BEFORE THE FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Rate of Return Represcription Staff Report	WC Docket Nos. 10-90

COMMENTS
OF
THE OREGON
TELECOMMUNICATIONS ASSOCIATION
AND
THE WASHINGTON INDEPENDENT
TELECOMMUNICATIONS ASSOCIATION

July 25, 2013

SUMMARY AND INTRODUCTION

Pursuant to the Public Notice released under DA 13-1110 on May 16, 2013, the Oregon Telecommunications Association (OTA) and the Washington Independent Telecommunications Association (WITA) hereby submit comments on the Wireline Competition Bureau's Rate of Return Represcription Staff Report (the "Staff Report"). The comments that follow will be brief and to the point: the Staff Report does not reflect the true risks faced by rate-of-return companies in today's market in rural America.

OTA and WITA are trade associations that represent incumbent local exchange carriers (ILECs) operating in their respective states.[1] The members of OTA and WITA are set forth in the attached Exhibit 1. OTA and WITA take the position that the Staff Report does not correctly reflect the highly increased financial risk that rural rate-of-return carriers have faced in recent years, nor the further increase to that risk created by the Commission's recent orders. The Staff Report relies on modeling, specifically the Discounted Cash Flow model. The Staff Report does not get to a "boots-on-the-ground" analysis of what is actually happening in rural markets. Rate-of-return carriers are facing a very uncertain future and the risk to their investments has increased substantially. Now is not the time to engage in rate-of-return represcription.

[1] OTA also includes competitive local exchange carriers (CLECs) among its members.

COMMENTS

In the opinion of OTA and WITA, the Staff Report does not reflect the reality faced by rate-of-return companies in trying to raise capital and make investments. This is a continuation of the trend that has marked the FCC's orders on universal service and intercarrier compensation reform: The failure to take into account real world concerns.

To be specific, there is a clear example of this over-reliance on academic models and the absence of real world analysis in the *Transformation Order*.[2] That example is the Commission's employment of the concept of quantile regression analysis (QRA) in the *Transformation Order*.[3] This academic theory is used by the Commission on the premise that application of the QRA will curb wasteful spending. However, the underlying assumption made by the Commission in this use of QRA is that whoever the highest cost provider is under certain metrics is engaging in wasteful spending just because it has the highest expense ratio. This tautology is used without any consideration of real world circumstances. There is no examination of whether or not the higher cost companies, in fact, used the lowest cost construction techniques available for their service areas. The Commission's use of QRA assumes that if a company's costs are higher than the Commission's selected seemingly "comparable" companies, there must be wasteful spending. There is no true analysis of whether the "comparable" companies are, in fact, comparable. The

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[2] *In the Matter of Connect America Fund, A National Broadband Plan for Our Future, Establishing Just and Reasonable Rates for Local Exchange Carriers, High-Cost Universal Service Support, Developing an Unified Intercarrier Compensation Regime, Federal-State Joint Board on Universal Service, Lifeline and Link-Up, Universal Service Reform - Mobility Fun,* WC Docket No. 10-90, GN Docket No. 09-51, WC Docket No. 07-135, WC Docket No. 05-337, CC Docket No. 01-92, CC Docket No. 96-45, WC Docket No. 03-109, WT Docket No. 10-208, Report and Order and Further Notice of Proposed Rulemaking, FCC 11-161 (rel. Nov. 18, 2011) (*Transformation Order*).

[3] *Transformation Order* at para. 210-226.

QRA is an academic theory applied by the Commission as an arbitrary means to curb support. Unfortunately, and ironically, the QRA may curb support in areas where support is needed the most.

This same reliance on a modeling approach is in the Staff Report on rate-of-return represcription. A model may show the theoretical basis for looking at rate-of-return carriers. However, the fact is that the risk to rate-of-return carriers is higher today than when the 11.25 percent rate-of-return was set in 1990. Telecommunications for rural rate-of-return carriers is a capital intensive business. Yet, as discussed below, sources of capital are drying up.

The rate-of-return companies face a decline in revenue. Although OTA and WITA recognize the argument that the CAF is a floor to the decline of access revenues and that floor seemingly reduces risk, the point is that the *Transformation Order* takes access revenue to zero and there is no apparent replacement for that mechanism. Instead of looking for ways to address access bypass, the Commission has chosen to eliminate the access source of revenue over time.

