

# NEWS & COMMENTARY

## ANALYSIS OF A CHANGING INDUSTRY

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### **MAKING YEAR-END LISTS AND CHECKING FOR WHAT'S NAUGHTY AND NICE: JSI LOOKS BACK AT 2009 AND SHARES AN OUTLOOK ON THE FUTURE**

As the New Year approaches, JSI has decided to use this edition of the newsletter to address a variety of topics uppermost in our thoughts as 2009 mercifully draws to a close. First, we wish you and yours a joyous holiday season and prosperous New Year. In these trying days, we hope you take the time to reflect upon the abundance of our great nation and the bedrock foundation of hard work and optimism on which our country rests. While current times may be hard and upheaval abounds, it is JSI's wish that you find comfort and cheer with those you hold dear.

Turning to industry visions dancing in our head, it goes without saying that the Federal Communications Commission (FCC) is hard at work. With Chairman Julius Genachowski at the helm for more than nine months now, we gain a clearer sense of where this FCC may be heading in the toss and tussle of a very dynamic industry. At times, what we see is encouraging; at other times, we realize the advocates of the rural telecom industry would do well to heed the warning signs that a time of fundamental change is upon us. And some of those changes portend imposing challenges for rural incumbent local exchange carriers (ILECs).

#### **Pending FCC Actions on USF Reform**

The next step for federal high-cost universal service reform, JSI observes, is not likely to be "incremental" in the same sense as the recent developments in DEM-weighting (see the article below), so we call your attention to two proceedings that, we believe, may better demonstrate how the FCC views USF reform. First, on Dec. 15, the FCC issued a Further Notice of Proposed Rulemaking addressing non-rural carriers' high-cost support (*FCC 09-112*). You may recall that many years ago, Qwest complained to the Tenth Circuit Court of Appeals that the FCC's non-rural modeling used to determine high-cost support was insufficient and in error. (Earlier this year, the FCC reported that the non-rural program currently provides support in only 10 states, with Mississippi receiving \$199 million, or 59 percent, of the annual non-rural high-cost fund.) Over subsequent years, the Court agreed with Qwest on two separate occasions, ordering the FCC to address the program's deficiencies.

In its Further Notice, the FCC tentatively concluded that any action adjusting the non-rural high-cost program in advance of comprehensive reform planned in conjunction with the national broadband plan would be ill-advised. While we are unsure of the exact contours of possible

long-term reform, we believe that non-rural reform will include targeting support to the wire center level. This specific targeting is intended to get support to rural areas served by non-rural carriers—areas that receive little or no high-cost support under the current statewide averaging mechanism. It has not gone unnoticed during these proceedings, and in other discussions about high-cost support, that non-rural carriers serve many rural areas of the nation. Without federal support, Qwest avers, the business case for the deployment of broadband services to these rural areas cannot be made.

The FCC suggests in the notice that reform prior to the national broadband plan should not raise the overall amount of non-rural high-cost support significantly above current levels. In support of this position, the FCC referenced the recently reported 95.7 percent telephone subscribership penetration rate, the highest reported level since the Census Bureau began collecting the data in 1983. The FCC said that “given the unprecedented level of telephone subscribership, we tentatively conclude that the current subsidy levels are at least sufficient (and may be more than enough) to ensure reasonably comparable and affordable rates that permit widespread access to basic telephone service.” While this is the first time JSI has ever seen the FCC rely on this data to support its conclusions about universal service funding levels, we do not believe it will be the last. In fact, we would not be surprised to see this same reasoning used as a foundation for the reforms incorporated in the national broadband plan. Specifically, we expect the FCC to conclude that voice-based universal service is complete, that no further funding for voice networks is needed, and that federal universal service support is finite.

One bright spot coming out of the FCC’s Dec. 16 meeting is the suggestion/recommendation that for any long-term transformation of the high-cost support programs (moving to support specific broadband goals) would take place over 5 to 10 years. In addition, based on FCC comments, several short-term adjustments are under consideration as part of the national broadband plan that will affect rural ILECs’ more immediate plans, including: (1) reducing the 11.25 percent interstate rate of return; (2) placing a per-line support cap on high-cost funds; and (3) targeting support away from areas where cable telephony is available to 95 percent of the market.

