.
- Each company provides voice and broadband services to schools, libraries, rural health care facilities, governmental agencies, and/or other anchor institutions within its service territory.
- Each company is one of the, if not the, largest employers in its rural service territory, providing jobs and financial stability in some of the most rural and economically depressed areas of the country.
- Each company has deployed substantial financial and human resources to provide voice and broadband services in these rural areas under the existing rate-of-return rules prescribed by the FCC and, in most cases, by the state public utilities commission.
- No company would have had the financial resources to deploy and maintain voice or broadband services without rate-of-return regulation and/or the support of the Universal Service Fund.

⁴ High Cost Support includes High Cost Loop Support, Interstate Common Line Support, Local Switching Support, Safety Net Additive, and Safety Valve Support. Not all of the Moss Adams Companies receive all types of support, but all receive at least one type of support.

II. Limits on Reimbursable Capital and Operating Costs for Rate-of-Return Carriers

For numerous reasons listed in the comments to follow, we recommend that the capital and operating expense limits⁵ proposed in the FNPRM⁶ be delayed by at least one year to resolve various legal, factual and practical flaws. We also offer various suggestions on the application of future capital and operating expense limitations in an effort to streamline the process and avoid the current anomalous results. In addition, we propose that whatever the direction taken, that all underlying data and computations performed be made available to carriers receiving support in advance of implementation, which would allow for the validation of the inputs or outputs beyond the first year of the analysis. Lastly, we propose that the underlying data and computations be performed for a minimum of five years at a time to give carriers that opportunity to plan and budget for the impacts of potential limitations.

Critically important to these comments is the fact that the Moss Adams Companies do not agree that regression analysis is needed for purposes of ensuring that capital and operating expenditures are appropriate. However, if the FCC is to maintain the current, or similar, path, we propose alternative approaches that would improve both the inputs and outputs of the model, making it a more reasonable determinant of the cost of building a network in rural areas. While we generally agree there is a need to ensure that carriers are utilizing capital and expense dollars appropriately, we do not agree that a statistical or mathematical model is necessarily the right approach, and believe it is highly improbable that such a model can produce representative results for rural carriers. The Commission could potentially attain the desired results, to ensure

⁵ Limits on reimbursable capital and operating costs are referred to as “capital and operating expense caps” and “regression caps” synonymously throughout these comments.

⁶ See *USF and ICC Reform Report and Order and FNPRM*, paragraphs 1079 through 1088 and Appendix H.

that universal service funding is being used for the intended purposes, using alternative and more understandable methods.

1. *The Report and Order and FNPRM Lacks Clarity on Implementation.*

It is unclear from the *Report and Order and FNPRM* as to how and when the regression caps will be implemented. In particular, when the caps are implemented no later than July 1, 2012⁷, it is not clear whether the caps will apply to support received after July 1, 2012, support calculated after July 1, 2012, or costs incurred after July 1, 2012. The timing of the implementation is vital, as it will have a significant impact on the revenues received by many carriers who are dependent on these revenue streams to cover their costs. If either of the first two scenarios comes to fruition, this will have a devastating effect on 2012 revenues and this lack of clarity highlights one of the major problems that the *Report and Order and FNPRM* have created; a company cannot be certain of its impacts and cannot appropriately plan for the future.

Based on our analysis of 65 companies, 23 companies were capped by a total of \$8,490,475 in High Cost Loop Support, or an average of \$369,151 per capped company. While this may not appear significant to the FCC, many rural carriers are operating on ever thinning margins, and this analysis does not include the potential impacts of the FCC's proposal to also limit the capital and operating expenses included in the calculation of Interstate Common Line Support (ICLS). Using a calculation based on the same percentage of limitation for HCLS⁸, 2013 ICLS would be limited by an estimated \$2,119,909 for 18 companies, or an average of \$122,990 per limited company. This is an average limitation of \$492,141 for both HCLS and

⁷ See *USF and ICC Reform Report and Order and FNPRM*, paragraphs 210 and 1079.

⁸ Both HCLS and ICLS are cost recovery mechanisms designed to support the high cost of local loops, and many of the costs included in the calculation of each are the same.

ICLS. In the 2010 Telergee Benchmarking Study⁹, the average pre-tax income of participating rural telecommunications carriers was approximately \$651,000. An average reduction in revenue of \$492,141 would reduce pre-tax income to \$158,859, a reduction of nearly 76%. The planning needed to weather these affects is daunting, and devastating if applied to 2012. Such a reduction, which directly impacts cash flow, would immediately impair a company's ability to service debt and may lead to insolvency.

We request that the Commission immediately clarify how and when the caps are to apply so that carriers will be better able to estimate the impacts of the *Report and Order and FNPRM* and begin planning for future expenditures and revenue reductions. In addition, the FCC must not apply limitations to investment that has been made throughout the life of the company, as the company has no ability to effectively "un-invest" the plant. Instead, the FCC should consider developing investment limitations based on the need for future expenditures. In doing so, the FCC could consider solutions such as the one proposed by the Rural Associations in this proceeding, whereby limitations on future investment are based on the level of accumulated depreciation of the carrier.¹⁰

2. The Regression Model is Overly Complex and Unpredictable Thus Discouraging Future Investment.

As it stands today, a company has no straight forward means of understanding the results relied upon by the Commission and predicting capped values in the future. Use of the tools that the FCC utilized in developing its regression analysis, such as the Tele Atlas

⁹ Telergee is an alliance of seven accounting and consulting firms that focus on the rural telecommunications industry. Each year Telergee prepares a financial benchmarking study of rural telecommunications providers that elect to participate. In 2010, 221 companies participated in the study. This is not publicly available data.

¹⁰ See Rural Associations *USF/ICC Transformation NPRM* Comments at 8-10, Appendix A.

