They Did What?!

Out with the Old & In with the New

An Overview of the FCC's landmark Universal Service and Intercarrier Compensation Order on Rate of Return ILECs

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Outline

- Brief History of the Proceeding(s)
  - Events leading to the Order
  - National Broadband Plan; Notice of Proposed Rulemaking; Industry Filings
- What did happen
- What didn’t happen
- Universal Service (USF or CAF)
- Intercarrier Compensation (ICC)
- Reporting Requirements
- Conclusion

Events Leading to Order

- Growth of competitive markets
  - Wireless; IP; Broadband; Video
- Growth in size of FUSF
  - CETC Identical Support Rule
    - Less than $5M in 1999 to over $1.2B in 2010
  - Total fund = $2.6B in 2001 vs. $4.5B in 2011
  - FUSC assessment ~ 6.8% in 1Q2002 to 17.4% in 2Q2012
  - "A closer look at ILEC USF receipts reveals that ILEC's non-access funding is down from $2.16 billion in 2003 to $1.37B in 2011" (Balhoff & Williams)
  - Other factors: growth of Rural Health Care USF program; E-Rate program

Events Leading to Order

- Expanding availability of broadband
  - Behind as ranking world leader
- Complicated hodge-podge of rules addressing various parts of the industry
  - Invites “gaming the system”

Brief History

- The National Broadband Plan
  - Released March 16, 2010
  - Originated from American Recovery & Reinvestment Act (ARRA) – Congress directed the FCC to develop the NBP
  - Includes a plan for ensuring every American has access to broadband Capability

Brief History

- USF/ICC Transformation Notice of Proposed Rulemaking
  - Released February 8, 2011
  - Proposed reforms to ICC and current USF
  - Designated broadband as supported universal service
  - Connect America Fund outlined
- Original Order released November 18th, 2011; Subsequent Order(s) released April 25th, 2012

What Did Happen in the Order

- Extends universal service definition to include broadband
- Establishes “firm” budget for USF ($4.5B)
- Creates the Connect America Fund
- Adopts Bill and Keep regime for all Intercarrier compensation
- Begins phase-down of legacy universal service support
- Addresses Access Stimulation and Phantom Traffic
- FCC entry into traditionally state-level regulation

What Did Not Happen

- Contribution reform
- Long Term CAF considerations for RLECs
- Increase in funding to reflect increased investment to meet NBP goals
- Adoption of target speeds in rural areas of more than 4 meg/1meg

Connecting America

UNIVERSAL SERVICE

Universal Service

- Comprehensive Budget ($s in billions)

Total Fund	$4.5
Price Cap	$1.8
RoR	$2.0
Mobility	$0.5
Remote Areas	$0.1

Universal Service – Rate of Return Carriers

- Reforms to legacy support mechanisms
  - Framework to limit capital and operating expense recovery (separate slides)
  - New unsubsidized competitor rule (separate slide)
  - Phase out Safety Net Additive
  - Cap per-line monthly support at $250 (or $3,000 per line annually)
  - Eliminate Local Switching Support (effective 7/1/2012)

Capital and Operating Expense Limitation

- Framework adopted in April 25th, 2012 Order
- Benchmarks for prudent levels of capital and operating costs for purposes of determining high-cost support amounts (more specifics next slide)
  - Called "Quantile Regression Analysis"; to be implemented no later than 7/1/2012
- Corporate operations expenses: extends current HCLS cap to ICLS

Capital and Operating Expense Limitation

- Quantile Regression Analysis
  - Proxy-based method to group "like kind"; "similarly-situated"; or "peer group" companies for purposes of cost recovery
  - In the original Order, the FCC used 11 regressions applied to various data lines in the HCLS algorithm. The final Order uses two regressions: one for CapX; one for OpEX
  - The FCC retained a 90th percentile for regression, meaning if a company's costs are above 90% of the costs included in the peer group, the company's costs above that level are generally disallowed for USF/CAF cost recovery
  - In the April 25th Order, the FCC states that approximately 100 companies will realize a decrease in HCLS revenue while about 500 companies will receive additional HCLS
  - Decreases to HCLS resulting from regression analysis will be phased in as follows: 25% beginning 7/1/2012; 50% beginning 1/1/2013; and 100% beginning 1/1/2014

