Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D. C. 20554

In the Matter of	)	
	)	
Connect America Fund	)	WC Docket No. 10-90
	)	
High-Cost Universal Service Support	)	WC Docket No. 05-337

APPLICATION FOR REVIEW OF THE AMERICAN CABLE ASSOCIATION

Pursuant to Section 1.115 of the Commission's rules,[1] the American Cable Association ("ACA") submits this application for review of the Wireline Competition Bureau's ("Bureau") April 22, 2014 decision in the *Connect America Cost Model Report and Order*,[2] in which it finalized decisions about the model's engineering assumptions and inputs. These actions enable the Commission to calculate the cost to serve census blocks in price cap local exchange carrier ("LEC") serving territories. The Bureau also identified the likely funding benchmark and estimated the final budget.

ACA, which has participated extensively in the Commission's proceedings to develop the Connect America Cost Model ("CAM"), submits that the Bureau's *Order* is erroneous in two material aspects. First, for the key input of the cost of money, the Bureau adopted a cost significantly in excess of forward-looking market rates. Second, the "take-rate" factor used in

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1 Relief is sought pursuant to Section 1.115(b)(2)(i), because the Bureau's actions are inconsistent with the Commission's objective of ensuring universal service support is not wasted and spent efficiently. *See Connect America Fund*, WC Docket No. 10-90 et al., Report and Order and Further Notice of Proposed Rulemaking, 26 FCC Rcd 17663, 17670, ¶11 (2011) ("*CAF Order*"). Relief also is sought pursuant to Section 1.115(b)(2)(iv), because, as explained herein, the Bureau's errors amount to an erroneous finding as to a material question of fact.

2 *Connect America Fund*, WC Docket No. 10-90, *High-Cost Universal Service Support*, WC Docket No. 05-337, Report and Order, (Wireline Competition Bur., rel. Apr. 22, 2014) ("*Connect America Cost Model Report and Order" or "Order"*).

establishing the funding benchmark is well below that expected over the long-run life of the CAM – and even below that expected over the five-year funding period. Taken together, these errors cause the CAM to provide support to the price cap LECs in excess of the amount required. If the CAM instead used the more accurate cost of money and the proper take-rate provided by ACA and discussed more fully herein, support would be provided more efficiently, enabling many more unserved locations to be supported in the Connect America Fund ("CAF") Phase II program. Accordingly, the Commission should reverse the Bureau's decisions on the cost of money and take-rate and adopt more accurate input values as proposed by ACA.

INTRODUCTION

In constructing the CAF Phase II program, the Commission adopted a hybrid approach: first giving the price cap LECs a right of first refusal to make a state-level commitment to receive support and provide the requisite broadband service; and then second, in areas where the LECs did not elect support, using competitive bidding open to other Eligible Telecommunications Carriers to award support.[3] To determine the amount of support a price cap LEC could receive if it accepted the state-level commitment, the Commission concluded it should use a cost model "to accurately estimate the cost of a modern voice and broadband capable network"[4] and establish a benchmark cost above which support would be provided up to an extremely high-cost benchmark set according to the annual budget. The Commission directed the Bureau to develop a cost model that (1) would be based on "wireline technology and at a census block or smaller level," (2) would maximize "the number of locations that will receive robust, scalable broadband within the budgeted amounts," and (3) would "ensure that the most

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[3] *See CAF Order* at ¶¶ 158-193.

[4] *Id.*, ¶ 184.

locations possible receive a 6 Mbps/1.5 Mbps or faster service."[5] The CAM is thus a lynchpin of the CAF Phase II program, and the Commission charged the Bureau with ensuring the cost model achieved the public interest obligations "as cost-effectively as possible."[6]

Over the past two years, the Bureau has worked deliberately and diligently to adopt the CAM. The Bureau's *Order* highlights the many notices, comments, workshops, and versions of the CAM.[7] ACA participated in most of these proceedings, seeking to make the model accurate and efficient.[8]

While ACA believes the Bureau's work has improved the model significantly from its beginnings as version 1.0 to the current version 4.1.1, the CAM continues to provide the price cap LECs with more funding than required to provide the requisite broadband and voice services to meet their public interest obligations. This inefficient expenditure of public funds is due to a significant extent to two factors: the cost of money continues to be greater than market rates, and the take-rate factor used to establish the high-cost benchmark is below the expected rate. We elaborate on these two problems below and provide rates that are more accurate and will ensure funds are spent efficiently. Accordingly, ACA asks the Commission to reverse the Bureau's decisions. Instead, it should adopt ACA's proposed rates.

