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

COMMENTS OF THE ALASKA RURAL COALITION

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I. Introduction.

The Alaska Rural Coalition[1] ("ARC") files its Comments in this proceeding pursuant to the *Public Notice* issued by the Federal Communications Commission ("Commission") on May 16, 2013 seeking comment on the Staff Report on Rate of Return Represcription ("Staff Report").[2] The ARC urges the Commission to evaluate the impacts of the Staff Report with a critical eye on the negative impact a substantial decrease in the authorized rate of return will have on the high-cost support needed to further the Commission's goals of extending broadband to unserved and underserved regions of rural America. The Staff Report recommends a rate of return in the range of 8.06% to 8.72%, which could be an almost 30% reduction from the current authorized rate of return of 11.25%.[3] Such a reduction will materially reduce all forms of high-cost support for rate of return ("RoR") carriers at a time when these carriers have stated emphatically that they need more support, not less, to fulfill the Commission's broadband goals.

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1 The ARC is composed of Arctic Slope Telephone Association Cooperative, Inc.; Bettles Telephone, Inc.; Bristol Bay Telephone Cooperative, Inc.; Bush-Tell, Inc.; Circle Telephone & Electric, LLC; Cordova Telephone Cooperative, Inc.; Copper Valley Telephone Cooperative, Inc.; City of Ketchikan, Ketchikan Public Utilities; Matanuska Telephone Association, Inc.; OTZ Telephone Cooperative, Inc.; Interior Telephone Company; Mukluk Telephone Company, Inc.; Alaska Telephone Company; North Country Telephone Inc.; Nushagak Electric and Telephone Company, Inc.; and The Summit Telephone and Telegraph Company, Inc.

2 *See Connect America Fund*, WC Docket No. 10-90, *A National Broadband Plan for our Future*, 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, Report and Order and Further Notice of Proposed Rulemaking, FCC 11-161 (rel. Nov. 18, 2011) ("*Transformation Order*" and "*FNPRM*"), *Universal Service Reform-Mobility Fund*, WT Docket No. 10-208; Federal Communications Commission, Public Notice, *Wireline Competition Bureau Seeks Comment on Rate of Return Represcription Staff Report*, WC Docket No. 10-90; (May 16, 2013) ("*Public Notice*").

3 *Public Notice* at 2.

The Commission must evaluate the Staff Report using the well established legal standards for the rate of return adopted by the Supreme Court in the *Hope* and *Bluefield* decisions.[4] The evidence presented to date by the entities that supply capital to rural RoR carriers indicates that capital attraction, a key component of the *Hope* and *Bluefield* decisions, is not being met with the current 11.25% rate of return. In fact, the evidence in the record suggests that the increased uncertainty and risk facing small RoR carriers should cause the Commission to increase the current rate of return. Based on the facts in the record, the Commission should reject the Staff Report and, at a minimum, take no action to reduce the rate of return from the currently authorized 11.25% level.

The ARC membership consists of essentially all of the RoR incumbent rural local exchange carriers ("RLECs") in Alaska, who share unified interests regarding the impacts of further proposed changes in universal service funding to the state. Many of the ARC companies provide some form of broadband service in the remote, high-cost areas of Alaska and are very dependent on continued high-cost support to maintain viable and affordable service. The ARC urges the Commission to focus on creating stability in the regulatory environment, as well as maintaining the sufficiency of the high-cost support being provided.

II. Supreme Court Standards Represent an Important Litmus Test For the Reasonableness of Staff Recommendations on the Rate of Return.

The Commission must follow the United States Supreme Court's established legal precedents for determining a fair rate of return for ratemaking purposes.[5] The rate of return has

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[4] *See Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923); *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

[5] *See Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923); *Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591*

long been recognized as critical to the survival of rural companies.[6] The Commission may prescribe the rate of return for rural companies, but it may not do so without due consideration, which is lacking in the Staff Report. The Court historically maintains three standards of fairness for a return allowance: financial integrity, capital attraction and comparable earnings.[7] In *Permian Basin Area Rate Cases*, the Supreme Court stressed that an agency decision regarding the rate of return should "reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable."[8]

The Staff Report's recommendation to slash the RoR violates this legal precedent. The record before the Commission amply demonstrates that a further curtailment of revenue for rural companies will significantly diminish the ability of those companies to attract capital and maintain their financial integrity.[9] Both CoBank and RUS have shared their grave concerns

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(1944); Permian Basin Area Rate Cases, 390 U.S. 747 (1968) and *Duquesne Light Company v. Barasch*, 488 U.S. 299 (1989).