Telecommunications Suite¹¹ and Stata¹² software is costly and requires a high level of sophistication to develop and modify inputs, run the models and analyze the results. The Commission's approach is not one that can be easily predicted or replicated, and as a consequence, companies cannot adequately plan for the future. Because cost recovery in this scenario is not predictable, it is highly likely that rural carriers will not invest in future capital expenditures. This outcome is contrary to the Commission's intent; to deploy 4 Mbps downstream/1 Mbps upstream broadband services to all areas of the country. In order to avoid this outcome, and assuming that regression caps will be utilized, underlying data and calculations must be readily available to carriers to allow for adequate financial and strategic planning. We believe that a minimum of five years of data should be made available to carriers, so that they can make appropriate financial decisions based on known cost recovery mechanisms.

3. The Proposed Regression Caps Are Based on a Model with Serious Faults

The Commission's proposed regression methodology fails to achieve a reasonable and appropriate objective of identifying which high-cost rural carriers may legitimately be outliers due to appropriate cost drivers (independent variables in the regression analysis), such as: population density, loop density per mile of cable, road mileage, soil type, terrain, labor costs, and other operating characteristics that impact loop costs. The independent variables that the FCC has selected do not do an adequate job of predicting the cost of providing service in rural areas. The Commission's failure to distinguish between these circumstances is irrational and

¹¹ Tele Atlas Telecommunications Suite 2010.6 is the FCC's source of study area boundaries used in the regression analysis. See Appendix H, paragraph 5 and footnote 10.

¹² Stata is the software used by the FCC to run the regression analysis. This is not referenced in the *Report and Order and FNPRM*, however, we were informed of the need to purchase the Stata software to replicate the analysis performed by the FCC, using the data set provided by the FCC.

reflects a failure to consider facts in evidence before the agency concerning the specific challenges carriers face in delivering service.

4. The Regression Analysis Relies on Flawed Data

There is some uncertainty, based on the documentation included in *Appendix H* of the *Report and Order and FNPRM*, as to the vintage of the census data utilized in the regression analysis. *Appendix H* states that, “Other than the number of loops the study area serves, all the independent variables are from the 2010 United States census.”¹³ Footnote 34 at the end of this sentence then states that, “Census has not yet released the urban/rural breakouts for 2010, so we used the 2000 urban/rural breakouts.” Presumably this footnote is referencing the determination of which census blocks are identified as non-urban, urban cluster and urban area, all of which impact multiple independent variables used in the regression analysis. Based on this, it would appear that the FCC elected to use data that is now eleven years old rather than wait until the final 2010 data is available. While it is difficult to know for sure how significant the impact of this data is on the analysis, it is interesting to note that the U.S. population grew by 27.3 million people, or 9.7%, from 2000 to 2010.¹⁴ We certainly hope that the FCC would not rely on 11 year old data that could vary this much from actual 2010 data.

Even the loop counts used in the model, which one would assume the FCC should be able to get correct given that they collect loop data from rural carriers on at least an annual basis, is substantially incorrect in certain situations. In cases where a rural carrier has acquired access lines under the FCC’s “Parent Trap” Rule, the loops and costs from the acquired territory are not included in the calculation of High Cost Loop Support (HCLS). If the FCC is to apply the

¹³ See *USF and ICC Reform Report and Order and FNPRM, Appendix H*, paragraph 20.

¹⁴ U.S. Census Bureau, *Population Distribution and Change: 2000 to 2010, 2010 Census Briefs*, issued March 2011.

regression based limitations to Interstate Common Line Support, as proposed in the FNPRM, the loop count must come from a source other than the HCLS inputs. It is also important to note that a carrier's loop costs are based on years of investment, including years in which loop counts may have been significantly greater than they are today. Given several years of substantial loop losses, it may be more appropriate to use a peak loop count from a prior year in the calculation of the appropriate limitations. An even more appropriate approach would likely be to look only at limiting future investment, rather than retroactively "un-investing" existing plant. Regardless of the model used, if the data inputs are flawed, so too will be the outputs. The FCC's independent variables are clearly flawed.

Some of the most easily quantifiable errors in the independent variables used by the FCC are created by the Commission's use of the TeleAtlas tool to define study areas, which for some companies are so far afield of reality it is difficult to believe that they passed even cursory review. One very noticeable example is illustrated in the Petition for Reconsideration and Clarification (PFRC) filed by Accipiter Communications Inc. (Accipiter)¹⁵. In its PFRC, Accipiter documents a model input for study area land area of 30.5 square miles, where the company's actual study area encompasses 1,010 square miles, an error of over 3,211%. Another excellent example is in the case of Penasco Valley Telephone Cooperative, Inc., where the model input utilized for study area land area is 2,331 square miles, where the company's actual study area encompasses 4,651 square miles, an error of 99.5%.

¹⁵ *Petition for Reconsideration and Clarification of Accipiter Communications Inc. 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, filed December 29, 2011.

In addition, even when the correct study area boundary is used to collect the census data used for the model inputs, the process can still produce substantial input errors. For example, census block boundaries and study area boundaries are not coterminous; however, the FCC has assumed that for any census block whose centroid falls within the study area, the entire census block falls within the study area. For rural carriers that serve low density areas adjacent to high-density areas, this introduces significant errors in inputs. Should the FCC eventually decide to use regression as a means to establish limitations on capital and operating expenses, affected carriers must have the opportunity to review the census blocks used to generate input data. Companies currently have no reasonable methodology to confirm the inputs utilized by the FCC, and therefore can put no level of reliance on the outputs produced by the model.

5. *The Regression Analysis Utilizes Flawed Independent Variables.*

The independent variables ultimately selected by the FCC for use in the regression formula do not appear to capture the primary drivers of a carrier's costs, or explain why an individual carrier may legitimately have costs that are significantly higher than the 90th quantile selected for limitation.