We believe that arguments made for targeted support at the wire-center level for non-rural carriers will likely ricochet onto the reform efforts for rural ILEC support. We have already seen the case for targeted rural support raised by NCTA, the cable association, in its proposal. (The NCTA proposal is our second USF reform “watch” item, discussed in detail below.)

We also believe that by increasing support to rural areas served by non-rural carriers, the FCC will be pressured to make “reform” cuts in rural ILEC support. The FCC recently set the USF contribution factor at 14.1 percent for the first quarter of 2010, up from 12.3 percent for fourth quarter 2009. The level of the contribution factor can serve as a barometer for the level of political attention high-cost support receives. Right now, the attention is intense, inasmuch as the factor at the proposed level is considered unsustainably high. In addition, FCC staff suggests that rural ILEC high-cost support cuts will be necessary to address the cause of broadband support raised in the national broadband plan due in February. We are in an environment where the FCC appears to have no appetite for keeping rural high-cost support at current levels when non-rural carrier support is likely to increase and broadband needs are on the horizon.

As noted, the second item we believe is charged with possible explosive effects for rural ILECs is the NCTA proposal. NCTA proposed its rural high-cost support reform early in November,

and the FCC has issued a notice seeking public comment on the proposal; comments are due in January. The proposal seeks to reduce high-cost support in areas of the country where there is “extensive unsubsidized facilities-based voice competition.” The intent of the NCTA proposal is to reduce the federal universal service contribution (again, slated to be 14.1 percent in the 1<sup>st</sup> quarter) and control the size of the existing high-cost fund, thereby enabling the FCC to address its broadband policy goals.

Specifically, NCTA called for the FCC to “establish a two-step process by which any party may request that the Commission reassess the level of support provided to a particular geographic area. In the first step, the burden would be on the petitioner to demonstrate that the area meets one of two competition-based triggers: (1) that unsubsidized wireline competitors offer service to more than 75 percent of the customers in an area without support, or (2) that the state has found sufficient competition to substantially deregulate the retail rates charged by an incumbent local exchange carrier.” Upon meeting one or both of the triggers, the FCC would move to a second step, in which “the burden would be on an ILEC to demonstrate the minimum amount of support necessary to ensure that non-competitive portions of the area will continue to be served” (*emphasis added*). In the petition, NCTA included evidence suggesting that more than \$1 billion of high-cost support “goes to rural LECs and CETCs in areas experiencing extensive facilities-based [wireline] competition” and went on to claim that “non-rural LECs and CETCs in states that have deregulated retail rates receive support totaling almost another \$1 billion.”

The proposal suggests that the FCC could achieve significant reductions in ILEC support without reducing the availability of universal service nationally. It also would place a significant burden on ILECs to show the “minimum amount of support” necessary to provide universal service support in a specific geographic area. This area, JSI observes, is not likely to be an ILEC study area, because cable providers get to define the area(s) of interest in their petitions. We believe the burden on ILECs to demonstrate their costs for geographic areas below the study area level will be significant.

A recent decision by the U.S. Court of Appeals for the District of Columbia sheds some light on the significance of this burden. The Court refused to overturn the FCC’s CETC Interim Cap Order (May 2008) that established a cap on federal high-cost payments to competitive eligible telecommunications carriers. The Court ruled: “petitioners [CETCs] have failed to demonstrate their high-cost support would actually be insufficient under the interim cap,” and it added that the CETCs failed to include “cost data showing they would, in fact, have to leave customers without service as a result of the cap and therefore give us no valid reason to believe the principle of ‘sufficiency,’ even viewed in isolation, will be violating the cap” (*emphasis added*). This standard of review, particularly the demonstration of “leaving customers without service,” is a very high standard that could well be applied to insufficient arguments going forward.

Discussions about reducing and retargeting current support to allow for broadband policy goals will only increase as the FCC prepares its national plan due to Congress on Feb. 17. The NCTA proposal also suggests that in areas where wireline competition exists, there is *no need* to provide high-cost support. This nugget of an idea carries with it a mother-lode of implication: One that comes almost immediately to mind is whether current implicit support flowing from service rates in towns to more rural areas of a study area where costs are exponentially higher – the so-called study area averaging principle – is sustainable. Reform of this principle could be part of potential reform for rural carriers in 2010.

