September 23, 2011

Ms. Marlene H. Dortch, Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Ex Parte Notice

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 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 01-92; *Federal-State Joint Board on Universal Service,* CC Docket No. 96-45; *Lifeline and Link-Up*, WC Docket No. 03-109

Dear Ms. Dortch:

The National Telecommunications Cooperative Association, the Organization for the Promotion and Advancement of Small Telecommunications Companies, and the Western Telecommunications Alliance (collectively, the Associations) hereby file the attached presentation in the above-captioned proceedings. This paper, "Why the FCC Should Not Hold a Position with Respect to Consolidation Within the Rural Telephone Industry", amplifies an issue raised by the Associations in Reply Comments of May 23, 2011 (p. 46), specifically, addressing proposed regulatory actions that may be intended to encourage consolidation within the rural telecommunications industry. The attached paper explains why pursuit of such policies would conflict with both the Commission's statutory authority and economic rationality.

Pursuant to Section 1.1206 of the Commission's rules, a copy of this letter and the attached report is being filed via ECFS with your office. If you have any questions, please do not hesitate to contact the undersigned.

Respectfully submitted,

Derrick Owens
Director of Government Affairs
Western Telecommunications Alliance

Stuart Polikoff
Vice President of Regulatory Policy and Business Development
Organization for the Promotion and Advancement of Small Telecommunications Companies

Joshua Seidemann
Director of Policy
National Telecommunications Cooperative Association

Attachment

Why the FCC Should Not Hold a Position with Respect to Consolidation Within the Rural Telephone Industry

September 2011

Harold Furchtgott-Roth

Why the FCC Should Not Hold a Position With Respect to Consolidation Within the Rural Telephone Industry

Harold Furchtgott-Roth[1]

I. Introduction and Executive Summary

In February 2011, the Federal Communications Commission (FCC) issued a Notice of Proposed Rulemaking (NPRM) that seeks to alter the Universal Service Fund (USF) and intercarrier compensation system ostensibly for a broadband marketplace. Among other things, the NPRM seeks comment on: "Streamlining the study area waiver process to eliminate barriers to consolidation and rationalization of service territories."[2] To the extent the proposed rule changes reduce regulation and lessen the burden on overregulated companies, the rule changes are praiseworthy.[3] But, the FCC appears to frame the discussion of changing rules on study area waiver requests not as a matter of deregulation, but rather as a matter of industrial policy aimed at reducing the number of small telephone companies and increasing the size of the remaining companies.[4] I find troubling the apparently unprecedented discussion of "consolidation" of small telephone companies in the NPRM. While I believe it is inadvertent, the discussion of consolidation leaves the impression that the FCC seeks new issues to regulate outside of the FCC's statutory authority. I do not intend to suggest that one paragraph in an NPRM reflects a carefully considered new policy of the FCC, but in an abundance of caution I offer these comments.

A. Background on consolidation among rural telephone companies

Hundreds of rural telephone companies serve America.[5] Like businesses in all industries in America, rural telephone companies are not static. Some are bought; others are sold. Some companies, such as American Broadband and Signal Telecom Partners, specialize in consolidating rural telephone companies.[6] Telephone cooperatives have a corporate structure that makes transactions difficult, but even so, efforts are sometimes made to acquire them.[7]

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[1] President, Furchtgott-Roth Economic Enterprises, and former Commissioner, Federal Communications Commission. I gratefully acknowledge a grant from the National Telecommunications Cooperative Association, the Organization for the Promotion and Advancement of Small Telecommunications Companies, and the Western Telecommunications Alliance. The views expressed in this paper are those of the author alone and do not necessarily reflect the views of any other party. Any errors in the paper are the responsibility of the author alone.

[2] *Connect America Fund, A National Broadband Plan for Our Future, Establishing Just and Reasonable Rates for Local Exchange Carriers, High-Cost Universal Service Support, Developing a Unified Intercarrier Compensation Regime, Federal-State Joint Board on Universal Service, Lifeline and Link-Up: Notice of Proposed Rulemaking and Further Notice of Proposed Rulemaking,* WC Docket No. 10-90, GN Docket No. 09-51, WC Docket No. 07-135, WC Docket No. 05-337, CC Docket No. 01-92, CC Docket No. 96-45, WC Docket No. 03-109, FCC 11-13, at paragraph 21 (2011) (NPRM).

[3] I have no particular view of the specific rules the Commission proposes with respect to study area waiver requests.

[4] *See,* NPRM at paragraph 217.