THE COST OF MONEY USED IN THE CAM DOES NOT REFLECT MARKET CONDITIONS AND IS UNREASONABLY HIGH

In the *Order*, the Bureau applied a methodology adopted in a 2013 staff report using data from price cap LECs to yield "a zone of reasonableness for a cost of money for price cap carriers

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5 *Id.*, ¶ 187.

6 *See id.*

7 *See Order*, ¶¶ 7-29.

8 *See e.g.*, Comments on Public Notice DA 12-911: Model Design and Data Inputs for Phase II of the Connect America Fund, WC Docket Nos. 10-90, 05-337 (July 9, 2012); Reply to Comments on Public Notice DA 12-911: Model Design and Data Inputs for Phase II of the Connect America Fund, WC Docket Nos. 10-90, 05-337 (July 23, 2012).

between 7.84 and 9.20 percent."[9] It then adopted a unitary cost of money of 8.5 percent – the mid-point in the range rather than at the lower end -- based on the conclusion "that this number will effectively be locked in for the next five years and accounts for the fact that the data used to calculate the zone of reasonableness reflects a time of historic lows."[10] ACA submits the Bureau's conclusion is in error: while rates may be at or near historic lows, there is little basis to assume they will increase appreciably during the five year duration of the Phase II program.

As the economy has recovered over the past several years, there is frequent commentary that interest rates will rise from their historic lows. Yet, these predictions have not been borne out. Instead, rates remain at or near historic lows, and the Federal Reserve does not expect to raise short-term rates before 2015,[11] and some market observers believe the Federal Reserve will not raise short-term rates until 2016.[12] In fact, between the most recent statement by the Federal Reserve in March to May 28th, 10-year Treasury yields fell from 2.78 percent to 2.44 percent. Not only does it appear that rates will remain low, price cap LECs have the ability to lock-in

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9 *See Order*, ¶ 107.

10 *Id.*

11 In March 2014, the Federal Open Market Committee, which sets monetary policy, released a survey that showed that most members (13) did not expect the Federal Reserve to raise the federal funds rate until 2015, with two officials expecting the first hike in 2016, and one expecting a hike in 2014. Additionally, most believed the Federal Reserve's short-term target rate will stay under 3 percent in 2016, which would be more than 200 basis points below the last high in 2006. Michael S. Derby and Ben Leubsdrof, "Majority of Fed Officials Still Expect First Interest-Rate Hike in 2015," March 19, 2014, http://blogs.wsj.com/economics/2014/03/19/majority-of-fed-officials-still-expect-first-interest-rate-hike-in-2015/. Accessed May 28, 2014.

12 Goldman Sachs's predicted in March 2014 that the Federal Reserve will not raise short-term rates until 2016. Scott Minerd of Global Guggenheim Partners also predicts that a rate rise will not come until 2016. *See* Min Zeng, "Fed Not Seen Boosting Rates Until 2016 – Goldman Sachs," http://blogs.wsj.com/moneybeat/2014/03/21/fed-not-seen-boosting-rates-until-2016-goldman-sachs/. Accessed May 28, 2014; *see* also Scott Minerd, "US rate rise to come later rather than sooner," April 28, 2014, http://www.ft.com/cms/s/0/971f656a-cb9b-11e3-8ccf-00144feabdc0.html#axzz3386nmVPn. Accessed May 28, 2014.

these low rates for the five year duration of Phase II in advance of any increase.[13] Thus, the Bureau's basis for adopting a cost of money in the mid-point of the range is flawed.

As for calculating the proper rate, ACA examined current market inputs based on a widely adopted methodology to estimate the cost of equity, the Capital Asset Pricing Model ("CAPM"), and on the price cap LECs' current 10-year debt costs. Then, using market data from May 28, 2014, it calculated that the cost of money for the price cap LECs ranges from 6.56 percent to 7.69 percent.[14] Finally, so that it would be conservative in its approach, ACA stress-tested the calculations by adding a 100-basis point rise in the 10-year Treasury yield (to 3.44%, a level last seen in April 2011[15]). This increases the range to between 7.14 percent and 8.27 percent.[16] ACA submits that the Commission should select the mid-point of this range -- 7.72 percent, but even a rate higher in the range would be more accurate than the Bureau's selection of 8.5 percent.

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13 AT&T, for instance, in early June sold 30-year bonds worth $2 billion at a yield of approximately 4.8 percent, which was only 1.40 percent above the comparable Treasury yield. *See* "AT&T's Bonds Draw Buyers," Wall Street Journal at C4 (June 4, 2014). This article also states, "Many Wall Street analysts expected bond yields would rise, and prices fall, as the economy gained steam this year. Instead, bonds have performed well."