If you have questions or comments about federal universal service support or our thoughts about the likelihood of change for rural ILECs, contact Manny Staurulakis ([mstaurulakis@jsitel.com](mailto:mstaurulakis@jsitel.com)) in Maryland, at 301-459-7590, or Douglas Meredith ([dmeredith@jsitel.com](mailto:dmeredith@jsitel.com)) in Utah, at 801-294-4576.

## **Broadband Stimulus Grants: What's Past and What's to Come**

Staying true to our year-end list motif, we now turn to the slow-to-develop broadband stimulus program. As you know, President Obama in February signed into law the American Recovery and Reinvestment Act that authorized \$7.2 billion to the National Telecommunications and Information Administration (NTIA) and the Rural Utilities Service (RUS) for grants and loans to qualifying broadband stimulus applicants. Following is a quick review of the status of the broadband program and our best guess of what to expect in 2010.

Given that this was a new program starting from whole cloth, NTIA and RUS asked for comments before the start of the application process on creating the best standards of eligibility for funding. These standards included definitions for significant terms, such as “broadband” and “unserved” and “underserved” areas. After sorting through the deluge of comments they received, the agencies set the ground rules for applications and established three rounds of fund distribution, which they subsequently reduced to two rounds.

The window for the submissions of stimulus applications in the first round opened on July 14 and closed shortly thereafter, Aug. 20. There was an overwhelming response in this first round of funding opportunity, with a total of 2,170 applications requesting \$28 billion. By contrast, the agencies had assigned only \$4 billion for funding in the first round. After the first-round applications had been submitted, and as companies waited for the next stage in the review process, NTIA and RUS announced that they would give existing broadband providers an opportunity to challenge applications proposing projects in existing carriers’ service territory. In various *e-Lerts* and releases, JSI recommended that all incumbent local exchange carriers (ILECs) providing broadband service submit challenges to applications proposing projects in areas they already serve. These challenges were necessary to provide the agencies with data to verify applicants’ assertions as to the “unserved” or “underserved” nature of their proposed funded service areas.

The first awards were not announced until this past Thursday, Dec. 17, with broadband funding for eighteen projects totaling approximately \$182 million. Projects under both the NTIA (BTOP) and RUS (BIP) programs received initial funding, with RUS awarding \$53.8 million for eight projects and NTIA awarding \$129 million for ten projects. The awards were distributed across four categories: middle mile, last mile, public computing, and sustainable adoption; and included: a private-public partnership to construct middle-mile infrastructure, a fiber-to-the-home project, and a proposal to provide 4-G wireless broadband Internet service to homes and businesses, as well as health clinics, schools, and tribal government facilities.

The first round of stimulus awards will continue through February; however, even before the first round is completed, the next round will begin with the release of the second Notice of Funds

Availability (NOFA), expected by the end of January. As we await the end of round one and the beginning of round two, JSI offers an assessment of what's on the horizon and a forecast of what to expect in the early part of 2010.

First, in assisting clients with their applications, JSI found the agencies' online electronic system fraught with network capacity deficiencies that caused problematic delays in filing. We encountered difficulties with the agencies' guidelines, mapping tool, and help-desk assistance, which in many cases were unclear, imprecise, and unsatisfactory. JSI raised these issues with NTIA and RUS in comments requested by the agencies. JSI hopes that the agencies will address the issues raised by JSI and others and implement improved guidance, standards and technical capabilities in the next round.

Second, clients that JSI assisted in filing applications reaped a tremendous strategic benefit by distilling their information and establishing a vision for broadband in their service areas. We expect that even those who do not receive funds—and there will be a shortage of funds given the application demand—will benefit from the process. One unexpected benefit for many applicants was that they achieved a clear plan for building out broadband infrastructure and for network expansion. Preparing an application provided timely guidance in creating a business plan, organizing financial data, and representing personnel accountability. For many companies that may not win an award grant or loan through BTOP or BIP, they should walk away nonetheless with many of the tools they need to pursue other investments or financial assistance.

