Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 200554

In the Matter of	)	
	)	
Connect America Fund	)	WC Docket No. 10-90

REPLY
of the
NATIONAL EXCHANGE CARRIER ASSOCIATION, Inc.;
NTCA-THE RURAL BROADBAND ASSOCIATION;
USTELECOM;
EASTERN RURAL TELECOM ASSOCIATION; and
WESTERN TELECOMMUNICATIONS ALLIANCE

Comments filed in response to the Bureau's *Staff Report*[1] make clear that rules and methods developed to prescribe the authorized interstate rate of return (RoR) for the "unified" telecommunications industry of the 1980's cannot rationally be applied to rate-of-return-regulated local exchange carriers (RLECs) operating in today's telecommunications marketplace.[2] Before proceeding further with a represcription, the Commission must (a) specify represcription procedures that provide affected RLECs with the "full opportunity for hearing" expressly required by section 205(a) of the Act, and (b) develop methods to analyze the cost of capital for RLECs that reflect the diverse, highly competitive, and increasingly uncertain telecommunications environment faced by these companies today.

[1] Wireline Competition Bureau, *Prescribing the Authorized Rate of Return: Analysis of Methods for Establishing Just and Reasonable Rates for Local Exchange Carriers*, Staff Report, WC Docket No. 10-90 (rel. May 16, 2013) (*Staff Report*).

[2] *See, e.g.,* Comments of NECA, NTCA, USTelecom, ERTA, and WTA at 8 (Associations); Moss Adams at 22; Alaska Rural Coalition at 9-10; ERTA at 6-9.

I. THE COMMISSION MUST CLARIFY THE PROCEDURAL RULES IT INTENDS TO FOLLOW IN FUTURE REPRESCRIPTION PROCEEDINGS.

In their initial comments the Associations explained that the Commission must establish clear rules governing represcription proceedings *prior* to moving forward with a rate prescription under section 205(a) of the Act.[3] Merely seeking comments from interested parties on the Bureau's *Staff Report* is clearly not sufficient to produce a record supporting a revised rate prescription. As GVNW explained:

> While we can debate various approaches to what adequately provides a fair "hearing", it seems intuitively obvious that carriers should be allowed to present factual evidence prior to preliminary conclusions being reached. The WCB Staff Report does not address or attempt to answer the important question of what process will be used in the coming months to achieve compliance with the law found in Section 205(a). Offering comments and replies in a short time frame to the WCB Staff Report falls far short of offering the type of hearing required under the Act.[4]

While section 205(a) may not require the Commission to conduct traditional "trial-type" hearing proceedings in all cases, it must conduct a "thorough fact-based inquiry that develops a great amount of probative evidence" prior to adopting a new rate prescription.[5]

Prior rate prescription hearings have involved multiple submissions from parties, giving each side a fair chance to address and rebut proffered facts and arguments.[6] Parties have also been given reasonable access to discovery (e.g., interrogatories and document requests), either directly or as part of a required

[3] Associations at 6, 34. *See also* Initial Comments of NECA, NTCA, OPASTCO, and WTA, WC Docket No. 10-90, *et al*., at 49-50 (filed Jan.18, 2012).

[4] GVNW at 3. *See also* Moss Adams at 10.

[5] Associations at 35, 37.

[6] *See id*. at 36, n.130.

filing.[7] Revised procedural rules must also specify who bears the burden to demonstrate the existing RoR is unjust and unreasonable and what level of new return on investment would be just and reasonable.[8]

The Commission must also provide sufficient time for parties to prepare submissions. In this regard, the Associations continue to recommend at a minimum the normal 60-60-21-day time frames for adversarial filings set forth in section 65.103 of its rules apply.[9] This is critical for RLECs with limited resources to develop the data needed to prepare direct cases and to obtain the services of qualified experts to analyze data and respond to adversarial filings.

II. THE COMMISSION MUST DEVELOP METHODS THAT ACCURATELY ESTIMATE CAPITAL COSTS FOR RLECs OPERATING IN TODAY'S TELECOMMUNICATIONS MARKETPLACE.

As part of any proceeding to develop rules to govern the represcription process, the Commission must also specify methods to estimate the cost of capital for RLECs that take fully into account the actual operating conditions faced by these companies today. Comments and analyses filed thus far in this proceeding confirm that application of 1980's-era methods to RLECs today would be inappropriate and would cause the Commission to seriously underestimate the cost of capital for these companies going forward.

