Small Company Coalition

Universal Broadband Service Proposal

Updated June 2014

Discussion Points

- SCC Goal
- FCC Stated Goals & Objectives
- Plan Proposed Goals
- Intercarrier Compensation Considerations
- Conceptual Framework
- Mechanics
- Capping Mechanism
- Walk Through Example
- Benefits of Updated SCC Proposal
- Working with ITTA Proposal
- Concerns of Forward Looking Cost Model
- Other Considerations

SCC Goal

"Create an explicit, efficient and fair funding mechanism that incents the deployment of broadband networks and the transition to IP networks while providing carriers with revenues that are sufficient to enable recovery of capital and operating costs, including a reasonable return on investment, incurred to provide universal broadband services to rural consumers at rates and conditions comparable to those charged to consumers in urban areas."

FCC Stated USF Goals

The FCC stated the following guiding principles in the *USF/ICC Transformation NPRM*:

- Modernize USF to include broadband
- Fiscal Responsibility – create efficiency in the program to control the size of the USF
- Accountability
- Incentive-based policies: proper incentives for carriers to invest in broadband technologies should be created

FCC Objectives

Subsequent FCC Orders indicate additional concerns:

- Universal Support Funds should have a total cap
- Rural consumers should pay their fair share
- Support to individual companies/areas should be equitable
- Uneconomic funding and improper incentives should be avoided
- USF reforms should reflect the fundamental shifts in technology, consumer behavior, and competition

Plan Proposed Goals

- No Retroactive Rulemaking: Ensure Rate-of-Return (RoR) carriers have the opportunity to recover properly incurred capital and operating costs incurred prior to date certain
- No Unfunded Mandates: Funding for new investment must be commensurate with any obligations imposed
- Predictable and Sufficient Funding: Any new broadband recovery mechanism should clearly define how funding for new investment will be recovered and ensure funding is sufficient to recover the cost to be supported under the plan
- Understandable Mechanisms: Any proposed industry plan should be transparent, understandable in concept and mechanics, and quantifiable as to impacts on carriers
- Comparable and Affordable Services for Rural Consumers. The plan should seek to ensure rural areas have access to broadband at terms, rates and conditions comparable to urban areas within the budget parameters of the universal service fund

Intercarrier Compensation

- To be clear, this is a USF-only proposal
- While voice traffic will never go away completely, it is declining [generally] at a rate of 5% - 15% annually
  - Nonetheless, networks are not being used less , but instead are being used more than ever
  - Of course IP and bandwidth is replacing TDM and voice traffic at an alarming rate

Conceptual Framework

The SCC Universal Broadband Service proposal consists of the following three components:

- *The Broadband High Cost Loop Fund (BHCLF).* This includes a comprehensive solution solely for RoR carriers. The Fund provides support for the deployment of broadband services as well as current voice telephony services, as follows:
  - Support is based on actual costs and calculated through a modified high cost loop model designed to incorporate broadband costs
  - Effectively replaces a) the current High Cost Loop Support (HCLS) fund, including Quantile Regression Analysis (QRA) methodology for RoR carriers; and b) Interstate Common Line Support (ICLS)
  - Combines HCLS and ICLS
  - Provides cost recovery of legacy investment; support for ongoing operating costs; and funding for new broadband investment

Conceptual Framework

- *Rate of Return Carrier-Specific Funding.* The model is premised off of an "RACPL" (Rate of Return Average Cost Per Loop). Currently, this could allow the Commission to analyze on a state by state basis the "outliers" participating in the fund, which creates a trigger for possible additional review, oversight, and inquiry. This trigger will help curtail fraud, waste, and abuse while requiring companies to adhere to reasonable spending limits and also provide attestations that they are in compliance with FCC rules. This trigger can also help the Commission by providing evidence toward the goal of offering 100 Mbps broadband speeds upon reasonable request by the year 2020

Conceptual Framework

- *The Broadband High Cost Loop Recovery Adjustment.* The SCC recognizes that interstate broadband equipment included in 47 CFR Part 36 categories is currently recovered through interstate special access charges. Consequently, an adjustment to the calculation of special access charges is needed to avoid duplicate and excessive cost recovery. The proposed BHCLF algorithm would allow the identification and quantification of support attributed to the broadband equipment categories. This amount is reduced from the 47 CFR Part 69 interstate special access rate element and added to the BHCLF in a manner similar to the way line port costs are shifted in the MAG adjustment. The proposed adjustment would result in decreased rates for broadband services charged to consumers by reducing the subject revenue requirement. Specifically, following are stakeholders that would benefit under the new model since the recovery adjustment compensates carriers from the CAF and directly offsets costs/revenue requirements currently included in the Part 69 special access rate element: a) consumers in rural America (via lower and more competitive end user prices); b) the National Exchange Carrier Association, or NECA (via lower tariffed rates); and c) carriers on their own tariff