[5] The NPRM finds 1,150 incumbent rate-of-return operating companies. (NPRM at paragraph 217.) Other small telecommunications companies are not rate-of-return carriers and still others are competitive local exchange carriers. Small telephone companies in the United States have a wide range of corporate structures including various forms of private corporations and cooperatives. Many small telephone companies are owned by families or are closely held businesses.

[6] *See e.g.,* American Broadband at http://www.americanbroadband.com; and http://www.signal-telecom.com.

[7] *See,* J. Engebretson, "Consolidation Pressure Leading to Co-Op Hostile Takeover?" *Telecompetitor,* July 18, 2011, at http://www.telecompetitor.com/consolidation-pressure-leading-to-co-op-hostile-takeover/.

I am not aware that the FCC, prior to the NPRM, has stated a position on consolidation among rural telephone companies. However, at paragraph 217 of the NPRM, the Commission makes some remarkable statements:

> Our current universal service rules may have the unintended consequence of discouraging beneficial consolidation of small carriers by subsidizing inefficient operating structures and limiting the ability of small companies to acquire and upgrade lines from other providers that have little interest in serving rural markets. As noted above, in 2010, there were 1,150 incumbent rate-of-return operating companies (owned by 754 incumbent telephone holding companies), the vast majority of which are also rural carriers eligible to receive HCLS. Although we recognize the benefits of local firms serving local markets, it may not serve the public interest for consumers across the country to subsidize the cost of operations for so many very small companies, when those companies could realize cost savings through implementation of efficiencies of scale in corporate operations that would have little impact on the customer experience.[8]

While perhaps not intended, the paragraph easily conveys the following impressions:

- The FCC has the statutory authority to hold a view and perhaps even to promulgate regulations with respect to the size and consolidation of small telephone companies;
- Small telephone companies are inherently less efficient than larger telephone companies;
- Many small telephone companies have demonstrably "inefficient operating structures;"
- These "inefficient operating structures" would be less likely if the FCC did not "subsidiz[e]" them through universal service rules;
- The number of rural telephone companies, "1,150 incumbent rate-of-return operating companies," is too large;
- The FCC believes that the American consumer is punished by the very existence of at least some of the small rural telephone companies: "it may not serve the public interest for consumers across the country to subsidize the cost of operations for so many very small companies;" and,
- Some and perhaps all of these small rural telephone companies could be become more efficient through consolidation, through which "those companies could realize cost savings through implementation of efficiencies of scale in corporate operations that would have little impact on the customer experience."

B. Summary of opinions

My comments can be summarized as follows:

A. No body of evidence leads to the conclusion of universal efficiencies of consolidation in the telecommunications industry.

B. The NPRM fails to address deregulation in the context of "Removing Barriers to Operating Efficiencies."

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[8] *See,* FCC 11-13, at paragraph 217 (footnotes omitted).

C. The FCC does not explain a compelling need to address consolidation in the rural telephone industry.

D. The FCC does not have specific statutory authority to regulate the size of telephone companies or the number of telephone companies.

E. The federal government typically does not have a view of consolidation in a particular industry.

F. The FCC has neither the criteria nor the evidence to evaluate consolidation in the rural telephone industry.

G. Changing FCC rules will have an indeterminate effect on consolidation in the rural telephone industry.

H. Government encouragement of consolidation could lead to a misallocation of resources as businesses make investments in consolidation artificially to meet government expectations.

I. Consequently, the FCC has no foundation in holding a position with respect to consolidation activities among rural telephone companies.

II. No body of evidence leads to the conclusion of universal efficiencies of consolidation in the telecommunications industry

Economists have standard techniques to evaluate whether a merger between two firms will lead to lower costs and efficiencies. One concept, economies of scale, or lower unit costs as the level of activity in providing a specific service increases, indicates that expanding the size of the specific service will lead to lower average costs. At least two types of economies of scale might be relevant to evaluating consolidation in the rural telephone company industry. One type of economies of scale would refer to economies within the same geographic area. With economies of scale, the average unit cost of providing a telecommunications service in a geographic market is lower with one firm than with two. Thus, if two rural telephone companies competed against each other providing the same telecommunications service in the same geographic market, and if there were economies of scale within that geographic market, then the consolidation of the two competing firms might lead to lower unit costs in the provision of a particular telecommunications service. Of course, the consolidation of two competing firms in the same geographic market might lead to antitrust concerns. Some studies may show economies of scale for the provision of telecommunications service in one or more particular geographic market. I am not aware, however, that any economic study has looked at economies of scale in the provision of a telecommunications service in each of the hundreds of local telecommunications markets in the United States, much less that such a study reached the conclusion of economies of scale for each telecommunications service in each of those geographic markets. Thus, I do not believe that there is a foundation for a claim of global economies of scale for every possible combination of telecommunications companies in every geographic market.