6 Professor Barbara Cherry & Professor Steven Wildman, *Paper: The Rate of Return for RLECs Must be in the Upper Range for Reform Under the Connect America Fund Order to Ensure Sustainable Policy Goals, available at* *http://apps.fcc.gov/ecfs/document/view?id=7021754004* ("The continued availability and affordability of voice and broadband services to certain customers and certain areas may be at risk if the Commission prescribes a rate of return that is too low to attract investment, even if not so low as to be unconstitutionally confiscatory. Faced with such a rate prescription, RLECs may need to make prudent business decisions to discontinue service or defer investments to certain customers and/or areas in order to maintain financial visibility. This may render universal service goals unachievable for those customers and/or areas.").

7 *See Bluefield Waterworks*, 262 U.S. at 692-93 and *Hope Natural Gas Co.*, 320 U.S. at 605.

8 *See Permian*, 390 U.S. at 792.

9 *See, e.g., Comments of Alaska Communications Systems, Inc., in the matter of Connect America Fund*, WC Docket No. 10-90 (Mar. 11, 2013) at 3-4 ("*ACS Comments*") ("ACS, like other price cap carriers, would face significant increases in its costs of service to deploy, operate,

regarding the financial health of the rural carriers in the wake of recent high cost support reforms. A downward adjustment of the RoR cannot be viewed as doing anything but further hampering the ability of rural carriers to attract the capital critical to the deployment of broadband.

Decreasing the RoR unfairly restricts carrier returns in violation of the established legal precedent for ratemaking. The Court has held that any return to the equity owner should be commensurate with the returns on investments in other businesses having equivalent risks.[10] "A public utility is entitled to such rates as will permit it to earn a return … equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties."[11] Recent reforms to high cost support have resulted in a highly volatile environment for RoR carriers, especially uncertainty regarding the availability of capital for these companies. The risks and uncertainties faced by RoR telecommunications carriers are significantly higher than those facing other rural public utilities.[12] Before decreasing the RoR, perhaps by as much as 30% as

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and maintain the facilities necessary to deliver broadband meeting the Commission's CAF Phase II standards throughout its service area covered by CAF Phase II support. ACS would be unable to meet these service commitments based on its current level of legacy support, let alone the sharply reduced levels of support currently suggested by recent CACM model results.").

10 320 U.S. at 603.

11 *Duquesne Light Company*, 488 U.S. at 314-15 (*quoting Bluefield Water Works*, 262 U.S. at 692-93.).

12 JSI Capital Advisors, *The Monitor: Communications Industry News and Analyses*, "Saving Rate of Return is Saving RLEC Financial Integrity" (Jan 25, 2012) , *available at* http://jsicapitaladvisors.com/monitors/2012/1/25/saving-rate-of-return-is-saving-rlec-financial-integrity.html ("Represcribing the rate of return before the rural telecom industry can fully grasp the extent of the other USF/ICC cuts and caps is at best cruel and at worst utterly unacceptable under the guidelines that USF support be predictable and sufficient…Quite simply, the reforms adopted in November, like regression analysis and bill-and-keep, place RLECs on an extremely uncertain path where existing investments may not be recouped and future investments may be

recommended in the Staff Report, the Commission must perform a detailed analysis on the record accounting for the impact on financial risk and overall financial stability that this decrease will cause for rural carriers.

The Staff Report is deficient in that it does not demonstrate how its recommended range for rate of return would comply with the governing legal standards discussed above. A significant change in the RoR at a time when financial and regulatory uncertainty are at a historic high contradicts the cautions outlined by the Court in its ratemaking cases. The ARC strongly urges the Commission to reject the Staff Report and reevaluate its analysis and conclusions.

