

NEWS & COMMENTARY

ANALYSIS OF A CHANGING INDUSTRY

No. 0705
December 5, 2007

SPECIAL EDITION

JOINT BOARD RELEASES “LONG-TERM” USF RECOMMENDED DECISION; NEGLECTS TO BRING THE LONG-TERM INTO FOCUS

Ansel Adams, the legendary photographer of the American West, once remarked, “I believe there is nothing more disturbing than a sharp image of a fuzzy concept.” JSI approaches its review of the Nov. 20 Federal-State Joint Board Recommended Decision (*Decision*) in a somewhat disturbed state because although we’d like our analysis to be in sharp focus, the *Decision* itself is fuzzy. As we’ll explain, many of the recommendations that the Joint Board presented are conceptual in nature, lacking the precise detail necessary to enable a full understanding of their implications for rural incumbent local exchange carriers (ILECs) and competitive eligible telecommunications carriers (CETCs). In this issue of *JSI News & Commentary*, we assess the *Decision* and focus on key issues to help our clients evaluate the long-term prospects of federal universal service and the immediate implications of the *Decision*.

As early as this past May, the Joint Board announced it would release a decision in November. On May 1, the Joint Board issued a Recommended Decision urging the Federal Communications Commission (FCC) to impose an interim cap on support received by CETCs. It also announced it would provide the FCC with its long-term reform of the federal high-cost support programs within six months (Nov. 1 was the six-month deadline). While the Joint Board delayed its long-term reform recommendations by three weeks, it seems the additional time did not help provide the detail necessary to understand fully many important provisions included in the *Decision*.

Overall Cap on Federal High-Cost Programs

The marquee attraction in the *Decision* is the recommendation that the FCC cap the high-cost universal service programs at \$4.5 billion annually. This cap would place a lid on all five high-cost programs, three of which are for rate-of-return/rural ILECs – high-cost loop support (HCL), local switching support (LSS), and interstate common-line support (ICLS) – and two for price-cap/non-rural carriers – interstate access support (IAS) and high-cost model (HCM) support. Now, one might ask, how did the Joint Board arrive at its overall cap level? Tellingly, the Joint Board provided no analysis in its *Decision* suggesting that this amount would be sufficient to meet the universal service goals established by Congress. Instead, the Joint Board expressed concern that consumers have to pay for universal service and that it wanted to avoid significantly increasing consumers’ burden. In JSI’s view, it appears to be no coincidence that the \$4.5 billion

amount the Joint Board proposed for the overall cap is just a tad more than what's been projected (\$4.47 billion) for the five programs in 2007. On a more positive note, the Joint Board did recommend that the FCC eliminate the identical support rule used to calculate support for CETCs.

It is important to note that the Joint Board recommended a cap on each of the five current support programs at their 2007 levels, while the FCC transitions to three new high-cost programs. These individual caps as well as the overall program cap have a number of important ramifications for rural ILECs. First, JSI regards the Joint Board's new-found conversion and sole focus on reducing consumer burden with some skepticism. It's been fully five years since the rural ILEC industry formally expressed its concern about the growth of the high-cost fund, driven largely by unfettered support to CETCs. Further, only six months ago did this same Joint Board eloquently defend its recommendation to cap only CETCs' support during an interim period. Nonetheless, the Joint Board now appears to have joined hands with consumer advocates to belt out a rousing chorus of "Kumbiya."

The Joint Board expressed its belief that its recommendation would not affect rural ILECs because support "to most if not all (rural ILECs) has been flat or has even declined since 2003." According to the footnote at this quote, the Joint Board based its belief on 2003-2006 aggregate data. JSI observes that even as the Joint Board made this claim, it neglected to mention that the overall annual growth cap and corporate operations cap imposed on the high-cost loop fund have shifted more than \$900 million (based on 2006 calendar year data) of recovery to the intrastate jurisdiction. If 2007 data and separate support by program are included, quite a different picture emerges. (*Note: The following analysis is for rural ILEC support only and does not include support projected for CETCs.*) The data shows that from 2003 to 2007, aggregate support for the rural ILECs in the three programs (HCL, LSS, and ICLS) grew by 3.5 percent. This modest aggregate growth rate for rural ILEC support may appear to be in line with the Joint Board's claim, but when we examine each program separately, the results are quite different: Since 2003, ICLS support for rural ILECs (including Long Term Support for 2003) has grown by 15 percent; HCL has remained relatively flat, since it is under a cap adjusted only for the rural growth factor; and LSS has declined by 9 percent. In making its recommendation, the Joint Board failed to recognize the vital role ICLS support plays in providing an environment that enables rural ILECs to deploy the networks necessary to deliver broadband services to rural areas of the nation.