The FCC's model uses the number of loops as an independent variable and specifically states that "the more loops a carrier is serving, the higher its expenses will be"¹⁶ and "as expected, the loops variable was the most influential independent variable in predicting the values for the algorithm steps"¹⁷. We believe that this approach applies too much weight to the absolute number of loops and does not take into account true customer density. Subscribers per mile of loop plant would be a more relevant density measurement. Simply utilizing loop counts

¹⁶ See *USF and ICC Reform Report and Order and FNPRM*, Appendix H, paragraph 23.

¹⁷ See *USF and ICC Reform Report and Order and FNPRM*, Appendix H, paragraph 30.

does not take into account the fact that many carriers serve large geographical areas with small populations, which results in very long, very expensive loops. The model as designed penalizes carriers in this situation and rewards those with a high number of loops, regardless of whether they are in a densely populated area with shorter subscriber loop facilities. The Moss Adams Companies recommend that the model be changed to incorporate more appropriate density measures, such as subscribers per mile of loop plant. In the cases where data is not publically available, the FCC can require companies to provide such data annually and rely upon certifications and auditing to vouch for the integrity of the data, as it currently does in other situations such as the U.S. Department of Agriculture Rural Development Utility Program Form 479.

The FCC's use of the number of census blocks as a proxy for population density is an inappropriate leap of faith. While census blocks may be an input that conveniently fits the FCC's regression model, and is readily available, the number of census blocks in a study area has nothing to do with the actual population or population density of the study area. We realize that the Census Bureau does utilize established criteria in defining census blocks, but the actual census block boundaries are nowhere near consistent and even less so in rural areas. There does not appear to be any justification for utilizing the number of census blocks in a study area as a determinant of the cost of providing service in that study area.

The FCC's utilization of the percentage of water in a study area as a surrogate independent variable for terrain and/or soil type is a major problem with the regression analysis. More appropriate independent variables for geographic constraints that impact a carrier's costs include: terrain such as mountains and valleys, soil types such as loam or rock, the length of construction season, the water table, weather patterns, and many more. In most cases, these

factors will have significantly greater impacts on a carrier's costs than will the percentage of water in the study area. Much of this data should be publicly available from the U.S. Geological Survey or can be provided and certified by carriers on an annual basis.

Finally, the FCC's inputs for housing units, land area and the number of census blocks in a study area are broken down according to the Census Bureau's categorization of each census block as "urbanized area," "urbanized cluster," or "non-urban." An urbanized area is a cluster of census blocks with more than 50,000 households, an urbanized cluster is a cluster of census blocks with less than 50,000 but more than 2,500 households, and non-urban is a cluster of census blocks with 2,500 or fewer households. Within the FCC's data set 7.6% of the study areas contain census blocks categorized as urban areas, 26.5% of the study areas contain census blocks categorized as urban clusters, and 99.9% of the study areas contain census blocks categorized as non-urban.

One would intuitively think that the more sparsely populated the census block, the more costly it would be to serve because customers are more spread out, which results in longer loops. However, this is not the case in the FCC's regression analysis. A review of the coefficients for households for each of the 11 ALs analyzed, shows that for 10 of 11 ALs, the most costly to serve census blocks are those categorized as urban clusters, then urban areas, and then non-urban. Interestingly, for AL 13 – CWF Maintenance Expense Assigned to CWF Cat.1 the cost structure is reversed. Not only is it puzzling that that households in non-urban areas are the least costly to serve, but also the order in which the categories fall on the cost spectrum defies logic. The coefficients should go in the order of household density, but they do not. Even more astonishing is the fact that for certain ALs, the FCC's coefficient for households in both non-urban census blocks and urban area census blocks are negative. This means that households in

these census blocks actually reduce the loop cost calculated in the regression model, where households in urban clusters add to the cost.

6. *The Limitations as Calculated Produce Anomalies and Do Not Yield Consistent Results for Similarly Situated Companies.*

As noted above, we do not believe that the FCC's regression model adequately accounts for density and cost of construction, including more reasonable factors such as loop length, which is a major factor leading to high loop costs. The model also does not take into account geographic conditions that must be overcome when constructing plant. The fact that these variables are not adequately considered in the regression analysis yields inconsistent results for similarly situated companies. This becomes quite apparent upon review of the proposed limitations for AL1 – cable and wire facilities plus the portion of cable and wire facilities leases assigned to Category 1 and AL2 – central office equipment plus the portion of central office equipment leases assigned to Category 4.13. These two items, arguably the most influential in the calculation of High Cost Loop Support and certainly the most impacted by density and construction elements, yield highly irregular results for similarly situated companies.

For example, Central Texas Telephone Cooperative (Central Texas) submitted ex parte communications¹⁸ to the FCC indicating that the company has 1.90 loops per square mile and has a limitation for AL1 of \$12,118 per mile. Logic would indicate that areas with few subscribers, or loops, per mile necessitate higher costs and those costs should be comparable for similarly situated companies. However, Central Texas provided data to the FCC indicating that out of six

¹⁸ *Notice of Ex Parte of Central Texas Telephone Cooperative, Inc., 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, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, and *Lifeline and Link-Up*, WC Docket No. 03-109, filed January 9, 2012.

comparable companies listed, three had more loops per mile (i.e. have a higher population density), however all three had significantly higher limitations per mile. For a similarly situated company with 3.07 loops/mile and very similar total loops (6,228 vs. 6,599), that is geographically very close to Central Texas, the regression model yielded a limitation of \$18,001 per mile; \$5,884 more per mile than Central Texas, even though they serve a more densely populated area. Utilizing the same \$18,001 per mile limitation of the comparable company yields a total limitation for AL1 of \$62,428,340 for Central Texas, an amount \$20,404,755 or 48.56% higher than its current limitation and much more consistent with Central Texas' actual investment.

This example clearly indicates that some companies are being penalized by the FCC's regression analysis for serving larger, less densely populated areas by not recognizing the additional costs associated with this undertaking. These anomalies in the regression results show that the FCC's regression model, as currently proposed, does not yield consistent results for similarly situated companies.