14 ACA used the following assumptions in its cost of capital calculations: 2.44 percent risk free rate based on 10-year Treasury bond rates, 10.00 percent market return based on historical equity market returns, 39.3 percent combined Federal and State marginal tax rate, and 0.57 telecom services unlevered beta which was levered for each firm based on current debt/equity ratios. The cost of equity was derived via CAPM. For the cost of debt, ACA used the yield to maturity of the price cap carriers' bonds that are closest to 10 years from May 28, 2014. *See* Appendix for sources.

15 US Department of Treasury, Daily Treasury Yield Rates, http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2011.

16 For the stress-test, ACA raised the risk-free rate 100 basis points to 3.4 percent and increased the cost of debt for each price cap LEC by 100 basis points, as well. ACA understands that the actual change in the cost of debt will depend on a variety of factors including the price cap LECs' debt/equity mix at the time of a rate rise and the market's perception of the riskiness of each price cap carriers' debt at that time. Given the difficulty of predicting these factors, ACA assumed a 100 basis point increase, which roughly tracks the increase in cost of debt for price cap LECs over the past year.

THE LOW TAKE RATE USED TO ESTIMATE REVENUES PROVIDES EXCESSIVE SUPPORT

The Bureau set the high-cost benchmark based on average revenue per user of $75 per month[17] multiplied by the expected take (subscription) rate, which it sets at 70 percent.[18] In setting the take rate, the Bureau concluded that it should be different than the rate used to estimate costs because "a location may have customer premises equipment without having a revenue-producing subscriber."[19] Further, the Bureau reviewed current take-rates estimates from "one peer review of the model" citing academic studies and from the Pew Research Center's Internet and American Life Project ("Pew Center"), and then used its predictive judgment to "find that an expected subscription rate of 70 percent is appropriate."[20] As discussed below, ACA submits the Bureau's conclusion is in error for two principal reasons. Further, in reviewing the points ACA raises, it is important to understand that minor adjustments in the take-rate can have an enormous impact on the number of supported locations and the funding received by price cap LECs for these locations.

First, the Bureau's decision to use a lower take-rate for estimating revenues than it uses for estimating costs, which is 80 percent, will inevitably overcompensate funding recipients. ACA agrees that the Bureau makes a valid point that the percentage of locations that will have drops, network interface devices, and customer premise equipment at the end of the five-year period will be higher than the number of subscribers at any given point, due to some customers at locations abandoning wireline broadband or locations becoming vacant. From that perspective,

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17 *See Order*, ¶ 172.

18 *See id.*, ¶ 177.

19[19] *See id.*, ¶ 178. The Bureau's conclusion was contrary to the positions of both USTelecom and ACA.

20 *See id.*, ¶ 179. US Telecom proposed a 60 percent rate; ACA a 90 percent rate.

there is a case for allocating additional capital expenditures for these locations. However, there is not a case for allocating operating expenditures – such as customer service and G&A expenses -- for these locations, because at these specific locations, there are no current customers. Yet, from the model's perspective, operating expenditures are still being allocated to these locations as if there are customers in perpetuity.

In addition, the cost model amortizes capital expenditures for drops, network interface devices, and customer premise equipment from the beginning of the support period, whereas rational operators only build out these components when customers subscribe to their service.[21] This preserves capital and increases the net present value of their investment. So even without any variance between the expected subscription rate and the customer drop rate, there is built-in overcompensation for recipients awarded support through the CAM.

Second, the take-rate should be based on expected (forward-looking) broadband adoption, not current broadband adoption. Today, 70 percent of US adults use broadband at home, according to the Pew Center, the most frequently referenced survey of broadband adoption.[22] Given the steady growth in broadband adoption over the previous decade, and the increasing centrality of the Internet to people's lives, home broadband adoption is expected to grow. For instance, earlier this year, analysts from UBS stated, "We expect penetration levels to further rise as growth in tablets and other internet devices drive the need for in-home

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[21] ACA raised this issue in a filing in the Virtual Workshop. *See*, American Cable Association Ex Parte Filing in the Virtual Workshop in Response to the Public Notice (DA 13-1136) on the Connect America Cost Model, WC Docket No. 10-90, at 3-6 (June 12, 2013) ("ACA *Ex Parte*").

[22] While we consider the Pew Center data reliable, its analysis underestimates broadband demand because it captures broadband adoption for all adults, without taking into account the fact that not all adults have access to broadband, which is the problem the CAF is trying to address.

connectivity."[23] Given that the current rate of broadband adoption is already 70 percent, estimates of lower figures from academic studies or peer review do not seem particularly relevant.