As mentioned, the Joint Board recommended capping all three programs separately at their 2007 levels during an unspecified transition period and urged the FCC not to shift funds among the programs during this period. Under this recommendation, none of the programs would be allowed to increase. Any future decreases in LSS, for example, could not be shifted to the ICLS program – even if the rural ILEC support stayed under the caps.

It is also unclear whether the Joint Board's cap recommendation removes the rural growth factor applied to the HCL fund. The existing cap on the high-cost loop program is adjusted for both growth in lines and an inflation factor. The Joint Board did not explicitly remove the rural growth factor from the HCL, nor did it explain whether the growth factor remains in place as part of the high-cost support process. If the rural growth factor process is eliminated by the Joint Board's recommendation, the FCC would cap the programs at their 2007 levels, fixing the future

federal universal service pie at \$4.5 billion. This might not be such a bad thing if the rural growth factor continues to trend negative over time.

In addition, as if pouring salt into the wound, the Joint Board was silent on the need to adjust the cap for inflation or for rural ILEC “exogenous” factors. This omission is particularly egregious because in recommending an interim CETC cap in May, the Joint Board expressly said there was no need to index the CETC cap since it was *interim in nature*. In the *Decision*, the Joint Board has recommended a *permanent* cap, but it remained silent on an inflation adjustment. The Joint Board expressed belief that federal support levels, thanks to long-term reform, will actually decline over time.

The ultimate effect of not allowing the cap to adjust for inflation or for exogenous factors is uncertain. The Joint Board noted a pending Qwest remand before the FCC that may increase the cap level. Aside from this Qwest proceeding, the Joint Board was silent on other possible changes to universal service. This suggests that shifting more access cost recovery into universal service – JSI clients may recall that the Missoula Plan sought to shift more cost recovery into a universal service type fund – or any effort to increase the meager broadband definition to a level at which national broadband speeds are comparable to those of other nations are non-starters. These types of reform would require significant support, and the Joint Board has effectively said it wants to buy the future on the cheap by failing to even recognize such changes in recommending a flat cap without adjustment.

The Joint Board also remained mum on the mechanics of the cap. It is clear the Joint Board wants a cap on the five major high-cost programs but declined to provide necessary details on how support would be distributed to carriers under a capped regime. During the (unspecified) transition period, the ICLS program would be capped at its 2007 level. Yet, as this program will likely grow in the future, it is not clear how the Joint Board expects to remain under the cap during the transition. In its interim decision in May, the Joint Board recommended that the CETC cap be administered by state commissions that would have the authority to distribute the capped support to their state CETCs. The Joint Board’s failure to explain how the cap would operate during the transition period leads to more fuzziness and uncertainty in the *Decision*.

Before we move on, we want to express our serious doubts about the reasoning of the Joint Board regarding the *consumer burden*. If the Joint Board had meaningful concern, it should have integrated a comprehensive recommendation for contribution reform in its *Decision*. Yet, there is no discussion of or reference to the needed reform, even as the Joint Board recommended expanding the Universal Service Fund to encompass a new broadband program. By enlarging the contribution base to all that directly benefit from the programs, the Joint Board could have reduced the burden on telecom consumers. Its failure to do that indicates, in JSI’s opinion, that capping the funds was driven by other motivations and the Joint Board’s attempt to justify the cap solely because of consumer interest is unconvincing.

The Significance of the Transition Cap

Looking beyond our concern with the apparent sloppiness of the *Decision*, what does all of this mean to rural ILECs? First, if adopted by the FCC, the transition period would likely be no less

than three to five years in length. Second, during this transition period, the individual high-cost programs would be capped at their 2007 levels. From now through any transition period, some rural ILECs will accelerate their capital expenditures, particularly for projects “in process.” Other rural companies whose investment projects are not already in process may postpone their capital expenditures because of the increased uncertainty surrounding federal high-cost support.

