Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 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	)	WC Docket No. 07-135
Local Exchange Carriers	)	
	)	
High-Cost Universal Service Support	)	WC Docket No. 05-337
	)	
Developing an Unified Intercarrier	)	CC Docket No. 01-92
Compensation Regime	)	
	)	
Federal-State Joint Board on	)	CC Docket No. 96-45
Universal Service	)	
	)	
Lifeline and Link-Up	)	WC Docket No. 03-109
	)	
Universal Service Reform – Mobility Fund	)	WT Docket No. 10-208

COMMENTS OF JOHN STAURULAKIS, INC.
ON RATE OF RETURN REPRESCRIPTION STAFF REPORT

July 25, 2013

I. Introduction and Summary

John Staurulakis, Inc. ("JSI")[1] hereby submits these comments in response to the Wireline Competition Bureau's ("Bureau") May 16, 2013 Public Notice ("*Public Notice*")[2] seeking comment on a Bureau staff report,[3] also released on May 16, about represcribing the 11.25 percent authorized rate of return for rural local exchange carriers ("RLECs"). The Bureau staff report, *Prescribing the Authorized Rate of Return: Analysis of Methods for Establishing Just and Reasonable Rates for Local Exchange Carriers*, follows a proceeding initiated in the November 2011 *USF/ICC Transformation Order and Further Notice of Proposed Rulemaking* ("*USF/ICC Order*")[4] to represcribe the rate of return, as it has now been 23 years since the 11.25 percent rate was prescribed and "major changes have occurred in the market, technology, and regulation," necessitating a represcription.[5] Preliminary analysis in the *USF/ICC Order* suggested that the rate of return should be no more than 9 percent, but the staff report recommends an even lower rate in the range of 7.39 to 8.72 percent (a "zone of reasonableness," according to the report). JSI understands the underlying argument that considerable market, technology, and regulatory changes have occurred in the past 23 years, but cautions the FCC not to create any further significant disruption to RLEC cash flows and investment behavior until other unresolved matters from the *USF/ICC Order* are addressed *and* the industry has had time

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1 John Staurulakis, Inc. is a consulting firm offering regulatory, financial and business development services to more than two hundred rate-of-return rural incumbent local exchange carriers throughout the United States.

2 *Wireline Competition Bureau Seeks Comment on Rate of Return Represcription Staff Report,* Public Notice, DA 13-1110 (rel. May 16, 2013) ("*Public Notice*").

3 *Prescribing the Authorized Rate of Return: Analysis of Methods for Establishing Just and Reasonable Rates for Local Exchange Carriers,* WC Docket No. 10-90, Staff Report, DA 13-1111 (rel. May 16, 2013) ("Staff Report").

4 *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 a 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 – Mobility Fund,* WT Docket No. 10-208, Report and Order and Further Notice of Proposed Rulemaking, FCC 11-161 (rel. Nov 18, 2011) ("*USF/ICC Order") pets. for review pending sub nom. In re: FCC 11-161,* No. 11-9900 (10th Cir. Filed Dec. 8, 2011).

5 *Public Notice* at 1.

to absorb the collective reductions in Universal Service Fund ("USF") and intercarrier compensation ("ICC"). JSI agrees that market, economic, technology, and regulatory changes over the last two decades have greatly altered the cost of capital for businesses—however, for RLECs, the regulatory changes in particular in the last few years have, if anything, made it substantially *more* difficult and *more* costly for these companies to access capital. Reducing the authorized rate of return at this time may make sense from some economic and political perspectives outside the RLEC industry, but ultimately it would exacerbate what is shaping up to be a distressing financial reality for RLECs as a result of the drastic regulatory changes imposed by the *USF/ICC Order*.