Unsubsidized Competitor Rule

- Definition: "Facilities-based provider of residential terrestrial fixed voice and broadband service that does not receive high cost support"
- Where an unsubsidized competitor is competing and covers 100% of a study area, no CAF funding will be available
  - Bureau is working on methodology to determine "100% overlap"
- In study areas with 100% overlap, high cost support is frozen at 2010 levels or $3,000 times the number of lines, whichever is lower
- Phased out over 3 years

The road to bill and keep

INTERCARRIER COMPENSATION

Intercarrier Compensation

- Immediate Actions – arbitrage practices
  - Access Stimulation
  - Phantom Traffic
- Adopts uniform national bill and keep regime for all intercarrier compensation
  - In Bill and Keep, carriers look to their customer first, and then to support mechanisms
- FCC adopts this framework for intrastate, as well as interstate, rates
  - States will continue to play a role

Recovery Mechanisms

Key Concepts

- Recovery will *not* be 100% revenue neutral
- Recovery sources
  - Access Replacement Charge (ARC) to end user
  - Access Revenue Replacement Support from CAF (“ICC CAF”)
- Eligible Recovery – the amount of ICC CAF revenue RoR LECs are allowed to recover
- Recovery Baseline – based on calendar year 2011 interstate switched access revenue requirement and F/Y 2011 state terminating and reciprocal compensation amounts, reduced each year by 5%

ARC Recovery

- If eligible (i.e. local rate plus surcharges is <$30), ARC surcharge of $.50/line/mo (residential and single line business) up to max of additional $3.00 and $1.00/line/mo (multi-line business) up to max of additional $12.20
  - The ARC charge is part of the $30 benchmark

Major changes

ACCOUNTING & OVERSIGHT REQUIREMENTS

New Section 54.313

- Applies to all high cost support recipients
  - Feb. 3rd clarification Order: postponed until 4/1/2013 except for FCC-designated ETCs, which are required to file a progress report by July 2nd, 2012
  - State-designated ETCs that currently file with states the information included with 54.313(a)(2-6) per below will now file that information with the FCC, USAC, etc by July 2nd, 2012 and annually thereafter. New Mexico already requires this information as part of their normal ETC designation process

1. Progress report on 5-year service quality improvement plan
2. Detailed information on outages
3. Unfulfilled service requests
4. Complaints per 1,000 connections
5. Service quality standard certification

New Section 54.313

6. Certification that carrier is able to remain functional in an emergency
7. Price offerings
8. Holding company information
9. Documentation of discussion with Tribal governments
10. Rate certification (starting 4/1/2013)
11. Results of network performance tests

Highlights of Feb. 3rd Clarification Order

- Local rate floor: only applies to HCLS, not ICLS ($10/$14 benchmark issue)
- Financial reporting obligations: RUS reports will suffice in lieu of annual audit
- High cost recipients still required to annually report ownership information, however compliance date not set yet for 2012
- VoIP traffic: clarifies that “toll” VoIP traffic (mou-sensitive and flat rate) will be same as non-VoIP toll traffic
- When state access rate is lower than interstate, state tariffs may NOT be modified to increase their access rates to interstate levels

Conclusion

- Still Pending:
  - Whether regression analysis should apply to ICLS
  - Final ICLS corporate expense cap limitation formula
  - How to account for unsubsidized competitor rule if less than 100% terrestrial competitor presence
  - Specific transition of originating rates
  - Long term reform (ARC phase out; ICC CAF phase out)
  - Rate of return represcription
  - NACPL “recycling”
- Next Steps
  - Further Notice follow up
  - Financial Analysis

Questions?

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