Third, JSI makes the following recommendations to clients for the second round:

- Begin gathering financial data now: This includes gathering audited financials and creating five-year *pro-forma* documents based on your existing business.
- Gather competitive broadband data early:
  - (a) Companies should begin to determine where they will propose broadband service/expansion and determine any landline or wireless competitors overlapping the company's project areas. This data is very important for determining the unserved or underserved nature of the project area necessary for eligibility.
  - (b) Since we now know that existing broadband providers will have the opportunity to challenge project service areas based on overlapping existing service, applicants in the second round should be aware of all potential challengers by learning which competitors are serving project areas and being prepared to preempt any such challenge with an explanation or counteractive data.
- Identify community anchor institutions early: Many companies in the first round delayed identifying hospitals, community centers, police stations, schools, etc. until late in the process. Demonstrating that a project will serve these or other such anchor institutions will lead to a higher ranking for the application. Identifying these institutions early will ensure timely input of this information in the application review.

- Remember that this is the final round of broadband stimulus funding. We encourage clients to begin preparations for applications early. JSI will issue e-Lerts regarding the second funding round as we get pertinent information.

If you have questions or comments regarding this article or the broadband stimulus program, contact Valerie Wimer ([vwimer@jsitel.com](mailto:vwimer@jsitel.com)) or John Kuykendall ([jkuykendall@jsitel.com](mailto:jkuykendall@jsitel.com)) in our Maryland office, at 301-459-7590, Lans Chase ([lchase@jsitel.com](mailto:lchase@jsitel.com)) in our Georgia office, at 770-569-2105, or Terri Parrilla ([tparrilla@jsitel.com](mailto:tparrilla@jsitel.com)) in our Mississippi office, at 228-896-0841.

### **FCC and Net Neutrality: The Rules Are What's New**

Most everyone understands that the Internet is transformative. It has transformed world economies and societies and propelled democracies to new heights in citizen participation. No wonder then that when the FCC issued a Notice of Proposed Rulemaking in October attempting to establish rules to foster an "open and transparent" Internet (*FCC 09-93*), rules that lay out and explain the principle of "net neutrality," they were met with strong support and opposition alike.

The FCC has not been shy about expressing its views on an open and transparent Internet. It established a policy statement in 2005 that described the principles of: access to content; access to applications/services; connection of devices to the network; and, access to competition. In addition, the FCC has frequently addressed the Internet in various other forums and discussions. However, the October notice marked the first time the FCC has attempted to establish by rule its views on net neutrality. Comments on the FCC's notice are due Jan. 14, and JSI expects the debate on the proposed rules to continue well into 2010. Specifically, the FCC seeks to codify the four principles it set forth in 2005 and to add non-discrimination and transparency provisions to its list, for a total of six rules governing an open and transparent Internet.

One worry expressed by carriers about the FCC's proposed rules is the concern of Internet Service Providers (ISPs) large enough to control Internet traffic through network management principles that they are often unable to handle surges in usage. Surges occur for a variety of reasons and are by nature unpredictable. In addition, over-the-top video (video received over the Internet) is expected to spark huge demands for increased Internet transport. Access to content and non-discrimination rules could require ISPs to incur the increased costs associated with what will likely be a large increase in baseline traffic. It has also been reported that attacks on the network can accompany or cause a traffic surge. In a recent FCC workshop, AT&T reported that it suffers approximately 40 million network attacks every month and argued that it must retain the capability to defend against these attacks using network management principles. The regulations proposed by the FCC allow for reasonable network management and generally allow for network practices that address congestion, harmful or unwanted traffic, and unlawful traffic. These provisions notwithstanding, the large carriers do not have the assurance that their current measures are permissible or can be continued under the new rules. This uncertainty leads them to question the need for a regulatory framework for the Internet. Hence, the debate is on.

The FCC's notice also recognizes a class of services that share network facilities but differ from broadband Internet access. The FCC anticipates that these managed, or specialized, services will require a separate policy, even exemption from the six proposed rules. Examples of these

services include voice or subscription video services, certain business services provided to enterprise customers, and specialized applications like telemedicine, smart grid, or e-learning offerings. The FCC states: “we recognize that some services ... may be provided to end users over the same facilities as broadband Internet access service, but may not themselves be an Internet access service and instead may be classified as distinct managed or specialized services. ... As these may not be ‘broadband Internet access services,’ none of the principles we propose would necessarily or automatically apply to these services.”