7. The Limitations Are Applied Incorrectly to the High Cost Loop Support Algorithm and are Missing Critical Components

We believe there are three accounting issues that must be addressed in the calculation and application of the proposed regression-based limitations. First, the High Cost Loop Support ("HCLS") data inputs ("data lines" or "DL") should be limited, not the outputs ("algorithm lines" or "AL"). Second, the limitations must take into account the impact of accumulated depreciation and other Part 32 accounts on the calculation of support. Third, the methodology used to calculate the limitations on depreciation expense must be modified.

We believe that the limitations should be applied to the HCLS data lines instead of the algorithm lines, which would allow the 26 step algorithm to work as designed. The current limitation of the algorithm lines does not account for the interrelationship between many of the data lines used in the calculation of support. It should be noted that all of the algorithm lines are calculations based on various data lines, so any proposed limitations can also be accomplished by adjusting the data lines. As currently proposed, the FCC's regression model limits outputs, rather than limiting inputs and allowing the inputs to be run through the model. An excellent example of this is AL 3, also referred to as the "A" Factor, which is calculated as Cable and Wire Facilities (CWF) divided by Total CWF. The "A" Factor is used in the allocation of expenses associated with CWF. AL 3 is one of several algorithm steps that uses both AL and DL inputs to produce the result; in this case AL1, DL 255 (Account 2400 - Total CWF) and DL 815 (Account 2680 – Amortizable Tangible Assets – CWF). The FCC's proposed treatment only limits the AL1 amount, however, neither DL 255 (which includes AL1) nor DL 815 are adjusted. As a result, the algorithm is not allowed to calculate support as it was intended and produces an incorrect result.

Accumulated depreciation and other Part 32 accounts must be taken into consideration if the FCC is going to limit the 11 proposed algorithm lines, or follow the approach to limiting the data lines described above. The FCC's proposed regression analysis neither limits the accumulated depreciation related to CWF and COE assets removed via AL1 and AL2, nor does it remove amounts from other associated accounts. If the FCC is going to limit both AL1 and AL2, the following data lines should also be limited:

DL 160 – Account 2001 – Total Plant in Service

DL 190 – Account 3100 – Accumulated Depreciation

DL 245 – Account 2210-2230 – Total COE

DL 255 – Account 2410 – Total CWF

DL 275 – Account 3122 – COE Accumulated Depreciation

DL 280 – Account 3124 – CWF Accumulated Depreciation

DL 700 – Cost Study Average CWF – Total Account 2410

DL 710 – Cost Study Average CWF Cat 1 – Total Subscriber Line Plant

By not limiting these data lines, the FCC's regression analysis yields flawed and punitive results on companies that are proposed to be limited. In addition, as discussed above, limiting the algorithm lines and not the data lines does not allow the HCLS algorithm to work as designed. There could be some question as to how to appropriately limit the accumulated depreciation reported on DL 190, DL 275 and DL 280, but this could be handled one of two ways. First, a ratio of the limited investment in the associated plant account to the total plant account could be developed and applied to the accumulated depreciation. Alternatively, the limited plant could be handled as a retirement, in which case Part 32 for retirement accounting would treat the investment as fully depreciated. Whichever method is selected would be more appropriate than the current approach of ignoring depreciation reserve and other associated accounts in the algorithm. The limitation of algorithm lines rather than data lines yields inappropriate results and ignores the net book value of the assets being removed.

Lastly, depreciation expenses have not been properly accounted for in the FCC's regression model. Specifically, depreciation expenses should not be analyzed independently via regression, as they are a byproduct of the associated plant investment. Instead, depreciation expenses should be reflected as a function of the asset values removed. The FCC's current, regression-based approach results in limitations on depreciation expenses on AL 17 and AL 18 that are excessive and inconsistent with Part 32 accounting principles. The FCC's current approach also creates situations where depreciation expense is limited when the associated plant account is not limited. This would suggest that the depreciation rates for these accounts are excessive, which is nearly impossible in a regulated environment. Depreciation rates are typically approved by state commissions and are therefore not subject to unilateral adjustment by the company. In cases where depreciation rates are not established by the state commission, the FCC has established depreciation guidelines.

Finally, most carriers are audited annually by an independent CPA firm that will verify the proper use of the approved depreciation rates, thus there is minimal risk of improper application. Therefore, we recommend that regression not be used to limit depreciation expense. Instead, we believe that depreciation expense limitations should be computed as the percentage of the limitation of the associated plant investment multiplied by the depreciation expense.

III. Connect America Fund for Rate-of-Return Carriers

One of the major concerns that exists within the rural ILEC community is the fact that 4/1 Mbps broadband availability has been mandated in order to continue to receive legacy funding¹⁹ for the voice network and to be eligible for Connect America Fund Intercarrier Compensation

¹⁹ Legacy funding includes High Cost Loop Support (HCLS) and Interstate Common Line Support (ICLS) but excludes Local Switching Support (LSS), which is being eliminated effective July 1, 2012.

(CAF ICC) support. While the FCC has stated that the CAF is designed to begin the transition of legacy high-cost universal service support to a broadband-focused CAF²⁰, the CAF ICC support identified in the *Report and Order and FNPRM* does not provide any recovery for the cost of deploying and maintaining broadband. Therefore, the requirement to deploy and maintain a 4/1 Mbps broadband capable network is an unfunded mandate.

The Rural Associations²¹ have proposed the creation of a new broadband-focused CAF mechanism that would support the cost of deploying and maintaining broadband, and that would ultimately replace existing support mechanisms for rate-of-return carriers. The FCC now seeks focused comment on this proposal and asks whether and how it could be modified consistent with the framework adopted in the Order to provide a path forward for rate-of-return carriers to invest in extending broadband to unserved areas.²² The FCC asks the following questions in relation to the Rural Associations' proposal.

