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May 21, 2013

VIA ECFS

Marlene Dortch, Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

**Re: American Cable Association (“ACA”) *Ex Parte* Filing on the Connect
America Cost Model, WC Docket No. 10-90**

Dear Ms. Dortch:

On May 17, 2013, Ross Lieberman (ACA), Ed Naef, Sam Kornstein, and Micah Sachs (ACA consultants), and the undersigned, Thomas Cohen (Kelley Drye & Warren LLP), had a call with Carol Matthey, Steve Rosenberg, Amy Bender, Katie King, and Talmage Cox from the Wireline Competition Bureau. The purpose of the meeting was to discuss three aspects of Connect America Cost Model (“CACM”): plant mix, the rate of return, and the cost floor and ceiling. Comments made by ACA were consistent with prior filings in this proceeding.

In addition, the Commission has inquired in its virtual workshop on the CACM about a series of inputs. Below, ACA comments on (1) starting year capital equipment price benchmarks, (2) an ongoing capital equipment price adjustment mechanism, and (3) equipment salvage rates.

1. Starting Year Capital Equipment Price Benchmarks

ACA Recommendation: Because starting year capital equipment prices provided for the cost model by incumbent local exchange carriers were determined based on data collected in 2011, they do not reflect the decline in market prices. Accordingly, starting year prices for capital equipment should be reduced.

The CACM estimates capital equipment costs via a detailed set of tables outlining prices for various components of the network. The data in the tables are drawn from a series of price surveys of members of the United States Telecom Association (“USTelecom”), which for the

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non-Fiber-to-the-Premises (“FTTP”) data points was conducted between March and May of 2011 and for FTTP data points in the fall of 2011.

Prices for communications equipment consistently fall year-over-year. The Board of Governors of the Federal Reserve records the following price declines for equipment relevant to a wireline broadband network:¹

- Enterprise and home voice equipment: 8.3 percent annual price decline from 2002-2011; 7.8 percent annual price decline from 2007-2011
- Transmission, local loop, and legacy central office equipment: 9.3 percent annual price decline from 2002-2011; 8.7 percent annual price decline from 2007-2011
- Data networking equipment: 12.3 percent annual price decline from 2002-2011; 13.1 percent annual price decline from 2007-2011

The Commission currently is planning to begin to distribute Connect America Fund (“CAF”) Phase II in 2014, more than two years after the dates of the original price surveys by USTelecom. Thus, for the capital equipment input to be up-to-date, the FCC needs to account for at least two years of price declines from the original capital expenditure estimates.

ACA recognizes that it may be preferable to apply a different price deflator to each capital equipment category. However, that level of specificity may not be available. Therefore, ACA recommends, as a balance between expedience and fairness, that the Commission use a single price deflator across all capital equipment price benchmarks, compounded on an annual basis for two years. Based on equipment price data cited above, ACA recommends a 9 percent annual price decline, which is the mid-point of the 4-year and 9-year Compound Annual Growth Rates of the price index of transmission, local loop, and legacy central office equipment. Given the more rapid price declines in FTTP equipment, this price deflator is likely conservative.

¹ See Board of Governors of the Federal Reserve System, *Industrial Production and Capacity Utilization – G.17: Communication Equipment Annual Industry Price Declines*, available at http://www.federalreserve.gov/releases/g17/commequip_annual_industry_price_table.htm (rel. Apr. 19, 2013).

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2. Ongoing Capital Equipment Price Adjustment Mechanism

ACA Recommendation: Because of the historical deflationary trend in pricing of telecommunications equipment, the CACM should include a mechanism that reduces capital equipment prices over time.

The current version of the CACM assumes that prices for capital equipment, once set at inception, will never change, yet, as indicated above prices for telecommunications equipment consistently decline. This assumption leads the CACM to overestimate subsidies as soon as year two of the model, because the use of Gompertz-Makeham survival curves implies that a certain percentage of each asset category will be replaced each year. For longer-lived equipment, such as conduit systems (economic useful life of 50 years), the impact on the subsidies in the model will be small due to the five-year horizon of the CAF and the declining time value of money. However, for shorter-lived equipment, such as digital switches (economic useful life of 11 years), the impact will be significant during the course of the CAF's five-year funding period. Accordingly, to reflect industry cost trends – and standard practice among numerous regulators – the Commission should add a mechanism that allows capital equipment prices to be reduced over time at a standard rate.²

² LRIC (long-run incremental cost) models adopted by other national regulatory authorities routinely include an automatic price adjusting mechanism so as to model accurately the declining cost of telecommunications capital equipment. The following are examples of this standard practice:

- The model used by the Australian Competition and Consumer Commission to set prices for five categories of fixed line services includes the functionality to change unit cost trends for capital equipment in the core network and access network. *See Model documentation for the Australian Competition and Consumer Commission: Fixed LRIC model user guide – Version 2.0*, 167 (Analysys Mason 2009) (“The unit cost trends over time can also be defined by the user.”).
- The model used by Ofcom, the regulator and competition authority for the United Kingdom communications industries, to set middle mile wholesale pricing, includes the functionality to change asset unit costs over time. *See Fixed Narrowband Market Review: NGN Cost Modeling Model Documentation v1.0 prepared for: Ofcom*, 21 (CSMG Global, 2012).
- The model used by the Norwegian Post and Telecommunications Authority to set mobile termination rates includes a worksheet titled “CostTrends,” which allows capital and operational costs to vary over time. *See Report for NPT: NPT’s mobile cost model version 5.1, Model documentation*, 3, 5, 29 (Analysys Mason 2009).