III. Lender Comments Prove Staff Recommendation Fails the Capital Attraction Test.

The Commission received strong evidence since the adoption of the *Transformation Order* demonstrating that access to capital has been substantially reduced for small, RoR carriers. The Rural Utilities Service ("RUS"), CoBank, ACB ("CoBank") and the Rural Telephone Finance Cooperative ("RTFC"), who together are the primary lenders to rural RoR carriers, have demonstrated through substantial evidence that less capital is available for RoR carriers.[13] These three entities represent the primary sources of capital for small RoR carriers.

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scaled back in light of increased risks and less access to capital. Adding "insult to injury" by prematurely reducing the rate of return could hurl the industry into a free-fall").

[13] *See Connect America Fund*, WC Docket No. 10-90, Comments of CoBank, ACB (June 21, 2012) ("*CoBank June 21 Comments*"), attached as Exhibit A; *Connect America Fund*, WC Docket No. 10-90, *A National Broadband Plan for our Future*, 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, Ex parte of United States Department of Agriculture, Rural Development (Feb. 15, 2013) ("*RUS 2013 Ex Parte*"), attached as Exhibit B; *See Connect America Fund*, WC Docket No. 10-90, *A National Broadband Plan for our Future*, 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

Without access to capital from these sources, it is unlikely that RoR carriers will be able to undertake the construction necessary to deliver broadband to rural areas.

Most recently CoBank submitted comments in response to the Staff Report taking exception to the comments made by Staff regarding CoBank's lending practices.[14] CoBank states:

> The other misleading implication from paragraph 49 of the Staff Report is that all RLECs have access to "extensive funding" from CoBank under the existing rate-of-return (RoR) regulations. 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 increasingly difficult for CoBank to extend credit for the purpose of deploying ubiquitous rural broadband networks."[15]

CoBank is correct in its assertion that many RLECs no longer meet CoBank's lending standards due to various new limitations on high-cost funding imposed by the *Transformation Order*. The ARC and other rural carriers have made clear to the Commission that these limitations would pose a threat to their ability to obtain credit. Unfortunately, the Commission has made few, if any revisions to the structure of universal service funding to address this problem.

The RUS also expressed grave concern regarding the ability of rural carriers to borrow. In February 2013, Secretary of Agriculture Thomas J. Vilsack, Secretary of the U.S. Department of Agriculture met with Chairman Genachowski to discuss access to broadband in rural America. Secretary Vilsack and other USDA staff members made clear that RUS is experiencing a reduction in demand for its loans that reflects the increasingly shaky financial status of RoR

Docket No. 03-109, Notice of Ex Parte communications of the Rural Utilities Service (July 29, 2011) ("*RUS 2011 Ex Parte*"), attached as Exhibit C.

14 *See CoBank June 21 Comments*.

15 *CoBank June 21 Comments* at 4-5.

carriers since the *Transformation Order*, and therefore underscores the importance of maintaining a reasonable rate of return for RoR carriers:

> According to the FCC's Eighth Broadband Progress Report, nearly one-fourth of the rural population lacks access to high speed broadband. Yet, demand for RUS loan funds dropped to roughly 37% of the total amount of loan funds appropriated by Congress in FY 2012. Current and prospective RUS borrowers have communicated their hesitation to increase their outstanding debt and move forward with planned construction due to the recently implemented reductions in USF support and Intercarrier Compensation (ICC) payments.[16]

RUS and CoBank provide irrefutable evidence to support the long-standing assertions of rural RoR carriers that they are less likely to proceed with borrowing capital and building out new broadband infrastructure than before the *Transformation Order*'s reforms. Reductions in support and uncertainty regarding future funding are paralyzing small rural carriers' goals for deploying broadband in their service areas. These developments are directly at odds with the Commission's stated goals of increased broadband deployment in currently unserved rural areas.