1. Given the FCC's \$2 billion USF budget, how can the FCC best accommodate the Rural Associations' Plan?

First, we contend that there is no reason why the FCC should establish an artificial budget to support the deployment of broadband services. The FCC has set a mandate that rate-of-return carriers make 4/1 Mbps broadband service available upon "reasonable request" by customers, and therefore must fund this mandate. Simply stating that there is a \$2 billion annual budget does not ensure sufficient funding for the deployment of the mandated network. Essentially, the FCC has put the cart (the budget) before the horse (the network). Properly done, the FCC would

²⁰ See *USF and ICC Reform Report and Order and FNPRM*, paragraph 1031.

²¹ The Rural Associations are comprised of the National Telecommunications Cooperative Association (NTCA), the Organization from the Promotion and Advancement of Small Telephone Companies (OPASTCO), the Western Telecommunications Alliance (WTA), and the National Exchange Carrier Association (NECA).

²² See *USF and ICC Reform Report and Order and FNPRM*, paragraph 1032.

first identify the cost of deploying the mandated network and then determine the amount of funding necessary to build such a network.

Given the \$2 billion budget that has been established, and assuming that this budget will not be modified, the Moss Adams Companies believe that the FCC has already outlined a few options that may accommodate the Rural Associations' Plan within this budget, although we do not necessarily agree with the initial conclusions that the FCC has appeared to reach on each. The first option would be to utilize the savings from other components of the CAF to increase funding for rate-of-return carriers. If these funds are not deemed necessary for the current recipients to provide supported services, we believe that shifting them to rate-of-return carriers would be a very appropriate use, as it would help to accomplish the broadband universal service goal in the highest cost areas of the country. The FCC seeks to add broadband to the services supported by universal service, which adds costs for carriers subject to that mandate. If the FCC is going to add to a carrier's cost burden, it also needs to fund that mandate through whatever sources are available. In this case, doing so would not add to the universal service burden placed on consumers.

A second option is to establish reasonable limitations on capital and operating expenses necessary to deploy and maintain the supported services, which would limit the amount of support available to carriers. As outlined above, the FCC's proposed regression analysis is fundamentally flawed and must be modified to establish reasonable limitations. Given the recommendations that we have provided in these comments, we believe that the FCC may be able to modify its proposed regression calculations to develop much more reasonable limitations for rate-of-return carriers that are based on both sound statistical principles and network deployment realities. However, the FCC should not establish limitations with the sole goal of

maintaining the proposed budget, as doing so may not ensure reasonable funding for the costs of meeting the mandate for the supported services.

Another option is to represcribe the rate-of-return as proposed in the Order. Any reduction in the authorized rate-of-return will generate additional “headroom” within the proposed budget of \$2 billion. However, artificially reducing the rate-of-return to a level that will achieve the desired budget is not appropriate. The Rural Associations proposed a 10% rate-of-return, which may or may not be sufficient to cover rural carriers’ weighted average cost of capital. The FCC must follow its own rules for the represcription of the rate-of-return, understanding that this process may not produce the desired results to accomplish the \$2 billion budget. Included in this process will be an analysis of the current cost of debt and an appropriate return on equity, which must take into account the risk inherent in investing in rural networks, including the significant changes outlined in the instant Order and those that will come out of the FNPRM. Once again, this is an area where the FCC has put the cart (the budget) before the horse (the rate-of-return). There is no way to know what the necessary budget is for cost recovery, which includes an appropriate rate-of-return, for the supported services until the FNPRM has been concluded and the rate-of-return has been established.

2. What are the benefits and the cost of providing support for “middle mile” facilities and access to the Internet backbone under the Rural Associations’ proposal?

The Moss Adams Companies have not performed a detailed analysis of middle mile or Internet backbone costs, but we do know that these costs are a significant cost burden for Internet service providers (ISP) in rural areas, including ISP affiliates of rural rate-of-return carriers. The *Report and Order and FNPRM* states that the “actual speed and latency be measured on each

ETC's access network from the end-user interface to the nearest Internet access point."²³ Figure 3 provided shows that this network includes everything from the customer's modem all the way to the connection point with the public Internet. Today, most rate-of-return carriers provide the connection from the end user customer to the ISP using regulated digital subscriber line (DSL) transport. This is the last mile or the local loop. The ISP is then responsible for the transport from the connection point with the rate-of-return carrier to the connection point with the public Internet. This is what the FCC has defined as "2nd Mile Transport" and "Middle Mile Transport", which are non-regulated costs today.

In order to continue receiving support, broadband providers, including rate-of-return carriers, must certify and report broadband speeds and latency metrics for this entire network to USAC on an annual basis. If the FCC is going to condition rate-of-return carriers' support on providing 4 Mbps downstream/1 Mbps upstream broadband across this entire network, it must also include the cost of the 2nd Mile and Middle Mile Transport in the calculation of that support. If the speed is mandated, it must also be supported.

3. The Rural Associations propose that costs be shifted to the interstate jurisdiction based on an individual carrier's "Broadband Take Rate"

This Broadband Take Rate (BTR), as proposed by the Rural Associations, would replace the Subscriber Plant Factor (SPF) currently used to allocate loop costs between the interstate and intrastate jurisdictions in the separations process. The SPF is currently set at 25% interstate and 75% intrastate. Today, the cost assigned to the interstate jurisdiction is recovered through a combination of a federally tariffed end user common line charge and Interstate Common Line Support. The cost assigned to the intrastate jurisdiction is recovered through a combination of

²³ See *USF and ICC Reform Report and Order and FNPRM*, paragraph 111 and Figure 3.

federal High Cost Loop Support, various local rates and intrastate high cost support, where applicable. Costs allocated via the SPF are associated with the local loop, which is used in the provision of both voice and broadband services.

