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
	)	
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

FNPRM REPLY COMMENTS OF GVNW CONSULTING, INC.
USF ISSUES

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EXECUTIVE SUMMARY

In its Transformation Order, the Commission has focused almost exclusively on managing all change to an artificial national cap as it has been unable to utilize a decade long record to reform the USF contribution mechanism. We believe the Commission's effort to date fails to meet the statutory test of providing sufficient and predictable support as is required by the tenets of the Telecommunications Act of 1996.

The difficulty in reaching a solution set to rural carrier middle mile funding is exacerbated in comments from a carrier afflicted with regulatory amnesia, Windstream. For many years, large national carriers have made choices to invest in their urban areas under price cap regulation. Quite frankly, that is a logical outcome of such an "incentive" approach. However, Windstream self-servingly seeks to take funds away from rural areas by asserting that money is being taken away from price cap areas where the greatest need for broadband funding is evident. Rural areas of rate of return carriers should not be penalized for the proactive choices made by large carriers, especially carriers such as Windstream that opted into price cap regulation.

Section 65.103 of the Commission's rules permits carriers to submit direct cases, reply comments and rebuttal testimony on interstate rate of return issues. The Commission shut off this option by waiving its own rules related to gathering factual information. In so doing, we believe that the Commission has formulated its tentative conclusion before thoroughly gathering and considering relevant information. This is no small thing, assuming that this rate-of-return adjustment could be in place for as long as the prior level has been in place, and thus has far-reaching impacts for rate-of-return carriers. The Commission's premature conclusion of a 9% interstate rate of return also

appears to totally ignore the increased regulatory risk – driven in large part by the Commission's own *Transformation Order*.

We agree with the Indiana URC in their encouragement to the FCC to avoid situations in which the USF support could be lost by a carrier that has overlap by an unsubsidized competitor in a town or village, but the same carrier is the only carrier in the areas outside the town or village. It is crucial to remember that rural carriers must construct their networks that have been engineered to meet carrier of last resort requirements in a holistic and integrated fashion. There are no "modules" that can be removed, based on a federal regulator's view of what constitutes competition in a portion of the service area, without creating harm for the other areas served by the carrier. The entire network for each rural carrier was deployed under a set of rules prior to December 29, 2011 that created a reasonable expectation that recovery of costs would be allowed to occur. We believe that changing the rules in this fashion would be determined to be retroactive ratemaking. We also recommend that any carrier that receives support from the schools and libraries fund, the rural health care fund, or the Lifeline fund be considered a subsidized competitor.

In Appendix H of the *Order,* the Commission signals its intent to limit reimbursable capital and operating costs for rate of return carriers by using quantile regression analyses (QRA). In a stunning indictment of the FCC's application of QRA, Exhibit E of the RAG filing details the report of Dr. Roger Koenker, the original author of QRA. For example, at page 1 of his report, Dr, Koenker indicates that the FCC inappropriately estimates quantiles for each distinct cost component, which "*undermines the very purpose of relying upon a quantile regression analysis in the first instance*."

We believe the Commission has erred in its attempt to apply such a model retroactively, has not properly selected its independent variables, has not properly accounted for the interrelationship between key variables, and should not apply this approach to ICLS payments for carriers.

We submit that the Commission's proposal to adopt regression caps that apply to legacy capital expenditures is unlawful and constitutes retroactive ratemaking. We believe that changing the recovery rules for investments placed into service prior to the effective date of the *Transformation Order* does not comport with the Act and basic rules of administrative procedure.

A thorough study of the data set prior to formulating a conclusion by the Commission staff would likely have uncovered several key variables that are presently missing from the proposed quantile regression. The proposed quantile regression approach does not utilize two important attributes of topography and geology for companies that operate in some of the harshest operating conditions in the United States. It seems illogical to assert that these carriers have been placed in a similarly-situated peer group if one chooses to ignore topography, geology and climatic conditions that serve to create much higher than average costs to operate.

We are concerned with the Commission's tentative conclusion in the *Transformation Order* that methods similar to the high cost loop support regression models will be used to limit costs that are eligible for the ICLS mechanism. We respectfully recommend that the Commission address the inadequacies with the current regression proposal prior to introducing more problems that are certain to occur with a regression modeling effort for ICLS.