RUS also provided the Commission information on how it views cost of capital in its July 29, 2011 ex parte, where it indicated "The Agency focuses on the financial projections and feasibility of a loan on a forward looking basis, *i.e.* whether the applicant can repay the loan with revenues in the future. Without a sufficient forward looking return on investment, RUS will not lend for the construction necessary to provide services."[17] That same ex parte went on to demonstrate how even a 5% reduction in USF can have a negative impact on loan covenants for RUS borrowers.[18]

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[16] *RUS 2013 Ex Parte* at 1-2.

[17] *See RUS 2011 Ex Parte*, Attachment at 16.

[18] *Id.*

The level of lending available to rural, RoR carriers at the current, authorized 11.25% rate of return has been greatly reduced due to the greater risks and uncertainties that now exist in the marketplace. The reduction in the authorized rate of return contemplated by the Staff Report will only exacerbate the problems articulated by the banks and further reduce the rural RoR carriers' ability to attract capital. The Staff Report presents no evidence to refute the above statements from lenders to rural companies. This proposal also fails the Supreme Court's capital attraction standard for establishing a fair rate of return, since it will only further reduce access to capital. Contrary to the conclusions of the Staff Report, the comments by lenders to rural companies and the existing data in the record strongly suggest the Commission should be raising the rate of return from the current 11.25% level, rather than reducing it.

IV. The Staff Report Fails to Demonstrate How Its Recommendations Meet a Comparable Earnings Test for Small, Rural RoR Carriers.

The Staff Report's recommended range for the rate of return represents a "one size fits all" approach to high-cost support that does not recognize the reality that the cost of capital varies depending on the size of the company. The Staff Report relies on data from mid and large-size carriers that are hundreds of times the size of the typical rural RoR carrier. It is a well recognized principle of economics that investments in small company stocks are riskier than large company stocks, and therefore require a higher rate of return. Studies by investment advisors such as Ibbotson Associates have confirmed the relationship between company size and required equity returns.[19] The Commission also recognizes that company size has an impact on the cost and operating characteristics of companies in its design of the Connect America Phase II

[19] See Ibbotson Associates *Stocks, Bonds, Bills and Inflation (SBBI): 2012 Yearbook Valuation Edition*, Chapter 7.

model-based support, where companies derive differing results based on the their relative size.[20]

The Staff Report notes that some of its analysis on the appropriate cost of equity appears abnormally low compared to the cost of debt.[21] Given the extensive comments by lenders to rural RoR carriers indicating that they have curtailed lending to rural carriers due to the greater risks and uncertainties facing these carriers' revenue streams, the record is clear that the cost of equity for rural carriers is rising. The Staff Report does not take into account these higher risks and therefore does not fairly evaluate what comparable earnings should be for small carriers in the marketplace going forward. Indeed, the Staff Report does not acknowledge that two of its 16 proxy companies, Hawaiian Tel and Fairpoint, recent went through bankruptcy and are now owned by the debt holders. The current financial uncertainty alone should indicate a higher level of risk for carriers serving in rural markets.

In its Capital Asset Pricing Model ("CAPM") analysis,[22] the Staff Report assumes a risk free Treasury rate of 1.92% from data obtained on March 26, 2013. The Staff Report does not acknowledge the fact that Treasury rates are at all-time historic lows due to the Federal Reserve's economic stimulus program, which is designed to hold interest rates low while the economy recovers. Recently the Federal Reserve has signaled that it may back off its economic

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[20] *See* Federal Communications Commission, Public Notice, *Wireline Competition Bureau Announces Availability of Version 3.1.3 of the Connect America Fund Phase II Cost Model*, WC Docket No. 10-90 (June 7, 2013).

[21] *See* Staff Report at para. 84. The Staff Report notes the DCF calculation used to determine the cost of equity results in an equity cost for Alaska Communications Systems, Inc. that is lower than the cost of debt, which clearly is erroneous since equity cost is always higher than debt cost. *See id.* at para. 107.