JSI takes some comfort in the FCC’s *saying* that managed or specialized services are not covered under its net neutrality efforts; however, when we examine the proposed rule attached to the Notice, *we do not find any explicit exemption or recognition* of managed or specialized services. Hence, we believe the definition of broadband Internet access must explicitly call out and exempt these services from proposed regulation. One reason for our concern rests in the newly proposed fifth principle, non-discrimination. This principle is explained by the FCC to mean that “a broadband Internet access service provider may not charge a content, application, or service provider for enhanced or prioritized access to the subscribers of the broadband Internet access service provider.” If VoIP is not excluded from the proposed rules, carriers offering VoIP services would be prevented from charging other carriers from using their network to deliver traffic (voice calls) to end-user customers. The inability to charge for the use of the network for voice traffic would violate fundamental principles long held in the industry that charges should be levied on network users.

The notice also proposes that the six principles be applied to all platforms for broadband Internet access, including wireless/mobile broadband. The FCC seeks comment on how and in what time frame should its principles apply to non-wireline broadband Internet access services.

Finally, JSI is concerned about the ability to provide quality of service (QoS) across networks for future services, such as video. Currently, QoS is not implemented across networks, but as we move to a more interconnected IP-network structure, QoS will become paramount. These provisions are likely to be addressed in private agreements established among providers. JSI’s concern is that the four 800-pound gorillas in the room – AT&T, Verizon, Comcast, and Time Warner, which dominate broadband with 46 percent of total users nationwide – enjoy the ability, incentive, and predisposition to impose unfavorable interconnection provisions on rural carriers. And our concern is not limited just to QoS. While the large providers do not pay each other to exchange traffic with each other because of their peering arrangements, smaller providers do not, or may not, have these same exchange privileges. What we fear may be coming is discrimination against rural providers offering services adjacent to or in competition with the large broadband players.

JSI anticipates an active comment-and-reply cycle at the FCC addressing these and other net neutrality issues. If you have questions or comments about net neutrality in general or this article in particular, contact Manny Staurulakis ([mstaurulakis@jsitel.com](mailto:mstaurulakis@jsitel.com)) or Valerie Wimer ([vwimer@jsitel.com](mailto:vwimer@jsitel.com)) in JSI’s Maryland office, at 301-459-7590, or Douglas Meredith ([dmeredith@jsitel.com](mailto:dmeredith@jsitel.com)) in Utah, at 801-294-4576.

## DEM-Weighting

After what seems like an eternity, the wait for the FCC to move on long-standing requests to revisit its DEM-weighting rule has recently seen promising progress. From the time JSI first raised the DEM issue at the FCC in 2006 to the myriad of *ex parte* presentations, including clients' participation in the Coalition for Equity in Switching Support, a break in the drama finally came on Oct. 9. The FCC issued a Notice of Proposed Rulemaking in which it tentatively concluded to change the current DEM-weighting rule to allow for changes to a carrier's DEM weighting according to its access line count. Previously, changes were required only when access line counts increased beyond a DEM-weight threshold; there was no change when total access lines decreased below a threshold. JSI and many clients affected by this rule participated in the initial round of comments. We also filed reply comments rebutting what we considered were the spurious and ineffectual comments of CTIA and Sprint-Nextel. We encouraged the FCC to expedite its review of the matter and effect the proposed change in its rules.

Readers should note that one reason the DEM-weighting issue is important is that it involves a minor change to federal universal service rule, which hitherto have been considered untouchable without undertaking comprehensive change. The FCC's appetite for incremental changes to the *corpus* of federal universal service rules gives us a possible glimpse why the FCC has taken this action now.

The industry's progress in lifting the DEM-weighting issue to the attention of the FCC commissioners is a noteworthy feat. Clients that would like to review the Notice of Proposed Rulemaking or the comments filed in this proceeding, can log on to MyJSI and click to open the DEM-weighting PDF portfolio located on the "Heads-Up" page. If you have questions or comments about the DEM-weighting issue, contact John Kuykendall ([jkuykendall@jsitel.com](mailto:jkuykendall@jsitel.com)) in the Maryland office, at 301-459-7590.

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