Introduction and Background

The purpose of these reply comments is to respond to the Further Notice of Proposed Rulemaking of the Federal Communications Commission released on November 18, 2011. For this reply comment date, the Commission seeks comment on certain additional issues in Section XVII A-K of the *Further Notice* related to universal service issues. We have focused our reply comments in this round to issues pertaining to the proposed Connect America Fund, the review of the authorized interstate rate of return for rural carriers, the proposed reductions to support when an unsubsidized competitor overlaps an incumbent's service territory, and criticism of the proposed quantile regression statistical limitation.

GVNW Consulting, Inc. (GVNW) is a management consulting firm that provides a wide variety of consulting services, including regulatory and advocacy support on issues such as universal service, intercarrier compensation reform, and strategic planning for communications carriers in rural America. We are pleased to have the opportunity to offer reply comments addressing the issues the Commission has raised in its *Further Notice*, as well as offer comments that relate to the *Transformation Order (Order*) released by the Commission on November 18, 2011.

We encourage the Commission to provide the legally necessary support that complies with the law as found in the Telecommunications Act of 1996.

B. CONNECT AMERICA FUND FOR RATE-OF-RETURN CARRIERS

<u>Aspects of the FCC proposals are not focused to fully realize the broadband levels needed in rural America</u>

RLECs have an outstanding track record of providing outstanding service, and as noted by the RAG at page 31, are "*not distracted by substantial urban, regional, national and international markets and business opportunities that compete for their resources in the name of higher profitability.*"

However, one potential distraction relates to carriers being required to post letters of credit (LOC). In this regard, we concur with the comments offered by ITTA and Frontier. ITTA pointed out that there are existing regulatory safeguards in place, such as the ETC designation process that address financial capability. Thus, a LOC requirement is unduly burdensome. Frontier points out that a LOC would unnecessarily divert resources away from broadband deployment. The Blooston Rural Broadband Carriers note that the FCC letter of credit proposal is a violation of due process.

The Commission has focused in its *Transformation Order* on how to restrict funds for the highest cost to serve areas via exclusions, phase-outs and caps. We concur with the Rural Association Group (RAG) at page 32 of its comment filing: The FCC's current[1] approach "*sacrifices RLEC broadband at the altar of imprudent constraints*."

In the proposal offered last summer by the Rural Associations as a key component of the Consensus Framework, a metric that measured the "broadband take rate" to

[1] We respectfully submit that a Connect America Fund mechanism will not be successful unless residents in the highest cost to serve areas have the ability to access reasonably comparable broadband services at a reasonably comparable price.

calibrate future Connect America Fund[2] eligibility was included. The logic behind this proposal was that if it is truly the public policy directive to incent a transition to broadband, then an appropriate way to accomplish this is to base future federal universal service support on achieving that precise goal.

In its *Transformation Order*, the Commission instead has focused almost exclusively on managing all change to an artificial national cap[3] as it has been unable to utilize a decade long record to reform the USF contribution mechanism. We believe the Commission's effort to date fails to meet the statutory test of providing sufficient and predictable support as is required by the tenets of the Telecommunications Act of 1996.

<u>Middle mile costs require different approaches in some areas</u>

The difficulty in reaching a solution set to rural carrier middle mile funding is highlighted in comments from a party demonstrating a case of regulatory amnesia, Windstream. For many years, large national carriers have made choices to invest in their urban areas under price cap regulation. Quite frankly, that is a logical outcome[4] of such an "incentive" approach. However, Windstream self-servingly seeks to take funds away from rural areas by asserting that money is being taken away from price cap areas where

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[2] We believe that the law as prescribed in the Communications Act of 1934, as amended by the Telecommunication Act of 1996 in Section 410(c), requires that proposed changes to the jurisdictional separations of costs (as prescribed in Part 36) must be referred to a Joint Board.

[3] Proposing a quantile regression technique that results in negative impacts for over 40% of the subject carriers is at best a draconian approach.

[4] As noted at footnote 13 of the Rural Association Group filing, recent annual reports show that the combined earnings of AT&T and Verizon are approximately twice the level of the entire $4.5 Billion USF. The FCC intends to provide additional support to these carriers without any evidence of need. This is not a criticism of large corporations making money. It simply points out that those companies have actively made choices to place money on their bottom-line and not deploy infrastructure in high cost to serve areas.

the greatest need for broadband funding is evident. Rural areas of rate of return carriers should not be penalized for the proactive choices made by large carriers, especially carriers such as Windstream that opted into price cap regulation.