[22] *Staff Report* at para. 65.

stimulus programs, and as a result the 10-Year Treasury rate has risen to 3.23%[23] as of July 19, 2013, almost double the rate assumed in the Staff Report. It is very likely the Treasury Rates will continue to rise.[24] The Risk Free Rate has a significant impact on the CAPM analysis in the Staff Report. Increases in the Risk-Free Rate indicate that the Commission should view the rate of return recommendations with a critical eye. This large a discrepancy in a critical component of the analysis should be cause for concern regarding the accuracy of the Staff Report's conclusions. The Staff Report contains material deficiencies in proving that its ultimate outcomes meet the Supreme Court's comparable earnings standard. This is further proof that the Commission should reject its analysis.

V. The Staff Report Reduces High-Cost Support When It Should Be Increased.

The Regulatory Commission of Alaska, Alaska carriers, and other Rural Associations have made clear to the Commission that substantial support will be needed to meet the Commission's goals for broadband access and speed in Alaska.[25] In light of Alaska's current

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23 *See* http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=longtermrate.

24 In a footnote to Table 7-7 of Ibbotson Associates *Stocks, Bonds, Bills and Inflation (SBBI): 2010 Yearbook Valuation Edition,* Ibbotson notes the historical riskless rate measured by the 84-year arithmetic mean income return component of 20 year government bonds is 5.18%.

25 *See Reply Comments of the Regulatory Commission of Alaska, in the matter of Connect America Fund*, et. al., WC Docket No. 10-90, 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, before the FCC (Feb. 17, 2012) ("*RCA Reply Comments*") at 7 ("Extremely limited fiber facilities and lack of access to the Internet are unique to Alaska and require unique solutions."); *Reply Comments of the Alaska Rural Coalition*, WC Docket No. 10-90, WC Docket No. 05-337, before the FCC (July 23, 2012) ("*ARC Reply Comments*") at 9 ("[T]he lack of roads, extreme climate and harsh geography of Alaska must remain in the forefront of the discussion when considering the role the Remote Areas Fund will play in Alaska"); *Comments of Alaska Communications Systems, Inc*. in the matter of Connect America Fund, WC Docket No. 10-90, 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, before the FCC (Jan. 18, 2012) ("*ACS USF Comments*") at 3, n. 4 ("Almost everything about providing communications services in Alaska

lack of infrastructure and high costs of service, reducing available support by decreasing the authorized rate of return will not produce the Commission's desired results. Indeed, the Commission has solicited comments on whether it should increase the rate of return for tribal areas, recognizing the unique circumstances that exist and the difficulty tribal areas have in attracting capital. [26] The ARC encourages the Commission to take into account the comments that have already been made by many parties regarding the critical needs for tribal areas and not reduce the rate of return authorized for carriers serving tribal areas, including Alaska.[27]

VI. Conclusion.

The Commission must evaluate the Staff Report using the Supreme Court's established criteria for setting a reasonable rate of return. The Staff Report recommendation for the rate of return fails to meet the Supreme Court's capital attraction and reasonable earnings standards and should be rejected. The Commission's goals as articulated in the *Transformation Order* suggest that the rate of return should be increased, rather than lowered. At a minimum, the Commission should adopt a "do no harm" approach and structure its programs to ensure that high-cost support

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is unique and sets its service providers apart from what other carriers across the country experience.") *Comments of General Communication, Inc. in the matter of Connect America Fund,* WC Docket No. 10-90, 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, before the FCC (Jan. 18, 2012) ("*GCI USF Comments*") at 2-4 ("Alaska is a uniquely high cost area within which to provide any telecommunications, whether traditional telephony, mobile or broadband. Much of remote Alaska lacks even the basic infrastructure critical to most telecommunications deployment, such as a road system and an intertied power grid.").

[26] Federal Communications Commission, Public Notice, *Tribal Mobility Fund Phase I Auction Scheduled for October 24, 2013, Comment Sought on Competitive Bidding Procedures for Auction 902 and Certain Program Requirements*, AU Docket No. 13-53 (March 29, 2013).

[27] *See, e.g., Comments of the Alaska Rural Coalition, in the matter of Auction 902 Tribal Mobility Fund Phase I,* AU Docket No. 13-53 (May 10, 2013).

is not further reduced from current levels if there is to be any hope of meeting the Commission's broadband goals for rural areas.

Respectfully submitted on this 25h day, July 2013.
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