JSI welcomes the opportunity to provide comments on the staff report and looks forward to contributing to this proceeding as a more substantial record is developed regarding the potential impacts to RLECs if the rate of return is reduced. In these comments, JSI demonstrates that the limitations in the staff report make it such that the report cannot be used as the basis for represcribing the authorized rate of return to the rates recommended in the report. JSI also provides results of our own analysis of a reduction in the rate of return to 8.72 percent and 8.06 percent to illustrate that the impacts of reducing the rate of return to the recommended range will have a severe negative impact on RLECs, and the impact would be especially severe if the FCC chooses not to redistribute the USF support reclaimed by substantially lowering the rate of return for RLECs to utilize for new broadband investment.

The timing could not be worse to reduce the rate of return. It is vital that the FCC provide assurance that it will not move forward with represcribing the rate of return for the foreseeable future—a renewed sense of regulatory stability is necessary to reinvigorate RLEC investment in rural broadband facilities, and reducing the rate of return while RLECs are still grappling with myriad revenue cuts and caps will not help achieve the underlying goals of the Universal Service Fund and the National Broadband Plan.

II. Limitations in the Staff Report Make it Unacceptable

One of the most glaring defects of the staff report is the application of financial assumptions about large- and mid-sized, publicly-traded telecommunications providers to the RLEC industry as a whole. The Bureau dedicates considerable time and energy in the report into determining the appropriate proxy group to represent "the universe of rate-of-return carriers;" and states that "The reliability of the Commission's analysis depends in large part on the representativeness of the proxy group it uses."[6] The FCC needs to analyze the appropriate financial metrics *about* the RLEC industry in order to reach an informed decision on represcribing the rate of return *for* RLECs. Indeed, the publicly-available financial information about companies like AT&T, Verizon, Frontier, and the larger RLECs is certainly an invaluable resource that must be included in a thorough represcription analysis, but the methodology of applying financial metrics of only a group of large ILECs that operate very differently than the majority of companies in "the universe of rate-of-return carriers" is flawed.

JSI notes that the staff report makes some questionable judgments about the behavior of rate-of-return carriers as compared to Regional Bell Holding Companies ("RCHs") that are not appropriate to apply to "the universe of rate-of-return carriers." The staff report states, "As compared with the incumbent LEC generally, the RHCs are subject to greater scrutiny from regulators, analysts and investors, including stock market traders, and consequently their self-reports are likely to be undertaken with greater care, and more quickly corrected where errors are made…Additionally, the RHCs have many large and sophisticated shareholders, who have

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6 Staff Report at paras. 14, 11.

strong incentives to watch the companies' behavior and to seek damages for misreporting."[7] Rate-of-return carriers are strictly regulated and also face severe consequences for not exercising "great care" in ensuring that regulatory and financial reports are done on time and without error. Furthermore, RLEC shareholders and investors have just as strong incentives to watch the companies' behavior as a Wall Street investor has to watch the behavior of AT&T. The FCC should reject these opinionated judgments from the staff report as they do not contribute meaningfully to the discussion nor can they be universally applied to rate-of-return carriers.

III. The Conclusions in the Staff Report Aggravate Existing Uncertainty

The use of a proxy group to characterize the debt and equity of the universe of rate-of-return carriers runs a similar risk as the FCC's application of certain problematic variables in the quantile regression analysis ("QRA") benchmarks for high-cost support. The still-unresolved defects in QRA have caused significant uncertainty and have negatively impacted investment across the RLEC industry as RLECs either face substantial USF cuts or are hesitant to make long-term investments in infrastructure out of fear that the investments will not be recovered through a predictable and sufficient USF mechanism. Add to this the uncertainty about the authorized rate of return, and the investment behavior of the RLEC industry suffers greatly, as noted by FCC Commissioner Ajit Pai in his statement on the Sixth Order on Reconsideration of the *USF/ICC Order*, which made modifications to QRA:

> This unpredictability does not promote certainty. And it appears the investment environment has cooled as a result, impeding the deployment of next-generation technologies and broadband services to rural Americans. Indeed, the Department of Agriculture recently told the Commission that demand for Rural Utilities Service loans for broadband build-out has plummeted this year due in part to uncertainty created by the QRA benchmarks. Communications infrastructure requires not a one- or two-year investment, but a ten- or twenty-year commitment. If a rural carrier does not know whether or how much universal service funding will be available, it will not invest in the

[7] Staff Report at para. 17.

higher-cost regions of America. Indeed, it may not even have the choice, as banks and investors are unlikely to lend to rural carriers with uncertain funding.[8]

Commissioner Pai's statement could very well be applied to the discussion about represcribing the rate of return, particularly the point about banks and investors being unlikely to lend to rural carriers with uncertain funding. Comments by CoBank on the staff report attempt to shed light on some of the FCC's misconceptions about RLECs' access to capital also confirm Commissioner Pai's statement: "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."[9] As the FCC considers reducing the rate of return, it must take into account the full spectrum of detrimental regulatory changes and maintain the fundamental principles of a specific, predictable and sufficient USF mechanism that preserves and advances advanced telecommunications and information services to all regions in the nation.[10] Reducing the rate of return will further chill investment which runs counter to the investment goals of the USF and the FCC's own goals set forth in the *USF/ICC Order*.

IV. Severe Negative Impacts to RLECs Will Occur if the FCC Adopts the Staff Report Recommendations

After the staff report was released, JSI conducted an analysis of 151 cost company clients and found that if the rate of return for these companies is lowered from 11.25 to 8.06 percent (the "lowest rate scenario" JSI analyzed), these companies would experience an average

[8] *Connect America Fund*, WC Docket No. 10-90, *High-Cost Universal Service Support*, WC Docket No. 05-337, Sixth Order on Reconsideration and Memorandum Opinion and Order, FCC 13-16 (rel. Feb. 27, 2013). Statement of Commissioner Ajit Pai, at 30.

[9] *Comments of CoBank, ABC*, WC Docket No. 10-90 (June 21, 2013).

[10] 47 C.F.R. § 254(b)

of $4.99 per line less per month in regulated revenues, and the collective total revenue reduction for the entire group would be **$64,983,870**. With a rate of return of 8.72 percent, the average support reduction would still be $3.99 per line per month, and the total revenue loss would exceed $50 million. An instant reduction in the rate of return to the recommended range would eliminate at least $50 million in revenue for this small subset of rate-of-return companies, indicating that the total impact across the industry would be considerably more severe. It is unknown at this time whether the FCC intends to redistribute the support through a yet-to-be-designed rate-of-return Connect America Fund. A severe and sudden elimination of vital revenue at such a critical time for investment in broadband infrastructure and maintaining suitable cash flows would be extremely detrimental to rate-of-return carriers and their customers, employees and investors.

V. Conclusion

The RLEC industry is in the midst of absorbing and adjusting to extensive changes and funding caps and cuts imposed by the *USF/ICC Order* as well as striving to meet customer demands for high-speed broadband while remaining financially healthy. The staff report correctly observes, "One thing that has not changed is the critical importance to both the industry and customers that the Commission establish an appropriate rate of return," which must be high enough "to provide investors confidence in the 'financial integrity' of a carrier, so that it can maintain its credit-worthiness and attract capital."[11] Maintaining the 11.25 percent rate of return is highly recommended at least until all of the various moving pieces in the *USF/ICC Order* are settled and some of the pervasive uncertainty is alleviated. JSI respectfully requests that the FCC resist moving forward with the rate of return represcription for the foreseeable future. JSI

[11] Staff Report at para. 6; U.S. v. FCC, 707 F.2d 610, 612 (D.C. Cir. 1983) (quoting Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944)).

recommends that the FCC conduct a full assessment of the impact of the reforms that have already been implemented as well as gather and analyze financial data about rate-of-return carriers in order to better understand the realities of the investment climate and RLECs' access to capital.

Respectfully submitted,

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