In addition, rural rate-of-return carriers used to enjoy a reputation of providing the highest quality of service. However, over the past two to three years, call termination problems have seriously eroded that reputation. Customers blame the rural, rate-of-return company for call termination problems when it is the interexchange carriers or their subcontractors that are causing the problem.[4] This damage to reputation results in customers terminating their service

[4] OTA and WITA have submitted comments in Docket No. WC 13-39 on May 13, 2013. *In the Matter of Rural Call Completion*, Docket No. WC 13-39, Notice of Proposed Rulemaking, FCC 13-18 (rel. Feb. 7, 2013). Urgent action is needed in that Docket to address call termination problems.

because they cannot receive important calls. With customers terminating service, revenues go down, but expenses remain the same or nearly so.

Beyond revenue sources going away and the damage to reputations from call termination issues, the *Transformation Order* has substantially increased administrative costs with all of the reporting that is now required. This has increased expenses, rather than reducing expenses, for rural, rate-of-return companies.

All of these factors taken together mean that while capital costs in society in general may have declined overall, the cost of both equity and debt have been increased by the rise in the overall risk to the small, rate-of-return carriers.

The increased risk and deteriorating financial conditions faced in the telecommunications industry by smaller, rural ILECs is discussed in more detail in the recent white paper by Michael Balhoff and Bradley Williams. See, Michael J. Balhoff and Bradley P. Williams, Balhoff & Williams, LLC, State USF White Paper: New Rural Investment Challenges, June 2013 (*New Rural Investment Challenges*). With the elimination of a very substantial percentage of the rural rate-of-return companies' revenue stream, investment in rural areas is discouraged. How does the customer benefit by lack of future investment? How does the consumer benefit by the increased risk and, perhaps, corresponding increased prices for local service? How do customers in rural areas benefit from a deterioration of the ability to make and receive calls to and from the outside world and deterioration in the availability of broadband access to the Internet?

The reality is that rate-of-return carriers are facing an increased risk for their existing operations. The current environment is not a stable environment that encourages future investment. Those rate-of-return carriers do not know how their investments and expenditures will be treated on a year-by-year basis under the QRA. Those carriers do not know where a steady stream of revenue can be found to replace the reductions in intercarrier compensation and USF support that appeared to be destined in the future. The small, rate-of-return carriers are losing customers, and the associated revenue, who, disgusted by call termination problems, disconnect their service.

As pointed out in the *New Rural Investment Challenges*, the *Transformation Order* has had a chilling effect on new investments:

> The reform's effect is predictable. In the absence of sufficient support funding, customers will have fewer choices to subscribe to critical services, including voice and broadband, except in regions that are economic-to-serve or funded adequately. This means that for many rural areas the result of the FCC reforms appears to be precisely the opposite of the new investment predicted by the Commission, even if other rural areas benefit from the reforms.[5]

The National Exchange Carrier Association (NECA) has estimated that rate-of-return carriers are expected to have industry-wide loss in 2020 of approximately one billion dollars annually.[6] The cumulative reduction estimated by NECA through 2021 is 4.6 billion dollars just for intercarrier compensation and universal service fund losses.[7] This does not include the effects of rate-of-return represcription. This loss of revenue can only mean that there is an

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[5] *New Rural Investment Challenges* at p. 3. It should be noted that the intent of this White Paper is to point out to state policy makers the need to act to provide support for rural rate-of-return carriers in light of the financial uncertainty that those carriers face as a result of the Commission's actions.
[6] As reported in *New Rural Investment Challenges* at p. 22.
[7] Presentation by NECA representatives Susan Doherty and Melody Crane to the Oregon Telecommunications Association and Washington Independent Telecommunications Association Annual Meeting, NECA Update, slide 10 (June 6, 2013).

increased risk for investments made by rate-of-return carriers. Not just new investment, but existing investment as well.

As reported in the *New Rural Investment Challenges*, the Rural Utility Service (RUS) has in the past been able to place its full loan portfolio every year. The RUS is one of the major sources for investment into rural telecommunication infrastructure. However, in 2012, this changed dramatically. Borrowers drew down only 11.6 percent of the 690 million dollars that was available from RUS. In addition, only 9.4 percent of the 736 million dollars available from RUS for broadband investment was drawn down in 2012.[8] It is not a coincidence that this drastic change in borrowing for investment purposes occurred directly after the issuance of the *Transformation Order*.