The Moss Adams Companies understand that there are varying opinions on the application of the BTR and the impact that it could have on cost recovery for rate-of-return carriers. In most cases, the Rural Associations' proposal would allocate significantly more loop costs to the interstate jurisdiction through the application of the BTR. Doing so could have positive impacts on some carriers and negative impacts on other carriers. For example, a carrier in a state without a high cost fund to support the high cost of local loops would likely benefit from allocating more loop costs to the interstate jurisdiction, as the Rural Associations' proposal would provide cost recovery via the broadband component of the CAF. Carriers in states with a high cost fund could benefit from maintaining cost recovery from intrastate sources, as this is a fully funded support mechanism today. The Moss Adams Companies do not take a specific position on the appropriate jurisdiction for this cost recovery. Whether broadband costs are recovered through the broadband component of the CAF or some combination of federal and state high cost funding is open for debate, but the FCC must recognize that its broadband mandate requires support of broadband related costs through fully funded support mechanisms.

4. The Connect America Fund for Rate-of-Return Carriers Must be Fully Funded

It is vital to the future of both voice and broadband in areas served by rural rate-of-return carriers that the FCC fully fund the CAF support mechanism. Anything short of a fully funded mechanism for these carriers of last resort will result in legitimate costs not being recovered and the prospect of rural carriers lacking the financial wherewithal to continue providing these services. While the FCC has established an estimated budget of \$2.0 billion for rate-of-return

carriers, approximately the size of the current fund for voice services, there is nothing in the record that indicates that this level of support is sufficient to continue providing supported voice services and to ensure the provision of broadband services, which will become newly supported services. The FCC must ensure that an artificial cap on the overall size of the fund does not preclude rural customers from receiving the benefits of universal service, for both voice and broadband services. We believe that the combination of an overall fund budget, the potential for limitations on capital and operating expenses and the threat of rate-of-return reprscription will thwart future investment by rate-of-return carriers, contrary to the voice and broadband universal service goals of the Commission.

IV. Rate-of-Return Represcription

As discussed briefly above, the authorized rate-of-return has a significant impact on the revenues that a rate-of-return regulated carrier can generate. The after tax rate-of-return becomes the profit that a carrier has to either reinvest in the network or to pay out in the form of principle and interest payments to lenders or dividends to shareholders. Large changes in the rate-of-return will have corresponding impacts on revenue streams and the ability to generate future investment in the company, either via debt or equity. As stated in the FNPRM, “The rate-of-return must be high enough to provide confidence in the “financial integrity” of the carrier, so that it can maintain its credit and attract capital.”²⁴ Neither debt nor equity investors will supply capital to a company that cannot generate enough profit to pay back the initial investment (debt or equity) and provide a return on that investment (interest or dividend).

²⁴ See *USF and ICC Reform Report and Order and FNPRM*, paragraph 1045.

Both lenders and equity investors will expect a return on their investment that recognizes the risk that they have taken in investing. Lenders recognize this risk through the interest rates they charge, while investors recognize this risk through the return on equity that they will receive. As stated in the FNPRM, “The return should also be “commensurate with returns on investments in other enterprises having corresponding risks.”²⁵ So what is an enterprise having a corresponding risk to rural rate-of-return carriers? The State Members of the Federal-State Joint Board, in support of an 8.5% rate-of-return, note that the interest rate on a three month Treasury Bill has fallen from 7.83% in 1990 to 0.15% in January of 2011 and the FCC observes that the average 10-year treasury constant maturity rate has declined from approximately 8.1% in January 1991 to approximately 2% in September of 2011²⁶.

While this is interesting information, investing in treasuries backed by the government of the United States is not an “enterprise having corresponding risks” to investing in a rural rate-of-return carrier. These treasury yields are the interest rates that are paid on the open market for treasury products and are determined by supply and demand. Because treasury products are considered very safe investments, treasury yields decline when demand is high and increase when demand is low. The fact that treasury yields have declined since 1991 to today is reflective of the economy as a whole and the market’s desire to invest in low risk alternatives in turbulent financial times. Treasury yields are not a good indicator of the returns that investors in a given market, including rural telecommunications, demand for their equity investment. The risk profiles for these two investments are very different.

²⁵ See *USF and ICC Reform Report and Order and FNPRM*, paragraph 1045.

²⁶ See *USF and ICC Reform Report and Order and FNPRM*, paragraph 1046.

If the FCC is going to look at enterprises having corresponding risks, it should at least look at the equity returns achieved by other telecommunications providers, and then take into account the additional risks that rural carriers have. For example, rural carriers have fewer customers across which to spread costs and are therefore much more dependent on intercarrier compensation (ICC) and universal service funding (USF) than are non-rural carriers. The FCC's Order reduces the amount of ICC revenue and USF support, revenue streams that rural carriers depend on to help recover costs, available to rural carriers, and pushes off to a future proceeding support for investment in broadband capable facilities. The reform enacted in this Order and the uncertainty around future proceedings, including rate-of-return re prescription and support for broadband investment, only adds to the risk of investing in rural carriers. It is vital that the FCC understand that the rate-of-return provides significant revenue streams to rate-of-return regulated carriers.

V. Eliminating Support for Areas with an Unsubsidized Competitor

In the Order, the FCC has determined that carriers with 100% overlap from an unsubsidized terrestrial, facilities-based competitor will have their USF support phased out over three years. The premise appears to be that if a competitor using similar technology can provide service without support, then the incumbent should not require support either. The FNPRM now seeks comment on a proposed methodology for determining the extent of overlap, a process for preliminary determinations of such overlap, a process for the affected ETC to challenge the accuracy of the purported overlap, and how to adjust support levels in situations with less than 100 percent overlap.²⁷

²⁷ See *USF and ICC Reform Report and Order and FNPRM*, paragraph 1061.