In addition, the Bureau should not have relied on a single academic study, cited by Professor Hogendorn in his peer review, estimating the rural take-rate to be as low as 50 percent. The take-rate in rural areas is fundamentally restrained by availability. The Pew Center reports that 62 percent of rural adults have home broadband, while wireline broadband is only available to 77.3 percent of the rural population. Using availability as the denominator, 80 percent of rural adults with access to broadband are subscribers. This indicates rural demand is higher, perhaps even higher than urban demand.

Based on current trends and use of the Commission's forecast adoption curve in the National Broadband Plan, ACA had proposed a take-rate of 90 percent.[24] While that may be too high, the 70 percent take rate adopted by the Bureau is clearly too low and does not accurately reflect the expected take-rate during the time CAF support would be awarded to price cap LECs. As a result, funding would be spent inefficiently, not maximizing the number of locations that could be served.

CONCLUSION

ACA appreciates the work undertaken by the Bureau to produce the CAM. The Bureau has produced a product substantially better than that first proposed by the price cap LECs and better than in the earliest version of the CAM. But, more refinement is necessary. The Commission's charge to the Bureau was to produce an accurate and cost-effective model that

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23 *See* "Telecommunications, Pricing power trumps weakening consumer metrics," UBS Global Research, at 3 (Feb. 27, 2014). UBS estimates 2014 year end penetration at 70.5 percent and 2015 at 71 percent.

24 *See* ACA *Ex Parte*, at 7-8.

maximizes the number of locations that would receive broadband service. If those objectives are to be achieved, the two problems discussed herein need to be revisited and recalculated by the Commission. ACA has sought to provide constructive criticism about the cost of money and take-rate inputs and endeavors to continue work with the Commission to reach its goals providing support most efficiently.

Respectfully submitted,

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Appendix

ACA Cost of Capital Calculation

1. Market Assumptions

Assumption	Value	Value Basis	Source
Risk Free Rate	2.44%	10-Y Treasury Yield	US Department of Treasury[1]
Market Return	10.00%	Historical S&P Return	NYU Stern - Annual Risk Premiums for Stocks over T-Bills[2]
Tax Rate	39.3%	CAM	Default CACM tax rate inputs (34% Federal, 5.3% State)[3]
Unlevered Beta	0.57	Telecom (Services)	NYU Stern - Betas by Sector (Updated January 14)[4]

2. Company-Specific Assumptions & Cost of Capital Calculation

Assumption	AT&T	Verizon	Windstream	CenturyLink	Frontier	Source
Debt %	47%	90%	92%	56%	67%	Morningstar Debt %[5]
Equity %	53%	10%	8%	45%	33%	Morningstar Equity %[5]
Debt/Equity Ratio	0.88	8.62	11.99	1.25	2.03	Refer to Calculation 1
Levered Beta	0.87	3.55	4.72	1.00	1.27	Refer to Calculation 2
Equity Cost	9.05%	29.28%	38.09%	10.01%	12.06%	Refer to Calculation 3
Debt Cost	3.54%	3.68%	6.51%	6.71%	6.74%	Morningstar 10-Y bond YTM (5.28.14)[5]
Cost of Capital	6.5%	6.3%	8.9%	8.2%	8.5%	Refer to Calculation 4

3. Cost of Capital Weighting Factors

Assumption	AT&T	Verizon	Windstream	CenturyLink	Frontier	Source
1. Market Cap	$183.60B	$206.00B	$5.80B	$21.60B	$6.00B	Morningstar Market Cap (5.28.14)[5]
% of Total	43.40%	48.70%	1.37%	5.11%	1.42%	% of Total Calculation
2. CAF-Eligible Locations Above Target Benchmark	1.44M	0.44M	0.46M	1.26M	0.77M	CAM Version 4.1 (4.17.14)[6]
% of Total	33%	10%	11%	29%	18%	% of Total Calculation
3. Total CAF-Eligible Locations	5.38M	1.49M	1.24M	3.64M	1.74M	CAM Version 4.1 (4.17.14)[6]
% of Total	40%	11%	9%	27%	13%	% of Total Calculation

4. Weighted Average Calculations

Weight Methodology/Factor	Cost of Capital
Market Cap	6.56%
CAF -Eligible Locations Above Target Benchmark	7.57%
Total CAF-Eligible Locations	7.41%
Simple Average	7.69%