The Associations' comments described many of the dramatic marketplace and regulatory changes that affect the cost of capital for RLECs in today's marketplace, and

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[7] *Id.*

[8] *Id.*

[9] Petition for Reconsideration of NECA, OPASTCO, and WTA, WC Docket No. 10-90, *et al.,* at 29 (filed Dec. 29, 2011).

urged the Commission to take these factors more fully into account in any represcription proceeding.[10] The Associations further noted that estimates of the weighted average cost of capital (WACC) for RLECs set forth in the *Staff Report* were actually *lower* than WACC estimates for the regional Bell Holding Companies (RHCs).[11] This appeared to reflect an assumption that RLECs operate in "safer" business environments than RHCs,[12] but as the Associations explained, RLECs now face significantly more marketplace and regulatory risk than RHCs. These companies are primarily focused on serving customers in sparsely-populated, high-cost rural areas, and are far more dependent on vanishing intercarrier compensation (ICC) revenue streams and capped universal service (USF) support flows.[13] They also have smaller percentages of large, more profitable business customers than RHCs serving larger urban markets.[14] Investors familiar with today's telecommunications business environment probably would not invest dollars in an RLEC if they could achieve the same or even *higher* returns by investing in RHCs – yet this is precisely the result implied by the *Staff Report's* calculations.

The Associations also described a number of data and analytical concerns raised by methods used in the *Staff Report*, including the Bureau's reliance on an "opportunity" sample of proxy companies not shown to be representative of RLECs;[15] the application of economic models such as the capital assets pricing model (CAPM) to determine the

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[10] *See* Associations at 15-20.

[11] *Id.* at 4.

[12] *Id.*

[13] *See id.* at 15-19. *See, e.g.,* Alexicon at iv, 25-28, 32; JSI at 1-2; Alaska Rural Coalition at 9-10; GVNW at 6; Moss Adams at 15-16; OTA and WITA at 5.

[14] Associations at 4.

[15] *Id.* at 20-24.

cost of equity for RLECs;[16] and the need to make adequate adjustments to account for small size and low-liquidity on effects and the need to recognize the impacts of low-liquidity on capital costs.[17] These concerns, among others, were described in detail in a statement by Prof. Randall Billingsley of Wake Forest University, attached to the Associations' comments as Exhibit A.[18] Dr. Billingsley also pointed out that the fact the Bureau needed to make various "adjustments" to its results to offset anomalous data input values should serve as a red flag to the Commission that there are serious flaws in the Bureau's underlying methods.[19]

Similar concerns were echoed by other commenters. RTFC, for example, also described the need for the Commission to update its WACC estimation techniques in light of marketplace and regulatory changes, pointing in particular to anomalous impacts caused by the Federal Reserve's stimulus program, which has tended to drive down the cost of debt in recent years.[20] RTFC also expressed concern that methods applied by the Bureau to estimate the WACC for RLECs may not be practical because these companies generally are not publically traded, and their risk profiles may exceed those of companies like AT&T and Verizon.[21]

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[16] *Id.* at 25-28.

[17] *Id.* at 28-29. *See also* RTFC at 3; Alaska Rural Coalition at 10-11.

[18] Associations, App. A, Statement of Dr. Randall S. Billingsley, FRM, CRRA, CFA (July 25, 2012) (Billingsley Statement).

[19] *Id.* at 30-31, *citing* Billingsley Statement at 16.

[20] RTFC at 3. The Associations likewise pointed out the need for the Commission to recognize that currently low Treasury bond rates do not necessarily imply that RLEC capital costs have fallen in tandem. Associations at 27, App. A at 14-15.

[21] RTFC at 4. Similar concerns were expressed by JSI at 2, 6; Alexicon at 25; and ERTA at 6-8.