It is not reasonable to phase incumbent ETC support out over a brief, three year period when there is overlap by an unsubsidized competitor. Doing so does not reflect the fact that the depreciable lives of telecommunications assets, and the associated loans that supported the investments, are much longer than three years in most cases. Most telecommunications infrastructure loan terms are 15 years or longer. These investments were made, and funds loaned, under the presumption that cost recovery would be sufficient and predictable based on the rules in effect at the time they were made. Many of these investments were made prior to competitive entry, and certainly prior to the competitor providing the supported services. The incumbent did not have the benefit of foresight when the investment decisions had to be made. The Moss Adams Companies recommend that the phase out period for any overlapped incumbent, whether 100% or a smaller percentage to be determined in this proceeding, be calculated on an individual company basis and be tied to that company's remaining depreciable life for existing assets or loan term for existing loans, whichever is longer. This will allow for a graceful migration from the incumbent network to the competitive network, allowing the incumbent to recover at least a portion of its costs, and repay borrowed funds, that were invested during a different regulatory regime.

To the extent that the FCC determines that overlap of less than 100% warrants a reduction in incumbent support, which we do not recommend, the FCC must recognize that there are certain fixed costs required for all networks regardless of the number of customers served or the level of competitive overlap. The first customer on a network is the most expensive to serve, as he requires an interoffice transport network, a switch, subscriber loop electronics, feeder and distribution networks, general support facilities, etc. All of these facilities are shared with other customers, but are necessary to serve the very first customer. The only facility that is not at least

partially shared with other customers is the drop to the customer's premises, and this may even be shared in a multi-tenant unit. The point is that the FCC cannot simply establish an overlap threshold and remove a like percentage of USF support. Doing so would ignore the fact that there are fixed and variable network costs, only the variable of which can be foregone when a customer is lost to a competitive provider.

The FCC must ensure that it does not reward competitive providers for cherry-picking low cost to serve customers. Incumbents have carrier of last resort responsibilities throughout their entire study area and as such are required to serve all customers within that study area. They cannot pick and choose which customers or areas of their study area are most financially viable. Customers within population centers tend to be easier and more cost effective to serve, while customers in outlying areas tend to be more difficult to serve and at much greater cost. By requiring competitive overlap at 100% of the study area, the FCC, if nothing else, has eliminated the opportunity for competitive providers to cherry pick the low cost customers while causing the phase out of support for those customers to the incumbent.

If the FCC is to define a lower level of overlap at which support is reduced rather than completely phased out, it must be very cautious not to provide the wrong incentives. Not all customers are created equal from a cost and support perspective and, as discussed above, there are fixed network costs that will exist regardless of how much competitive overlap exists. If less than 100% overlap is used to adjust support, we recommend that the FCC establish a baseline cost and support percentage that recognizes these fixed costs and only applies the support reduction to the variable costs for the overlapped area. The FCC has already attempted to do something similar in its regression analysis introduced in this proceeding²⁸, in determining that

²⁸ See *USF and ICC Reform Report and Order and FNPRM*, paragraphs 1079 through 1088 and *Appendix H*.

each independent variable has a “constant”, which represents the value of the independent variable that is not impacted by the dependent variable.

Finally, the FCC must hold competitive providers to the same service standards that an ETC would be held. The *FNPRM* identifies the process that the FCC staff utilized to determine study areas with 100% overlap. In doing so, it states that “staff identified study areas where a wired provider other than the incumbent local exchange carrier offered broadband service at speeds of at least 3 Mbps downstream/768 kbps upstream to all of the census blocks in the study area.”²⁹ This is not an appropriate methodology for determining areas with overlap, because the FCC is not holding competitive providers to the same 4 Mbps downstream/1 Mbps upstream broadband standard that incumbents are required to provide in order to be eligible for universal service funding. If an incumbent is to lose its support, for which it qualifies, in part, as a result of providing 4/1 Mbps broadband, then the competitor that is causing that support to be lost must also be held to the same standard. In addition, there is no discussion of voice service or carrier of last resort obligations to be applied to the competitive provider. In any situation where the incumbent loses all support as a result of overlap by a competitor, the carrier of last resort obligation must transfer from the incumbent to the competitor, otherwise there is a possibility that some customers will not be served by the competitor if or when the incumbent leaves the market. With so much support on the line for the incumbent carrier, competitors must play on a level field or customers will suffer the consequences.

²⁹ See *USF and ICC Reform Report and Order and FNPRM*, paragraph 1063.

VI. Remote Areas Fund

The FCC seeks comment on how best to implement the Connect America Fund for remote areas. We believe that the Remote Areas Fund is best tied to the requirement for rural rate-of-return carriers to provide 4 Mbps downstream/1 Mbps upstream broadband to customers upon reasonable request.³⁰ In respect to the reasonable request obligation, the Order states that, “we require ETCs to include in their annual reports to USAC and to the relevant state commission and Tribal government, if applicable, the number of unfulfilled requests for service from potential customers and the number of customer complaints, broken out separately for voice and broadband services. We will monitor carriers’ filings to determine whether reasonable requests for broadband service are being fulfilled...”³¹ The reasonable request standard is not defined in any level of detail and clearly the reporting requirements are limited.³²

As a result of this nebulous “reasonable request” standard and limited reporting requirements, we believe that the FCC should establish a process by which rural rate-of-return carriers, or their customers, can apply to have the customer’s service request moved to an alternative provider and supported through the Remote Areas Fund. We believe that this transfer process could be handled by USAC and would be in everyone’s best interest. The customer would have their request for broadband service handled by a provider that is better situated and supported to provide the service. The rural rate-of-return carrier would be released of its obligation to build facilities to provide the requested service and would not have to continue to report an unfulfilled request for service to USAC.

³⁰ See *USF and ICC Reform Report and Order and FNPRM*, paragraph 206.

³¹ See *USF and ICC Reform Report and Order and FNPRM*, paragraph 208.