As another indication of the poor investment climate created by the *Transformation Order*, the *New Rural Investment Challenge* cites to testimony submitted by the CoBank, ACB, another major lender for investment in telecommunications infrastructure in rural America:

> CoBank is concerned about the negative impact the Transformation Order (the Order) is having on investment in rural broadband. The various caps and limitations on universal service funding and inter-carrier compensation, especially for rate-of-return carriers, are making it increasingly difficult for us to extend credit for the purpose of deploying ubiquitous rural broadband networks. . . . It is a stated objective of the Commission to support the deployment of rural broadband. Unfortunately, we view many of the provision of the Order, especially the use of QRA, as antithetical to that goal. Affordable broadband for all Americans cannot be achieved without increasing the funding spent to support broadband deployment. The rate-of-return regulated Rural Local Exchange Carrier has historically done the lion's share of the work in deploying truly robust broadband in rural America. Instead of trying to find ways to cut and curtail

[8] *New Rural Investment Challenges* at p. 25, citing The United States Department of Agriculture/Rural Development, "The Telecommunications Program," presentation by RUS Deputy Administrator Jessica Zufolo to the National Association of Regulatory Utility Commissioners, Washington DC, February 2, 2013, slide 5.

> support to these carriers, we continue to believe the Commission's goals would be better served in finding ways to help these carriers continue to succeed in their decades-long mission of bringing the modern telecommunications services to their subscribers.[9]

This point was reemphasized in recent Comments of CoBank, ACB filed as early comments in this docket on June 21, 2013.[10]

The purpose of CoBank's early comments was to ask that the Staff Report be corrected on several factual matters. One of these is the statement in this Staff Report that "extensive funding is readily available to most RLECs. . . ."[11] CoBank corrects this misstatement of fact as follows: "Regrettably, many RLECs do not meet CoBank's lending standards due to the various caps and limitations on universal service funding and inter-carrier compensation. It is unfortunate that the uncertainty of a stable, predictable cost recovery mechanism is making it increasing difficult for CoBank to extend credit for the purpose of deploying ubiquitous rural broadband networks."[12] As CoBank goes on to state, ". . . for those communication companies serving high-cost areas, deploying affordable broadband is not economically possible without a sufficient, sustainable, and predictable level of support."[13] CoBank concludes: "If RLECs don't have a sufficient, sustainable and predictable level of support, deploying affordable broadband is not economically possible and; therefore, not bankable."[14]

The real world is clear. Investment in rural telecommunications infrastructure has already decreased as a result of the *Transformation Order*. This reduction in new investment

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[9] *New Rural Investment Challenges* at p. 25.
[10] Comments of CoBank, ACB (June 21, 2013).
[11] Staff Report at para. 49.
[12] Comment of CoBank, ACB at p. 4-5.
[13] Comments of CoBank, ACB at p. 6.
[14] Ibid.

reflects an increase in risk to the rate-of-return carriers as a result of the Commission's orders and its academic focus rather than real world focus. Where there is increased risk, a higher rate-of-return, not a lower rate-of-return, is needed to attract investment.

To underscore these matters, OTA and WITA point to the recent financial results of its rate-of-return members. The results that follow are for those ILEC members of OTA and WITA that are not associated with a publicly traded company. This means that they are small carriers, usually serving very rural areas. It also means that, as a general matter, there are fewer opportunities to seek to enhance business services as the residential service base decreases.

In Washington, there are thirteen rate-of-return carriers that are not associated with publicly traded companies.[15] These thirteen carriers have invested more than $244,045,909 to provide telecommunications and broadband services to rural areas in Washington.[16] The aggregate rate-of-return for these companies, as a group, for total company regulated operations for calendar year 2011 was a negative 5.27%! Seven of the thirteen companies had net operating losses. These thirteen companies collectively incurred a net loss of $3,613,248 from total company regulated operations in 2011. Looking at the seven companies with net operating losses, the collective total loss was $5,024,959. These low returns demonstrate a very high risk to investment in rural telecommunications infrastructure for the future as well as raising the question of an ability to recover past investments. In fact, for those companies, the net rate base

[15] The omission of operating companies associated with publicly traded companies should not imply those companies did much better than the other companies. In fact, their results were similar. The omission is to blunt the unfortunate criticism that those companies should be evaluated at the parent company level.
[16] Source is a rate-of-return analysis developed by the Washington Utilities and Transportation Commission in Docket No. UT-110858. The numbers submitted in Docket No. UT-110858 were updated to reflect 2011 results.

declined from $76,053,687 in 2009 to $68,591,071 in 2011, demonstrating a decline in new investment.