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3. Equipment Salvage Values

ACA Recommendation: Because the CACM uses the low end of project equipment lives, the Commission should use higher salvage rates for estimating the recoverable value of equipment at the end of its useful life.

In the recent *Cost Model Order* regarding CACM design, the Commission affirmed that the model will utilize the same economic useful lives as used by the High Cost Proxy Model (“HCPM”), which was adopted to implement provisions in the Telecommunications Act of 1996.³ These economic useful lives are the low end of projection life ranges found in the depreciation tables in the order adopting the HCPM.⁴ The impact of using the low end of useful life ranges is to shorten the depreciation period for equipment, and therefore to amortize its cost over a shorter period of time, which increases the annual levelized cost to serve.

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- LRIC models used by ANCOM, the National Authority for Management and Regulations in Communications, to set pricing levels for various fixed line, mobile, interconnection and Ethernet backhaul services, include the capability to change asset prices over time. *See Calculation of the costs of efficient provision for some electronic communications services provided at the wholesale level in Romania, Fixed Core Model Documentation*, 64 (ANCOM, 2012) (“Price trends are used in order to take into account changes in prices.”). *See also Calculation of the costs of efficient provision for some electronic communications services provided at the wholesale level in Romania, Mobile Model Documentation*, 54 (ANCOM, 2012); *Calculation of the costs of efficient provision for some electronic communications services provided at the wholesale level in Romania, PoI Cost Model Documentation*, 19 (ANCOM, 2012); and *Calculation of the costs of efficient provision for some electronic communications services provided at the wholesale level in Romania*, 14 (ANCOM, 2012).
 - The model used by British Telecommunications plc to set the retail price of call termination and origination for wholesale fixed voice includes the ability to change some asset prices over time. *See Long Run Incremental Cost Model: Relationships & Parameters*, 129 (BT, 2012) (“Equipment Unit costs are indexed forward using the ASU cost trend.”).

³ *See Connect America Fund/Universal Service Support*, WC Docket Nos. 10-90, 05-337, Report and Order, DA 13-807, ¶ 35 (Apr. 22, 2013) (“*Cost Model Order*”) (“Based on our review of the record, we now conclude the model will utilize the same economic lives for assets as specified by the Commission previously when it adopted the HCPM.”).

⁴ *See 1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers*, CC Docket No. 98-137, Report and Order, FCC 99-397, Appendix B (Dec. 30, 1999).

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This depreciation table also includes ranges for asset classes' future net salvage rate. In addition to using the low end of useful life ranges, the current version of the CACM also uses the low end of salvage rate ranges. For example, the model assumes that digital switches will be worth nothing (0 percent salvage rate) after 11 years, rather than 5 percent (5 percent salvage rate) of their current value. In another example, the model assumes that it will cost 30 percent of current value (-30 percent salvage rate) to remove intrabuilding copper rather than 5 percent of current value (-5 percent salvage rate).

If the low ends of useful life ranges are to be used, then one would expect that the salvage rate would be higher than the low end of the salvage rate range. For example, the CACM assumes that digital switches will need to be replaced after 11 years, rather than the high end of the useful life range of 13 years. A digital switch replaced in 11 years is more likely to have recoverable value than a digital switch replaced in 13 years. Therefore, the salvage rate for an 11-year-old digital switch should not be the low value of 0 percent but rather the high value of 5 percent.

Moreover, even when using the high end of the salvage rate ranges, six of the 19 asset classes have negative future net salvage rates, implying there is an additional cost that must be incurred by the end of these assets' lives. As ACA has noted in its comments on the WCB Cost Model Virtual Workshop,⁵ it is not clear why the model should include any additional costs at the end of the asset lives, especially given that the modeled operating expenses provide funding for certain repairs and replacements. These negative values increase the depreciation expenses, resulting in higher ACFs and therefore greater annual levelized costs for each of the asset categories with negative salvage rates. For example, in the case of the 'Pole' asset category, if a pole costs \$100 and has an economic life of 25 years, the -75 percent future net salvage value means that the model provides \$175 in capital recovery to the price-cap LECs for the \$100 capital expense. As such, \$175 would be depreciated over 25 years, rather than the \$100 value of the asset.

Consequently, ACA recommends that the future net salvage rates used in the CACM be modified in two ways: (1) for asset classes where the high end of the salvage rate range is positive, the Commission should adopt the high end of the salvage rate range, and (2) for asset classes where the high end of the salvage rate is negative, the FCC should adopt a salvage rate of zero.

⁵ See Thomas Cohen, Comments on *WCB Cost Model Virtual Workshop 2012: Determining the Annualized Cost of Capital Investments*, available at <http://www.fcc.gov/blog/wcb-cost-model-virtual-workshop-2012-determining-the-annualized-cost-of-capital-investments> (posted Mar. 7, 2013).

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This letter is being filed electronically pursuant to section 1.1206 of the Commission's rules.

Sincerely,



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