Conceptual Framework

- Support would be available to 1) build-out to customers without adequate availability to broadband service from a competitor; and/or 2) maintain a broadband-centric network, thereby insuring efficient use of fund resources
  - The term "adequate availability" would be determined by the Commission on a periodic basis (i.e., annually, biannually, etc.) in light of technological advances and the needs for broadband service by rural Americans
- The SCC also contends, and would like to supplement the record, that the definition of "access lines", which currently includes TDM-based/Voice lines, must be modified to include all "connections", including broadband connections

Mechanics of SCC Proposal

- The SCC's USF reform proposal works similar to the previous HCLS algorithm, but includes broadband-centric cost study categories that now result in cost recoveries via CAF-related broadband funding. The following list briefly describes the model and its abilities:
  - Rate-of-return is based off of cost recovery, which the model uses as its premise
  - Cost causation: 86-111; 64-901(b); Part 36.2 – All support the concept of cost-causation
  - Incorporates Parts 32, 36, and 69 into its algorithm

Mechanics of SCC Proposal

- Specifically incorporates FCC CFR Part 36 broadband Separations categories
- Computes additional incremental CAF received, and correspondingly offsets FCC CFR Part 69 special access revenue requirements, which reduces pressure on NECA's (and others) tariff and also reduces end user rates
- Works with a capped or uncapped fund

Mechanics of SCC Proposal

- All companies are on a level playing field, each having equal opportunity to invest and receive corresponding cost recovery reimbursement under RoR regulation, creating predictability
- Quantifies support and provides stable funding
- If a company invests prudently and not excessively, it is incentivized through cost recovery from the CAF; if a company opts not to invest, its costs are not recoverable from the CAF

Mechanics of SCC Proposal

- Accommodates various types and all sizes of ILECs (Co-ops; Tribal; Privately-Held; Municipalities)
- Can accommodate corporate expense threshold limitations
- Recognizes and accommodates the ideas that reforms should a) reflect the fundamental shifts in technology, consumer behavior, and competition; and b) create proper incentives for carriers to invest in broadband technologies
- Efficiently leverages an existing explicit support mechanism with a limited transition period required

Capping Mechanism

- The SCC understands that a capped fund should assist in promoting fiscal responsibility
- The SCC, in reconsideration of its previous position for Capital and Operating cost capping mechanisms, recommends the Commission consider specific criteria that would effectively define “high cost carriers”, in accordance with the intent of Section 254

Capping Mechanism

The SCC suggests that criteria used to define "high cost" can generally be grouped into four areas:

1. Number of combined access line & broadband "connections" per square mile served
   - ✓ For example, a smaller carrier with fewer connections in their service area, but with a large area to serve, will arguably have higher study area-specific costs than a larger carrier with more connections serving a relatively smaller service area
2. Cost of living per census block
   - ✓ This variable needs to consider wage comparability for positions within the company that require highly technical, financial, and managerial skills
3. Extreme weather conditions
4. Percent of IP versus non-IP plant in a given network. If a carrier is deemed to need significant upgrades to transition to IP, that carrier would be entitled to greater spending limits

The SCC believes these characteristics and attributes more appropriately define what necessitates otherwise similar RoR carriers from being high cost versus "average" or "lower" cost carriers. Under this approach, for example, instead of financially benchmarking a RoR carrier in Alaska to a RoR carrier in Virginia, the criteria above would be used to determine if a carrier was "high cost" under the intent and application of Section 254

Capping Mechanism

Trigger/NACPL

- The SCC still contends a "trigger" could be introduced if the FCC believes a company's costs are excessive
- The trigger works such that, on a state-by-state basis, an RACPL, including standard deviations, is computed to determine if a carrier in the pool of companies significantly exceeds the state-specific RACPL. If so, the FCC has the option to review the company's costs for reasonableness and/or request further information

Walk Through Example

- Under the SCC's updated ideology to present a long term Connect America Fund for RoR carriers, the following example (next slides) walks through how the fund disbursements and allocations would work
- The SCC recommends one combined fund for HCLS and ICLS, called the "Broadband High Cost Loop Fund"
- The SCC also recommends using a "top down" approach under its modified ideology

Walk Through Example

- Assumptions Used:
  - $2B total annual fund. Includes HCLS; ICLS; SNA; ICC CAF
  - SNA = $15M annually (average per 7th Order on Recon over four years)
  - ICC CAF = $300M annually (estimation)
  - Combined HCLS/ICLS = residual of $1.685B annually
  - # of "Voice Access Lines" in RoR areas = 4.1M (based on NECA published data for year end 2012)
  - # of Broadband Connections in RoR areas = 4.1M (for example only. This assumes a 50/50 methodology in RoR areas and is thus the same as A/L's; the split is also similar to recent NTCA member poll)