We find it significant that the Regulatory Commission of Alaska stated that satellite facilities are not sufficient as the technology of last resort to extend broadband services in the state of Alaska.

C. INTERSTATE RATE OF RETURN REPRESCRIPTION

At paragraph 645 of the *Transformation Order*, the Commission waived its own rules related to gathering factual information for a rate of return proceeding. In so doing, we believe that the Commission has formulated its tentative conclusion before thoroughly gathering and considering relevant information. Thus, when at paragraph 1057 the Commission offers its tentative conclusion,[5] that the authorized interstate rate of return "*should be no more than 9 percent*," we believe its approach is flawed.

This contention is supported by the Rural Association Group (RAG). In its filing, the RAG offered an Exhibit from Professor Billingsley that contradicts the Commission's empirically unsupported[6] assertion. As the RAG states at page 140 of its comments:

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[5] Since it has been over two decades since the last formal represcription, we would have expected that the Commission would have initiated a process to develop a methodology that would properly capture the circumstances that rate of return carriers face in the current environment. Using section 65.103 of the Commission's rules, this would have been possible as that section of the rules is the section that permits carriers to submit direct cases, reply comments and rebuttal testimony. This would have created an opportunity for impacted carriers to receive a fair and equitable hearing of the facts and circumstances in play during 2012. As US Telecom notes, the FCC retains a statutory responsibility to have a fair and thorough rate of return represcription proceeding.

[6] This motivation for the unsupported assertion appears to be based, at least in part, on the Commission's overarching desire to measure all decisions against its arbitrary national budget cap for USF.

Reliance on private firms as critical instruments for achieving public policy requires that the financial viability of those firms be taken into account in policy decisions.

When a commenter such as the Wisconsin PSC asserts that rate of return should be lower to keep pace with the reality of the marketplace, they are totally ignoring the increased regulatory risk – driven in large part by the Commission's own *Transformation Order*.

D. ELIMINATING SUPPORT FOR AREAS WITH AN UNSUBSIDIZED COMPETITOR

At paragraph 1038 of the Further Notice, the Commission poses the question as to whether it should adopt rules so that rate-of-return carriers are not required to serve locations within their study area that is served by an unsubsidized competitor, and in turn will not receive support for those lines they choose to serve in the areas of competitive overlap. A number of respondents expressed concern about this type of approach.

<u>Competitive overlap issues require further study and analysis</u>

We respectfully submit that such an approach would be problematic for several reasons. Several groups suggested an additional layer of review be added. For instance, the California PUC indicated that the FCC should conduct an initial review, and then provide the relevant state commission(s) time to review and comment on the preliminary findings. The Indiana URC echoed these same concerns, stressing that state commissions must have the opportunity to provide a second review after the FCC has conducted its initial overlap analysis.

We also recommend that any carrier that receives support from the schools and libraries fund, the rural health care fund, or the Lifeline fund be considered a subsidized competitor.

Unintended consequences should be avoided

The Indiana URC encouraged the FCC to avoid situations in which the USF support could be lost by a carrier that has overlap by an unsubsidized competitor in a town or village, but the same carrier is the only carrier in the areas outside the town or village. It is crucial to remember that rural carriers must construct their networks that have been engineered to meet carrier of last resort requirements in a holistic and integrated fashion. There are no "modules" that can be removed, based on a regulator's view of what constitutes competition in a portion of the service area, without creating harm[7] for the other areas served by the carrier. Now that the FCC has eliminated disaggregation options with its February 3, 2012 Clarification Order, disaggregating support does not appear to be an option to avoid unintended consequences.

We believe that such an approach would preclude a carrier from meeting its obligation under state rules to fulfill carrier of last resort (COLR) responsibilities. It appears that the Commission has not fully studied or contemplated this COLR issue. In its own rules, the Commission uses Section 214(e) (1) to require a carrier to advertise the availability of service throughout the study area. Segmenting portions of a study area

[7] The entire network for each rural carrier was deployed under a set of rules prior to December 29, 2011 that created a reasonable expectation that recovery of costs would be allowed to occur. We believe that changing the rules in this fashion would be determined to be retroactive ratemaking.

would, at a minimum, complicate greatly this portion of the requirements and potentially add to customer confusion.