The second concept of economies of scale for rural telephone companies refers to economies across different geographic markets. With economies of scale across geographic markets, the average unit cost of providing a telecommunications service in both geographic markets is lower with one firm in both geographic markets rather than one firm in each geographic market. Thus, if there were economies of scale in the provision of telecommunications services in region A combined with region B, then a merger between a rural telephone company in region A with a rural telephone company in region B should lead to lower unit costs for the provision of telecommunications services in both regions. Some economic studies may show economies of scale for the provision of a telecommunications service across specific geographic markets. I am not aware, however, that any economic study has looked at economies of scale in the provision of a telecommunications services in combinations of each of the hundreds of local telecommunications markets in the United States, much less that such a study reached the conclusion of economies of scale for each telecommunications service in combinations of each of those geographic markets. Thus, I do not believe that there is a foundation for a claim of global economies of scale for every possible combination of telecommunications companies across every geographic market.

Separate from economies of scale in the provision of one telecommunications service are the economies of scope across different telecommunications services. With economies of scope, one firm can provide two different telecommunications services at a lower cost than a separate firm for each service. Thus, if a wireline firm in a geographic market were merging with a wireless firm in the same geographic market, and if there were economies of scope between the provision of wireline and wireless services in that geographic market, one would expect lower costs from the merger. Some economic studies may show economies of scope for the provision of two specific telecommunications services in one or more particular geographic markets. I am not aware, however, that any economic study has looked at economies of scope in the provision of every combination of telecommunications services in each of the hundreds of local telecommunications markets in the United States, much less that such a study reached the conclusion of economies of scope for each telecommunications service in each of those geographic markets. Thus, I do not believe that there is a foundation for a claim of global economies of scope for every possible combination of telecommunications services in every geographic market.

III. The NPRM fails to address deregulation in the context of "removing barriers to operating efficiencies"

In discussing a change to rules on "removing barriers to operating efficiencies," including study area waivers, the FCC does not focus on the statutory goal of deregulation but on, of all issues, consolidation in the rural telephone industry.[9] No mention is made of the potential benefit of deregulation. The preamble to the Telecommunications Act of 1996 (Act) states that it is a law "to promote competition and reduce regulation," not a law to increase regulation or to fret over consolidation among rural telephone companies.[10] The Act has many sections that focus on deregulation,[11] yet the NPRM does not cite any when rationalizing the proposed new rules with respect to purported barriers to operational efficiencies including study area waivers.

IV. The FCC does not explain a compelling need to address consolidation in the rural telephone industry

In proposing new rules or addressing a new policy issue, the FCC usually explains the compelling need for FCC involvement. In this instance, however, an explanation for FCC involvement in

[9] NPRM at paragraphs 216-227.

[10] Preamble to the Telecommunications Act of 1996.

[11] *See, e.g.,* Sections 10 and 11.

consolidation in the rural telephone industry is missing. Other than vague assertions that the operations of small companies are inefficient, the FCC offers no reason for its involvement.[12] Nor does the FCC offer, as an example, evidence for even one rural telephone company where a possible merger would be efficient, let alone for each of the hundreds of small rural telephone companies in existence. Decades ago, Ronald Coase explained why firms are created and the nature of the size of a firm; larger is not always less costly.[13] Modern economics provides methods to measure the cost efficiency of firms.[14] I am not aware that econometric studies have been conducted for the cost structure of each of the hundreds of small telephone companies in the United States, much less that such studies show that merger combinations would lead to lower cost structures for even one combination of small companies.

If the FCC wants now to argue that larger firms are inherently more efficient than smaller firms, the FCC may be compelled to revisit its views in many other proceedings where it takes the opposite position.

V. The FCC does not have specific statutory authority to regulate the size of telephone companies or the number of telephone companies

No statute instructs the FCC to regulate *per* se the size of telephone companies in the United States, or to otherwise editorialize or disparage the developed market. There are no statutory thresholds of what constitutes a telecommunications company that is too large or one that is too small; no statutory thresholds determine what constitutes too few telecommunications companies or too many.

The absence of statutory thresholds is not accidental. Managed economies have governments that may dictate the number of firms in an industry or prescribe their size. In a market economy, by contrast—and our telecommunications markets are, by statute, left to as many market and competitive forces as possible[15]—the number of firms in a market is left to the market to determine. Firms will enter a market if such entry is expected to be profitable and exit a market based on a decision of the firm. The size of each firm will be determined by market forces, not government diktat.

Even if the FCC believed that it should have a view about the appropriate size of telephone companies or the number of telephone companies, two principles contradict the Commission's implied preference to reduce the number of small telephone companies: (1) the Federal preference for small businesses and (2) the Federal statutory preference for rural telephone companies.