Walk Through Example

- Calculation: $1.685B / 8,200,000 *connections* = $205 RACPL
- Using a $205 RACPL, and considering RoR carriers that would qualify as a high cost carrier versus non-high cost carrier under the SCC's recommended criteria (and also under the broadband high cost loop fund algorithm, including the 115% and 150% thresholds), carriers that are lower cost will not need as much funding and carriers that qualify as high cost will be permitted additional funding

Benefits of Updated SCC Proposal

- Many benefits to the SCC's modified proposal can be gained:
  - Establishes a Connect America Fund specifically for RoR carriers
  - End users will benefit via lower broadband prices, ensuring that all consumers have access to reasonably comparable services at reasonably comparable rates
  - End users would pay a fair share via a broadband end user fee
  - USF/CAF is modernized to include funding for broadband
  - Carriers are incentivized to invest in broadband technologies and networks
  - The model works within the $2B capped fund and can be modified to accommodate a larger or smaller fund size
  - Funding is predictable and sufficient
  - The existing HCLS algorithm is retained, leveraging this mechanism for a short transition period. This creates efficiency as the existing algorithm has been utilized for decades and is understandable
  - HCLS and ICLS are combined into one fund, creating less administrative work for all parties to maintain multiple funds

Benefits of Updated SCC Proposal

- After implementation, the RACPL could be frozen in the same manner as published in the 7th Order on Recon (para 262)
- RoR carriers will be compensated based on legitimate high cost criteria
- Meets the Commission's overall objective to support both voice and broadband-capable networks in areas without adequate availability from a competitor
- Accommodates voice, voice/data, and stand-alone broadband services
- Basing on connections, and not access lines, alleviates concerns of a carrier losing a voice line and the associated increase in per line costs
- Under this proposal, ICC rate and phased down cost recovery reductions could continue
- Discourages inefficiencies via high cost criteria

SCC Proposal Works With ITTA Proposal

- Voluntary option under ITTA allows RoR carriers to choose which model works best for them. While the SCC argues that forward looking model-based support will not work as a general rule, RoR carriers should be allowed to weigh their options
- In the 7th Order on Recon, para 278, the Commission concedes that a participating carrier could opt in for model-based support "for a subset of its study areas". Thus a carrier could bifurcate its study area between the SCC proposal and ITTA plan
- As noted earlier, the SCC proposal leverages an existing mechanism, thereby allowing a speedy transition. This could work hand in hand with ITTA's proposal for a two-phase transition, again under the auspices that RoR carriers be given the option to choose which plan best fits their company-specific circumstances

Concerns of Forward Looking Cost Model

- Track record of failure
- Previous recommendations (FCC; Joint Board; RTF; other parties) advise against forward looking models in RoR areas
- “No proxy can replace real costs”
- Section 254 of the Act does not contemplate forward-looking costs, but rather “high cost”

Other Considerations

A. *Other Funding Mechanisms.* In order to help alleviate pressure on the universal service funding mechanism, the Commission should consider implementing a methodology whereby the carriers responsible for building and maintaining the rural broadband network receive some form of compensation from *all* users of such network
   - Expand contribution base
   - Possibly "rate band" the FUSC charge??

B. *$250/Line/Month Cap:* This cap should be discarded as the allowable level of funding decreases with access line losses. However if "connections" replace access lines in their application within funding mechanisms, smaller companies with legitimate high costs would be provided additional necessary USF funding allowance. The "trigger" mechanism would effectively replace this rule instead of an automatic presumptive disallowance of funding
   - Fully phased in as of 7/1/2014

Other Considerations

C. *Transitional Period.* The SCC understands and realizes the need to phase down funding for legacy voice networks and phase in funding for broadband-capable networks. The SCC hereby believes its proposal addresses many industry concerns, including Commission concerns, and agrees to a reasonable transition period of 10 years for this conversion from voice to broadband to take place (also in agreement with the 7th Order on Recon, para 280)

D. *Broadband End User Fee.* In accordance with earlier statements in this presentation, the SCC believes customers should be liable and responsible for their fair share in addressing the "comparable services at reasonably comparable rates" standard. With this, the SCC proposes the implementation of a broadband end user fee, rate banded based on bandwidth take rates, to help offset the additional funding necessary with broadband costs now being recovered through the BHCLF

Questions?

James Kail, Executive Committee
jjkail@lhtot.com
Godfrey Enjady, Executive Committee
genjady@matinetworks.net
Glenn Lovelace, Executive Committee
GLovelace@pvt.com
Douglas K. Kitch, CPA
doug@alexicon.net
719-531-6342