E. THE RAG EXHIBITS DEMONSTRATE THE COMMISSION'S USE OF THE QUANTILE REGRESSION MODEL IS FLAWED AND WILL LEAD TO SERIOUS DISTORTIONS IN SUPPORT

In Appendix H of the *Order,* the Commission signals its intent to limit reimbursable capital and operating costs for rate of return carriers through the application of quantile regression analyses (QRA). The *Further Notice* requests comments on this proposal.

In a stunning indictment of the FCC's application of QRA, Exhibit E of the RAG filing details the report[8] of Dr. Roger Koenker, the original author of QRA. For example, at page 1 of his report, Dr, Koenker indicates that the FCC inappropriately estimates quantiles for each distinct cost component, which "*undermines the very purpose of relying upon a quantile regression analysis in the first instance*."

As we noted in our initial comments and append to below, we believe the Commission has erred in its attempt to apply such a model retroactively, has not properly selected its independent variables, has not properly accounted for the interrelationship between key variables, and should not apply this approach to ICLS payments for carriers.

Equally disturbing is the fact that key FCC staff chose to ignore the benefit of knowledge gained from visual observation of high cost to serve territory during a May, 2011 visit to Valdez, Alaska. In the comment round of this proceeding, Copper Valley Telephone Cooperative, Inc. provided detailed information concerning its project to

[8] Assessment of FCC Quantile Regression Methods for Estimation of Reimburseable Cost Limits, Dr. Roger Koenker.

extend service through the Keystone Canyon and Thompson Pass. As Copper Valley noted at page 6 of its filing:

Construction in the CVTC service areas can prove to be quite expensive. One piece of the CVTC fiber network passes through the Keystone Canyon. This is a 3 mile canyon that required boring under the canyon to bring fiber to Valdez. The price for this project included costs of $132 per foot just for the boring work, or nearly $700,000 per mile. This fiber also traverses Thompson Pass, which is the same region that the Trans Alaska Pipeline (TAPS) traverses carrying crude oil from Alaska's North Slope to the tide water in Valdez. It is worth noting that this section of the TAPS was the most expensive section of pipeline of the entire 800 mile TAPS route.

Copper Valley's CEO and General Manager drove a key FCC staffer through the Keystone Canyon in May of 2011, demonstrating the rugged terrain involved in such a project. After analyzing the results produced by the Appendix H proposal for Copper Valley, it appears that data points such as the Keystone Canyon are not "similarly situated" to the preordained solution proposed by the Commission staff in its Appendix H. As the Alaska Rural Coalition noted in its comments, any limits on reimbursable capital and operating costs for rate of return carriers must reflect the reality of Alaska's extreme high-cost areas.

<u>Applying Regression Analysis to Existing Investment Is Unlawful and Confiscatory</u>

Carriers have been operating, in some cases for decades, under a specific set of FCC and various state PUC rules through the effective date of December 29, 2011 of the Commission's *Transformation Order*. These rules permitted carriers to act as a carrier of last resort and provide service to customers in their territory.

We submit that the Commission's proposal to adopt regression caps that apply to legacy capital expenditures is unlawful and constitutes retroactive ratemaking. As the

Blooston Rural Broadband Carriers noted in their comments, retroactive application of such limits is a violation of well-settled administrative law precedent. We concur and assert that changing the recovery rules for investments placed into service prior to the effective date of the *Transformation Order* does not comport with the Act and basic rules of administrative procedure.

Independent Variables were not properly selected

In his report, Dr. Koenker notes that all independent variables in the Commission's models[9], except for the counts of loops, contribute to incorrect models, and to wrong estimates based on the models. This shows the benefit of a public policy process that should have received input before reaching an unsupported conclusion. While the FCC claims that statistical significance is not important for predictive purposes, we submit that any model used for descriptive or predictive purposes should at least be representative of the population it aims to describe or predict. Statistically speaking, the output of a model is only as good as the model itself.

A thorough study of the data set prior to formulating a conclusion[10] by the Commission staff would likely have uncovered several key variables that are presently missing from the proposed quantile regression. The proposed quantile regression approach does not utilize two important attributes of topography and geology for

[9] The Commission has proposed a number of independent variables that include the number of loops, number of households, urban-rural designation, and percentage quantity of water. Our initial analysis indicates that several of these variables used in the study to create the proposed regression caps are not statistically significant.