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[12] *Ibid.*

[13] R. H. Coase, "The Nature of the Firm," *Economica*, New Series, Vol. 4, 1937, pp. 386-405. Professor Coase explains that when transactions costs of doing business with entities outside the firm are high, the firm will acquire those entities so that the transactions are internal to the firm. On the other hand, overhead and bureaucracy costs limit the efficient size of a firm. Nothing in Coase, or in most of economic literature, leads to the general conclusion that larger firms are always more efficient at all scale of activities.

[14] Econometrically, it is efficient for a firm to grow as long as marginal costs are falling. When marginal costs increase, the firm likely would be more efficient to decrease in size.

[15] *See,* Preamble to the Telecommunications Act of 1996.

A. The federal government has laws and rules that favor small businesses

The federal government has laws and rules that give preferential treatment to small businesses relative to large businesses.[16] Federal agencies, including the FCC, have statutory requirements to give preferential treatment to small businesses.[17]

The Communications Act of 1934, as amended, has preferences for small businesses. As an example, Section 257 instructs the FCC to eliminate "market entry barriers for entrepreneurs and other small businesses in the provision and ownership of telecommunications services:"

> Within 15 months after the date of enactment of the Telecommunications Act of 1996, the Commission shall complete a proceeding for the purpose of identifying and eliminating, by regulations pursuant to its authority under this Act (other than this section), market entry barriers for entrepreneurs and other small businesses in the provision and ownership of telecommunications services and information services, or in the provision of parts or services to providers of telecommunications services and information services.[18]

It is difficult to read either the Communications Act or other federal statutes and find statutory language that would give the FCC authority to take positions, either by regulation or policy position, that would result in the following:

- Creation of barriers for small businesses to own telecommunications companies;
- Encouragement of small businesses to exit a market; or,
- Encouragement of a small business to be acquired by another party.

B. The Communications Act specifically recognizes small rural telephone companies

The Communications Act creates a special definition and a special status for rural telephone companies.[19] The vast majority of rural telephone companies would qualify as small businesses under many federal provisions, and these companies are granted a special status under the Communications Act.[20] It is difficult to read the Communications Act and find statutory language that would give the FCC authority to take positions that would result in the following:

- Creation of barriers for rural telephone companies to own telecommunications companies;
- Encouragement of rural telephone companies to exit a market; or,
- Encouragement of a rural telephone company to be acquired by another party.

For the reasons stated above, I believe the FCC would have no statutory foundation to develop a policy of reducing the number of small rural telephone companies.

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[16] *See, e.g.,* 15 U.S.C. § 631 *et seq.* (Chapter 14A). References to "small businesses" can be found in many if not most titles of the U.S. Code.

[17] *See, e.g.,* 47 U.S.C. § 257.

[18] 47 U.S.C. § 257(a).

[19] 47 U.S.C. § 153(37).

[20] *See, e.g.,* 47 U.S.C. § 214(e), 251(f), 253(f), 256(b), and 309(j).

VI. The federal government typically does not have a view of consolidation in a particular industry

Even if the FCC could find a statutory provision that could possibly support its taking a position on consolidation in the rural telephone industry, the unambiguous precedent the FCC has taken in other areas is to discourage industry consolidation. The repeated positions against consolidation in other industries (including broadcasting) taken by the FCC have had little, if any, statutory or economic foundation. While I do not agree with the positions the FCC has taken generally on consolidation in other industries, the FCC would appear inconsistent and arbitrary were it now to go beyond statutory authority to take a position *favoring* industry consolidation in only one industry, that including rural telephone companies.

The federal government typically has a neutral view of consolidation in an industry. Other than statutes related to antitrust or national security concerns, I am not aware of any statute that requires, or even encourages, a federal agency to take a position favoring or opposing a specific merger or acquisition. Some federal agencies, including the FCC, have promulgated rules restricting transactions for certain assets,[21] but none of these rules apply to mergers and acquisitions of telecommunications companies, generally, or rural telephone companies in particular.

To the extent it has a view of mergers and acquisitions, the FCC appears to view them skeptically, even absent statutory authority to do so. Thus, the FCC has rules on the ownership of broadcast stations that doubtlessly discourage mergers and acquisitions. The FCC reviews major mergers in detail over many months and often attaches conditions when approving them.[22] The merger review process at the FCC may serve many purposes, but encouraging transactions and industry consolidation is not among them.