³² See also, 47 CFR §54.313(f)(1)(i), “A letter certifying that it is taking reasonable steps to provide upon reasonable request broadband service...”

VII. Annual Financial Statement Audit Requirements Due by April 1st Each Year

In its *Report and Order and FNPRM*, and associated rules, the FCC establishes new reporting requirements that apply to all privately-held rate-of-return carriers receiving high cost and/or Connect America Fund support³³. These rules include the requirement for privately-held rate-of-return carriers to provide an annual report of the company's financial condition and operations as of the end of the preceding fiscal year that is audited and certified by an independent certified public accountant in a form satisfactory to the Commission, and accompanied by a report of such audit. The filing deadline for this information is April 1, 2012 for what appears to be audits of the preceding fiscal year.

The Moss Adams Companies have several concerns with this requirement. First, the process of planning for and performing an audit can take weeks and in some cases, months depending on the size and complexity of the company under audit. This process can require significant internal resources and coordination for companies to prepare for the audit, in addition to the expense associated with hiring the certified public accountant to complete the audit procedures and issue the report. Audits can also require information from third parties such as actuarial reports for pension liabilities or financial statements from material investments, where the companies under audit have limited control over the timing of receipt of the information. Many companies that currently receive a financial statement audit have structured this process and their resources around current reporting deadlines required by key industry lenders such as the Rural Utilities Service, CoBank and the Rural Telephone Finance Cooperative, which allow 120 days from the previous fiscal year end to finalize the audit.

³³ See 47 CFR §54.313(f)(2) and §54.313(j).

As a result of the current filing deadlines for audits established by lenders, most public accounting firms with industry experience in serving recipients of high cost support have structured their audit practice around meeting the 120-day deadline based on the needs of their client base. Further, the majority of support recipients operate on a calendar year basis with fiscal years ending December 31st, which results in a condensed 16-week period for audit fieldwork to be performed and the audit report and financial statements to be issued. Audit fieldwork typically is not scheduled for the first two weeks in January as most companies have not yet closed their year-end transactions, which results in a 14-week window for companies and accounting firms to conduct audit fieldwork, wrap the engagement and issue the audit report.

Depending on the size of company, audit fieldwork can range from a few days to several weeks and even months to complete for the largest, most complex carriers. To comply with professional audit standards, the process of wrapping the audit after fieldwork typically includes reviewing the audit documentation, preparing and reviewing the financial statements and footnote disclosures, and preparing and finalizing the audit report and required communications with management and those charged with corporate governance (i.e. Boards of Directors and owners). This process can also take a matter of weeks to complete.

By requiring audits to be submitted by April 1st rather than May 1st, the Commission is reducing the timeframe that companies and firms have to complete the audit by nearly 30%. This will create significant additional burden on companies and firms that could result in a decrease in the overall quality of the audits and will most likely reduce the number of firms performing the audits that have the appropriate level of industry experience to provide the oversight that the Commission seeks with this requirement.

Within the Moss Adams client base, we estimate that over two-thirds of the audits we perform with calendar year ends are submitted by April 1st with the remaining third being submitted by May 1st, with a small number of exceptions for unusual events or circumstances that come up periodically. We anticipate that this timing is relatively consistent with other firms that specialize in audits for high cost support recipients. We are confident that the Commission would receive a significant portion of the audits by April 1st anyway, regardless of the deadline, and feel that the benefit of the Commission requesting the information at the earlier date does not outweigh the significant cost associated with reducing the time companies and firms have to complete the audits.

Additionally, the new reporting requirements will most likely result in companies or subsidiaries being audited that have not received an audit in previous years. The process of performing a first-year audit typically requires significantly more time and resources, as audit procedures need to be performed on beginning balances in addition to ending balances in order for the certified public accountant to express an opinion on the financial statements. There are also documentation and other procedures required by professional audit standards that take significantly more time in the initial year such as risk assessment, internal control documentation and testing and developing an understanding of the company's operations and management.

The April 1, 2012 deadline is not practical for companies undergoing their first audit due to the additional time required to plan, perform and complete a first-year audit to comply with professional audit standards.

The Commission should modify the annual reporting deadline outlined in 47 CFR §54.313(f)(2) and §54.313(j) to at least May 1st, and potentially later, and defer the effective date of this requirement to begin on May 1, 2013 for audit reports on fiscal years ending during 2012.

While preserving the Commission's oversight objectives, these deadlines would prevent companies that currently receive an audit from incurring additional burden and expense, maintain the overall quality of audits and the pool of accounting firms with the requisite industry experience to perform the audits and would allow companies subject to a first-year audit adequate time to prepare for and meet the reporting requirements. In addition, such a delay would allow the Commission to provide further guidance on additional items that should be included in the audit report, such as depreciable life tables or cable miles, to ensure compliance and regulatory reporting.

VIII. Conclusion

The FCC's *Report and Order and FNPRM* as written would negatively impact rural rate-of-return carriers and inhibit their ability to maintain the FCC's universal service mandate for both voice and broadband services. As it works through the *FNPRM*, the FCC must be mindful to balance the interests of consumers who pay into the universal service fund and the consumers who receive universal service as a result of the fund. Consumers in the most sparsely populated and costly to serve areas of the country rely upon the services provided by rural rate-of-return carriers.

The FCC must ensure that support for these carriers is sufficient to ensure their financial viability and the deployment and maintenance of the network upon which universal service depends. Arbitrary limitations on capital and operating expenses, a predetermined budget for USF support, significant reduction in the rate-of-return, and increased regulatory reporting requirements do not bode well for rate-of-return carriers and their provision of universal service in rural America.

January 18, 2012

Respectfully Submitted



MOSS ADAMS LLP

By:

Chad A. Duval, Principal

Clay R. Sturgis, Partner

Gregg A. Amend, Partner

601 W. Riverside Ave., Suite 1800

Spokane, WA 99201

509-747-2600

chad.duval@mossadams.com