Alexicon similarly argues that the *Staff Report's* recommendations did not include the risk premiums needed to account for differences between the proxy group and the subject group of RoR ILECs.[22] Commenters also expressed concerns about the Bureau's application of traditional economic models to RLECs,[23] and the need to consider impacts of small firm size and illiquidity on RLEC capital costs.[24]

In addition to highlighting technical flaws with the analyses set forth in the *Staff Report,* several commenters urge the Commission to consider adverse impacts on customers and prospects for broadband deployment in rural areas if the RoR for RLECs were lowered to levels recommended in the *Staff Report.*[25]

Only two commenters make even half-hearted attempts to urge the Commission to take action on the Bureau's recommendations. NCTA urges the Commission to expeditiously implement the recommendations in the Bureau's *Staff Report* and establish a rate of return between 8.06 and 8.72 percent, on the asserted but unsubstantiated ground that "there is a significant gap between the debt and equity costs that incumbent LECs face in the marketplace and the much higher rate of return that they receive under the Commission's rules . . . ."[26] NASUCA argues the Commission should represcribe the RoR at the *bottom* point of the zone of reasonableness identified by the Bureau (*i.e.*, at

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[22] Alexicon at 3-4. ICORE (at 7-8) suggested in this regard that studies could be undertaken to quantify the dissimilarities between publicly-traded corporations and smaller operations with the results used either to establish separate RoRs for large ILECs and small RLECs, or develop a component to be added by RLECs to the large ILEC-based RoR, in order to recognize the substantial differences between these two groups of carriers.

[23] *E.g.,* RTFC at 6; Alexicon at 9, 12, 14.

[24] ICORE at 7-8; JSI at 3; GVNW at 4.

[25] *See, e.g.*, JSI at 5-6; Moss Adams at 6, 26; ICORE at 4-5; NTTA at 4.

[26] NCTA at 3.

7.39 percent), claiming that RLECs do not need a "subsidy" above actual capital costs.[27] But neither NCTA nor NASUCA provides any evidence, independent analysis, or data to support their claims. Instead, their comments merely echo the *Staff Report's* findings.

As the Associations explained in comments, parties seeking a change in the authorized RoR – including the Commission's staff – bear the burden of proving a change is needed.[28] In this case, the Bureau's recommendations to reduce the authorized RoR have been shown to be based on flawed data and outdated rules and assumptions. Neither of the two parties supporting the Bureau's recommendations has proffered any evidence of their own in support of a reduced RoR. The Associations and numerous other parties have, however, provided credible evidence that the actual cost of capital for RLECs facing today's regulatory and marketplace environment is *at least* 11.25 percent, if not higher, and that the impact of represcription would be adverse for consumers. Consequently, there is no rational basis for the Commission to reduce the authorized RoR from the existing level.

The Commission should accordingly defer further action on represcribing the authorized RoR, and instead direct the Bureau to search for updated methods of estimating cost of capital for RLECs based on the actual current operating conditions and circumstances that they face. Such methods must not rely on data from publicly-traded proxy companies that are not demonstrated, and cannot be demonstrated, to be representative of RLECs. Rather, they must instead estimate the WACC of the affected RLEC industry on the basis of data for RLECs themselves. The Associations suggested one such method that, if adopted by the Commission, could utilize market data from sales

[27] NASUCA at 2, 5.

[28] Associations at 37-38.

of exchange assets by RLECs to estimate costs of raising capital.[29] This approach was supported by GVNW, [30] which pointed out the proposed method relies exclusively on RLEC-specific data rather than data assembled from proxy companies.[31]

In any case, the record as currently compiled does not support a decrease in the authorized RoR. The Commission should accordingly decline to adopt the Bureau's recommendations but should instead consider adopting procedures and methods to analyze cost of capital for RLECs in today's marketplace and regulatory environments.

III. CONCLUSION

The record thus far in this proceeding makes it clear that the rules and methods developed in the 1980's to prescribe the authorized interstate RoR are wholly outdated and inappropriate for application to RLECs in today's diverse, competitive, and uncertain marketplace. Put simply, neither the Bureau nor any commenting party has yet made the showing necessary to change the authorized RoR for RLECs; in fact, evidence presented to date indicates the cost of capital for RLECs is at least 11.25 percent, if not higher.

Before proceeding further, the Commission must develop procedures that provide affected RLECs with the "full opportunity for hearing" expressly required by section

[29] Associations at 31-33; Appendix B.

[30] GVNW at 3, 7.

[31] Other parties, including Alexicon (filing on behalf of the Rural Company Group), proposed additional adjustments to the Bureau's methods, which could be considered by the Commission as well. *See* Alexicon at 9-20.

205(a) of the Act for such rate prescriptions. The Commission must also develop revised analytical methods that will accurately estimate the WACC of RLECs facing today's actual operating conditions.

Respectfully submitted,

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