VII. The FCC has neither the criteria nor the evidence to evaluate consolidation in the rural telephone industry

Even if the FCC were to have a policy on consolidation among rural telephone companies, the FCC does not have criteria to determine whether there is too little or too much consolidation. I am not aware of such criteria in statute or federal regulation, nor am I aware that any proposed criteria have been discussed by the FCC or publicly noticed.

Furthermore, even if the FCC were to have criteria to determine whether there is too much or too little consolidation among rural telephone companies, I am not aware that the FCC has collected or considered relevant information to evaluate those criteria. Ultimately, even if the FCC were to have a view about consolidation in the rural telephone industry, the FCC has neither the criteria nor the information to determine whether there is too little or too much consolidation.

[21] *See, e.g.,* FCC rules with ownership limits of broadcast licenses. For a review of these rules, *see,* http://www.fcc.gov/guides/review-broadcast-ownership-rules.

[22] *See,* http://www.fcc.gov/mergers.

VIII. Changing FCC rules will have an indeterminate effect on consolidation in the rural telephone industry

Even if the FCC were to have criteria and information to determine whether there is too much or too little consolidation in the rural telephone industry, the FCC could not easily structure rules to lead to more consolidation for at least two reasons: (1) FCC rules are a not a dominant factor in most mergers and acquisitions; and (2) even where FCC rules may affect mergers and acquisitions, changes in the specific parameters of FCC rules do not have a predictable effect on mergers and acquisitions.

A. FCC rules are not a dominant factor in most mergers and acquisitions

Businesses choose to engage, or not engage, in mergers and acquisitions for many reasons. While FCC rules are sometimes a factor in merger decisions, FCC rules are rarely the only or even the dominant factor. Potential sellers must decide whether to sell based on many factors, including the potential value of the asset and a comparison of the expected profitability of selling versus not selling. Potential buyers make similar calculations, including the potential value of the asset and a comparison of the expected profitability of buying versus not buying.

For any business operating in the United States, and for many operating abroad, federal rules can and do influence both the value of a business and the relative profitability of buying or selling. But, so do many other factors unrelated, or only indirectly related, to federal rules. Thus, while FCC rules do influence the potential value of the company, it is not surprising that, for a rural telephone company, many other factors unrelated to FCC rules influence the potential value, as well. The inherent characteristics of a particular asset in a particular market facing particular forms of competition usually are far more important in determining the value of an asset than general rules that apply to hundreds or thousands of companies. Thus, the number of subscribers, the revenue structure of the firm, the plant and equipment of a network, the cost structure of the company, and the competitive position of the firm are likely to have more influence on the value of a rural telephone company than a federal rule.

To the extent the FCC proposes outcomes intended to diminish cost recovery opportunities for rural telephone companies, incentives for consolidation among rural telephone companies may well diminish as such companies become less profitable and less attractive acquisition targets.

B. Changes in the specific parameters of FCC rules do not have a predictable effect on mergers and acquisitions

The net effect of a specific government regulation on the value of any firm—including rural telephone companies—varies by firm. For some rural telephone companies, one federal rule may have relatively little effect, while for another company the effect may be more pronounced in one direction, and for another firm the effect may be pronounced in the opposite direction.

The NPRM discusses many different proposed rules, not just those related to study area waivers. Some of the proposed rules may result in more consolidation in the rural telephone industry, some in less, and for many if not all of the rules, the effect on consolidation is impossible to predict.

IX. Government encouragement of consolidation could lead to a misallocation of resources as businesses make investments in consolidation artificially to meet government expectations

The NPRM implies that current rules lead to artificially low levels of consolidation in the rural telephone industry. Focusing attention on purported low levels of consolidation, and altering FCC rules to encourage greater consolidation, could have the consequences of diverting resources artificially into consolidation and resulting in artificially high levels of consolidation. The Communications Act delegates to the FCC no specific authority or policy guidance either to encourage or to discourage consolidation. The better approach would be for the FCC to focus its efforts on those areas where it has specific statutory instruction.

X. Consequently, the FCC has no foundation in holding a position with respect to consolidation activities among rural telephone companies

For all of the reasons presented above, the FCC has no foundation in holding a position with respect to consolidation activities among rural telephone companies.

XI. Conclusion

Little or no economic evidence demonstrates that consolidation would have a predictably efficiency-enhancing effect for every possible combination of telecommunications companies. Even if economic evidence consistently found economies of scale or economies of scope, the FCC has no legal authority, and no foundation of information, to have a view with respect to consolidation of the telecommunications industry, nor has the FCC offered a consistent view in the past of encouraging consolidation. For these and other reasons, as it reviews whether and how to alter its universal service and intercarrier compensation rules, the FCC should not consider rules with the specific purpose of encouraging consolidation.

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