5. Calculation Descriptions

Reference	Calculation
Calculation 1	(Debt %) / (Equity %)
Calculation 2	Unlevered Beta X (1 + (1 – tax rate) X ((Debt %) / (Equity %))
Calculation 3	Risk Free Rate + Levered Beta X (Market Return – Risk Free Rate)
Calculation 4	(Equity %) X (Equity Cost) + (Debt %) X (Debt Cost)

1 US Department of Treasury: http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield
2 NYU Stern - Annual Returns on Stock, T. Bonds and T. Bills: 1928-Current: http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html
3 Default CACM tax rate inputs (34% Federal, 5.3% State), CQCapCostforCACM.xls', 'Capital Cost Inputs' Worksheet
4 NYU Stern - Betas by Sector (Updated January 2014): http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/Betas.html
5 Morningstar Public Firm Bond and Stock Profiles: http://morningstar.com
6 Connect America Cost Model Version 4.1.1, Support Model Detail Report

ACA Cost of Capital Calculation - Stress Test

1. Market Assumptions

Assumption	Value	Value Basis	Source
Risk Free Rate	3.44%	10-Y Treasury Yield	US Department of Treasury[1] rate for 5.28.14, plus 100 basis points
Market Return	10.00%	Historical S&P Return	NYU Stern - Annual Risk Premiums for Stocks over T-Bills[2]
Tax Rate	39.3%	CAM	Default CACM tax rate inputs (34% Federal, 5.3% State)[3]
Unlevered Beta	0.57	Telecom (Services)	NYU Stern - Betas by Sector (Updated January 14)[4]

2. Company-Specific Assumptions & Cost of Capital Calculation

Assumption	AT&T	Verizon	Windstream	CenturyLink	Frontier	Source
Debt %	47%	90%	92%	56%	67%	Morningstar Debt %[5]
Equity %	53%	10%	8%	45%	33%	Morningstar Equity %[5]
Debt/Equity Ratio	0.88	8.62	11.99	1.25	2.03	Refer to Calculation 1
Levered Beta	0.87	3.55	4.72	1.00	1.27	Refer to Calculation 2
Equity Cost	9.18%	26.73%	34.39%	10.01%	11.79%	Refer to Calculation 3
Debt Cost	4.54%	4.68%	7.51%	7.71%	7.74%	Morningstar 10-Y bond YTM (5.28.14)[5], plus 100 basis points
Cost of Capital	7.0%	7.0%	9.6%	8.7%	9.1%	Refer to Calculation 4

3. Cost of Capital Weighting Factors

Assumption	AT&T	Verizon	Windstream	CenturyLink	Frontier	Source
1. Market Cap	$183.60B	$206.00B	$5.80B	$21.60B	$6.00B	Morningstar Market Cap (5.28.14)[5]
% of Total	43.40%	48.70%	1.37%	5.11%	1.42%	% of Total Calculation
2. CAF-Eligible Locations Above Target Benchmark	1.44M	0.44M	0.46M	1.26M	0.77M	CAM Version 4.1 (4.17.14)[6]
% of Total	33%	10%	11%	29%	18%	% of Total Calculation
3. Total CAF-Eligible Locations	5.38M	1.49M	1.24M	3.64M	1.74M	CAM Version 4.1 (4.17.14)[6]
% of Total	40%	11%	9%	27%	13%	% of Total Calculation

4. Weighted Average Calculations

Weight Methodology/Factor	Cost of Capital
Market Cap	7.14%
CAF -Eligible Locations Above Target Benchmark	8.14%
Total CAF-Eligible Locations	7.97%
Simple Average	8.27%

5. Calculation Descriptions

Reference	Calculation
Calculation 1	(Debt %) / (Equity %)
Calculation 2	Unlevered Beta X (1 + (1 – tax rate) X ((Debt %) / (Equity %))
Calculation 3	Risk Free Rate + Levered Beta X (Market Return – Risk Free Rate)
Calculation 4	(Equity %) X (Equity Cost) + (Debt %) X (Debt Cost)

1 US Department of Treasury: http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield
2 NYU Stern - Annual Returns on Stock, T. Bonds and T. Bills: 1928-Current: http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html
3 Default CACM tax rate inputs (34% Federal, 5.3% State), CQCapCostforCACM.xls', 'Capital Cost Inputs' Worksheet
4 NYU Stern - Betas by Sector (Updated January 2014): http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/Betas.html
5 Morningstar Public Firm Bond and Stock Profiles: http://morningstar.com
6 Connect America Cost Model Version 4.1.1, Support Model Detail Report

CERTIFICATE OF SERVICE

I, Thomas Cohen, do hereby certify that I have caused the foregoing Application for Review of the American Cable Association to be served via First Class United States mail, postage prepaid, on the parties listed on the attached service list.

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