JSI strongly urges all clients to evaluate their future plans in light of this *Decision*. We suspect that it is likely the FCC will adopt a cap on federal high-cost support. While we would prefer that this cap apply solely to CETCs during the transition period (as recommended by the Joint Board in May), the possibility that a cap would be applied to rural ILECs as well is more than fifty-fifty. Thus, we think all clients would be wise to reevaluate their future capital expenditure plans and include a likely cap on ICLS in their business-case analysis. The specifics of how an ICLS cap would operate are uncertain. We can think of several scenarios but cannot provide any specifics until the FCC either decides how the transition cap would operate or requests details from the Joint Board. In the meantime, the level of uncertainty regarding federal high-cost support has increased.

Long-Term Prospects: New Programs and Reform of Existing Support

The Joint Board recommended long-term reform of high-cost universal service. It advised the FCC to establish three funds: Broadband, Mobility, and Provider of Last Resort (POLR). Each fund would have separate objectives and budgets. First, the Broadband Fund would be allotted \$300 million annually in federal funds to provide grants for broadband service deployment in unserved and underserved areas. The Joint Board wants the FCC to explore ways to encourage states to support this program – possibly providing matching federal funds. The Broadband Fund also would provide ongoing support in areas where it is not economically viable to offer broadband services.

The Mobility Fund would be allotted \$1 billion annually to provide grants to unserved areas and provide ongoing operational support in uneconomic areas. The Joint Board also recommended that the FCC explore state participation in this fund. The Joint Board declined to recommend that the Mobility Fund provide grants to under-served areas; *e.g.*, upgrading existing facilities. Instead, the Joint Board suggested that the FCC further explore this type of funding.

The current support received by CETCs amounts to approximately \$1.3 billion annually, the same amount the Joint Board recommended be transferred from the current programs to fund the Broadband and Mobility funds. There would be a transition of an unspecified number of years during which the dollars for the Broadband and Mobility funds would come from a series of reductions in the current programs, presumably reducing CETC support gradually and transferring these support amounts to the new programs.

The current high-cost programs would migrate to the POLR Fund. Aside from the overall cap, the Joint Board did not offer any new reforms for the POLR Fund. However, the *Decision* includes many potential reforms, including exploring the use of reverse auctions for the distribution of POLR support to one wireline provider, initially the ILEC, in a geographic area. The Joint Board believes the FCC should focus its attention on developing a unified POLR

mechanism for rural and non-rural carriers, meaning that the FCC would consider moving rural carriers toward using a forward-looking cost model or reverse auctions to determine support levels. In JSI's estimation, it is highly unlikely that any "unifying" reform would require non-rural carriers; *e.g.*, Verizon, AT&T, and Qwest, to move toward a more cost-based support mechanism similar to those currently used by rural ILECs. Thus, the only alternative is for the rural carrier mechanisms to change.

Other reforms of the current programs include possible adjustments based on rates paid by consumers (so-called rate testing), merging the current programs into one unified program, considering unregulated revenues in calculating carrier support levels, providing more limits on support for operational expenses, and reducing or eliminating over time support to areas with multiple providers. All of these conceptual reforms are merely listed in the *Decision*. The Joint Board offered no concrete reform recommendations for POLR at present.

JSI's Own Recommendation: Rural ILECs Better Get Focused!

As we hope you have surmised, JSI considers the general direction of the Joint Board regarding existing cost-based support for rural carriers to be quite disturbing. As a result, the importance of rural ILEC advocacy at this time cannot be overstated. Now more than ever, NTCA, OPASTCO, and all the rural associations need to gather their resources and demonstrate how the recommended reforms will affect consumers and jeopardize investment in rural areas that are supposed to receive *predictable and sustainable* support for universal service objectives. Without such advocacy, wireless and wireline CETC interests are eager and committed to sway the FCC's decision making, likely to the significant disadvantage of rural ILECs.

In sum, the overall impact of the Joint Board's unfocused recommendations leads JSI to urge that clients examine their future capital expenditure plans in the face of a possible cap and to accelerate their rural advocacy efforts designed to thwart reforms that would run counter to long-established, cost-based universal service support. Naturally, we will continue to report on developments in upcoming issues of *JSI News & Commentary* and our *e-Lerts*. If you have questions about the Joint Board's action or this article, or would like assistance in evaluating your company-specific concerns, please contact Manny Staurulakis (mstaurulakis@jsitel.com) in our Greenbelt, Md. office, at 301-459-7590, or Douglas Meredith (dmeredith@jsitel.com) in Utah, at 801-294-4576.

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