For Oregon, on aggregate, the non-publicly traded rate-of-return carriers have invested in plant-in-service to provide telecommunications and broadband service to portions of rural Oregon in the amount of $423,794,000.[17] For calendar year 2011, on aggregate, these companies achieved only a 5.5 percent rate-of-return on their net investment.[18] Two companies had negative returns. What this low level of achieved return on investment demonstrates is that the risk associated with the operations of rural rate-of-return carriers is real. This translates in to very little ability to attract additional capital. This means that the cost of capital is correspondingly much higher than it would be for investments that have a record of generating a greater return on investment.

CONCLUSION

OTA and WITA respectfully submit the Staff Report is not based on the real world facts faced by small, rate-of-return carriers. The current environment is one of far greater risk than the rate-of-return carriers have faced in the past. Investment in rural infrastructure is threatened. The rural rate-of-return carriers face increasing difficult challenges to attracting additional equity

[17] This information comes from the Form I that each carrier is required to file with the Oregon Public Utility Commission. It represents calendar year 2011 figures, which are the most recent available financial results at the Oregon Commission. It does not include the results for three average schedule companies, since the average schedule companies do not file Form I.

[18] It may be that the reason that Oregon companies fared better than their Washington compatriots, is that Oregon had an explicit State universal service fund and Washington did not for 2011. Washington does have an explicit fund that will begin in July 2014. However, that fund is capped at $5 million annually and will not adequately address the issues discussed in these comments. Even with a State universal service fund, the returns in Oregon are at unacceptably low levels.

capital and in the ability to find and fund debt for capital projects. Now is not the time to further endanger the financial operations of these carriers by engaging in rate-of-return represcription.

Respectfully submitted this 25th day of July, 2013.

WASHINGTON INDEPENDENT
TELECOMMUNICATIONS ASSOCIATION

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Betty S. Buckley, Executive Director

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Oregon Telecommunications Association

Asotin Telephone Company d/b/a TDS Telecom
Beaver Creek Cooperative Telephone Company
CAL-ORE Communications
Canby Telephone Association d/b/a Canby Telecom
Cascade Utilities, Inc., d/b/a Reliance Connects
*CenturyTel of Oregon, Inc., d/b/a CenturyLink
*CenturyTel of Eastern Oregon, Inc., d/b/a CenturyLink
Clear Creek Mutual Telephone Company
Colton Telephone Company, d/b/a ColtonTel
Douglas Fast Net
Eagle Telephone System, Inc
Eastern Oregon Telecom, LLC
*Frontier Communications Northwest, Inc
Gervais Telephone Company
Helix Telephone Company
Home Telephone Company d/b/a TDS Telecom
McMinnville Access Company
MINET
Molalla Telephone Company d/b/a Molalla Communications Company
Monitor Cooperative Telephone Company
Monroe Telephone Company
Mt. Angel Telephone Company
Nehalem Telecommunications, Inc., d/b/a RTI Nehalem Telecom
North-State Telephone Co
Oregon-Idaho Utilities, Inc
Oregon Telephone Corporation
People's Telephone Co
Pine Telephone System, Inc
Pioneer Telephone Cooperative
Roome Telecommunications, Inc
St. Paul Cooperative Telephone Association
Scio Mutual Telephone Association
Stayton Cooperative Telephone Company
Trans-Cascades Telephone Company, d/b/a Reliance Connects
Warm Springs Telecom

*Not participating in these comments.

Washington Independent Telecommunications Association

Asotin Telephone Company d/b/a TDS Telecom
*CenturyTel of Cowiche, Inc., d/b/a CenturyLink
*CenturyTel of Inter-Island, Inc., d/b/a CenturyLink
*CenturyTel of Washington, Inc., d/b/a CenturyLink
Ellensburg Telephone Company d/b/a FairPoint Communications
Hat Island Telephone Company
Hood Canal Telephone Co., Inc. d/b/a Hood Canal Communications
Inland Telephone Company
Kalama Telephone Company
Lewis River Telephone Company, Inc. d/b/a TDS Telecom
Mashell Telecom, Inc. d/b/a Rainier Connect
McDaniel Telephone Co. d/b/a TDS Telecom
Pend Oreille Telephone Company, d/b/a RTI
Pioneer Telephone Company
St. John Co-operative Telephone and Telegraph Company
Skyline Telecom, Inc.
Tenino Telephone Company
The Toledo Telephone Co., Inc. d/b/a ToledoTel
Western Wahkiakum County Telephone Company d/b/a Wahkiakum West Telephone
Whidbey Telephone Company
YCOM Networks, Inc. d/b/a FairPoint Communications

*Not participating in these comments.