[10] From a regulatory perspective, it borders on amusing when parties such as NASUCA, et al allege that the FCC should reject the RAG plan because it is arcane and cumbersome in a proceeding where quantile regression analysis is proposed as a solution set.

companies that operate in some of the harshest operating conditions in the United States. It seems illogical to assert that these carriers have been placed in a similarly-situated peer group if one chooses to ignore topography, geology and climatic conditions that serve to create much higher than average costs to operate.

Some variables are interdependent, which is not reflected in Appendix H

Networks are deployed in a holistic manner, with choices being made with respect to levels of investment for the discrete piece parts. Savings in one area will create a need for more investment in a different account. As the RAG notes at page 69:

Network optimization depends on a variety of circumstances with various levels of costs within each account. Subjecting carriers to limitations placed on individual accounts will in many cases produce exactly the opposite outcomes of those intended: the Commission would be motivating carriers to reduce costs in individual accounts that may have little, if any, impact on overall carrier network efficiency. In short, the Commission's new system at once discourages efficiency in some respects and invites gamesmanship instead. The Commission's total outlays for universal service will therefore not be optimized, and broadband networks can be expected to suffer as a result.

Failing to recognize the delicate interrelationship[11] between key variables results in some disastrous unintended consequences for small carriers serving sparsely populated areas.

[11] As we noted in our initial comment filing, one example of a company that would suffer from disastrous unintended consequences of the Commission's proposed regression model is a small carrier serving approximately 4,000 square miles of service territory in some of the sparsely populated regions of California, The Ponderosa Telephone Company, headquartered in O'Neals, California. Over the last several years, Ponderosa has endeavored to reduce its software upgrade costs and annual maintenance contracts for eight Nortel DMS-10's by collapsing seven of those switches into one central switching point. In turn, this has necessitated spending additional money on subscriber carrier equipment (COE category 4.13) and cable and wire facilities to connect the remote points in the switching complex. The proposed quantile regression approach offered by the Commission would be extremely detrimental to Ponderosa, with a projected support reduction of over $140,000 per month. It is worth noting for Ponderosa that its costs/network

Applying a similar approach to ICLS would be problematic

We are concerned with the Commission's tentative conclusion in the *Transformation Order* that methods similar to the high cost loop support regression models will be used to limit costs that are eligible for the ICLS mechanism. We urge the Commission to proceed cautiously in this regard for several reasons. As the RAG filing noted at page 73:

Considering the extensive absence of methods, rationale, and impact assessment, it was premature for the Commission to conclude that statistical models to limit capital and operating expenses should apply to ICLS. . . there is not a reasonable path for the Commission to extend that fundamentally flawed methodology to ICLS.

These concerns stem from several reasons. First, ICLS and HCLS are paid to carriers on different bases. ICLS is paid to carriers initially based on projected data, and subsequently trued up to reflect actual amounts for the applicable year of payments. Second, the data input needed to calculate ICLS is different than what is needed for the HCLS computations. As the Commission is aware, the ICLS payments in 2012 will reflect current accounting data. High cost loop support payments in 2012 reflect activity from the 2010 calendar. We believe it will require separate models to accomplish such a task. We respectfully recommend that the Commission address the inadequacies with the

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configuration are reviewed on a periodic basis by the California Public Utility Commission, and have been determined to be reasonable. What it appears that the Federal Communications Commission is attempting to assert with its quantile regression approach is that 25% of the carrier's network cost assigned to the interstate jurisdiction should be viewed differently than the 75% of the network allocated to intrastate that has been reviewed by state regulators. In essence, the Commission has concluded that its quantile regression model more accurately reflects the cost of the network required to serve a particular area than can be determined by state regulators. We believe that in this case the FCC is off base. By limiting individual accounts, we believe the Commission's proposal creates unintended yet serious consequences for carriers such as Ponderosa that have attempted to pursue efficient network design. Instead of properly recognizing the switching cost savings and the reasonableness of the entire network design, the quantile approach is punitive.

current regression proposal prior to introducing more problems that are certain to occur with a regression modeling effort for ICLS.

<u>The no-flash cuts pledge requires a delay until 2013 or 2014</u>

Prior pledges from this Commission to avoid flash cuts would seem to indicate that any regression model implementation should be delayed until 2013 or 2014. As the RAG filing notes in its footnote 136: "*No firm can 'turn on a dime' and comply with a new regulation, and the Chairman has been appropriately concerned about 'flash cuts' in reform.*"

Respectfully submitted,

Via ECFS at 2/17/12

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