Welcome to the New Frontier

January 30, 2013

PUC Filing Center
P.O. Box 2148
Salem, OR 97308-2148

RE: UM 1481 Reply Testimony of R. Kirk Lee on Behalf of Frontier Communications Northwest Inc. and Citizens Telecommunications Company of Oregon

Dear Filing Center,

Please find enclosed the original and five copies of the Reply Testimony of R. Kirk Lee on behalf of Frontier Communications Northwest Inc. and Citizens Telecommunications Company of Oregon (collectively, "Frontier").

Sincerely,

Renee M. Willer

Renee Willer
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Enclosures

cc: Service List

BEFORE THE

PUBLIC UTILITY COMMISSION OF OREGON

In The Matter Of	**)**	
	)	
PUBLIC UTILITY COMMISSION OF	**)**	
OREGON	**)**	**DOCKET NO. UM 1481**
	)	
Staff Investigation of the Oregon Universal	**)**	
Service Fund	**)**	

REPLY TESTIMONY OF

R. KIRK LEE

MANAGER-GOVERNMENT AND EXTERNAL AFFAIRS

ON BEHALF OF

FRONTIER COMMUNICATIONS NORTHWEST INC.

and

CITIZENS TELECOMMUNICATIONS COMPANY OF OREGON, INC.

JANUARY 30, 2013

INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is R. Kirk Lee. My business address is 1800 41st Street, Everett, Washington, 98201.

Q. ARE YOU THE R. KIRK LEE WHO SUBMITTED DIRECT TESTIMONY IN THIS PROCEEDING ON BEHALF OF FRONTIER COMMUNICATIONS NORTHWEST INC. (FRONTIER NW) AND CITIZENS TELECOMMUNICATIONS COMPANY OF OREGON, INC. (CITIZENS), COLLECTIVELY "FRONTIER"?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR REPLY TESTIMONY?

A. My reply testimony responds to the direct testimony submitted by other parties to this case and presents Frontier's positions on the action the Commission should take on those parties' proposed changes to the Oregon Universal Service Fund (OUSF) program. I will specifically address certain recommendations for changes to the OUSF set forth in the opening testimonies of witnesses Roger White on behalf of Commission Staff ("Staff"), Don Price on behalf of Verizon and Dr. August H. Ankum, Ph.D. on behalf of the Oregon Cable Telecommunications Association (OCTA).

Q. PLEASE BRIEFLY SUMMARIZE FRONTIER'S POSITIONS?

A. The Commission should reject the changes to the OUSF program proposed by the Commission Staff, the OCTA, and Verizon (with the exception of Staff's proposal that all VoIP providers contribute to the OUSF).

These three parties' proposals would radically change the OUSF in ways that are inconsistent with Oregon's public policy, that would discourage investment in network infrastructure, and that would harm consumers in the state. At worst, some of the proposals would eliminate the OUSF all together, eliminate support for non-rural ILECs,[1] or slash support for rural ILECs to a small fraction of current levels, jeopardizing the continued provisioning of affordable telephone service to consumers who rely on the telephone for their communication needs. Staff's proposal for one adjustment alone, changing the benchmark to $30, would result in a $3.7 million or 34% reduction in annual OUSF support for Frontier NW. And this does not reflect the unquantified revenue reductions associated with Staff's proposal to allocate costs to other services or the impact of the "needs" determination process. At best, their proposals are unworkable in numerous respects, and, if they were somehow to be implemented, they would introduce unacceptable unpredictability in the OUSF program and consequent frequent changes in basic telephone service -- and perhaps other -- rates. And, fundamentally, their approaches to the issues in this case improperly ignore the regulatory context in which the OUSF was created and operates.

The Commission should retain its existing methodology for calculating the amount of support per line available in high-cost wire centers and distributing it to eligible basic telephone service providers. The Commission should ensure that all legally required contributions to the OUSF, including from VoIP providers, are in fact being made. No changes are needed as to regulating how the OUSF funds are used by ILECs. Existing reports and Commission oversight provide transparency and accountability for

[1] "Incumbent local exchange carrier." A term from the federal Telecommunications Act of 1996 that is commonly used for what are "telecommunications utilities" under Oregon law. The "rural" and "non-rural" classifications are also from the federal act.

the ILECs to ensure that the OUSF funds are serving the intended purpose, and public policy goal, of maintaining affordable basic telephone service in high-cost areas.

Q. HOW WOULD THE STAFF'S, OCTA'S AND VERIZON'S PROPOSALS BE INCONSISTENT WITH THE GOAL OF THE FUND?

A. The goal of the OUSF fund is to remove implicit support from telephone service rates and provide explicit support to assure reasonable and affordable rates in the more rural, sparsely populated and high cost areas of Oregon. The proposals included in the testimony of Staff, OCTA and Verizon are short on specific details so the scope of the potential impact from these proposals is unclear based on the record in this case. However, the clear intention of the proposals is for a significant reduction or elimination of OUSF support for companies currently providing affordable phone service in the high cost service areas in the State. While Staff's proposal would not necessarily result in total elimination of support, its primary goal is targeting a specific surcharge level, leaving the resulting level of support for high-cost areas as a "plug number" based on whatever funding is achieved using the target surcharge rate. Elimination or reduction of support in high-cost areas would necessitate a series of actions with respect to replacing the lost OUSF revenue. For example, it would lead to reintroduction of implicit support, such as by increasing basic service rates across the entirety of the recipient companies' service territory, so that customers in lower costs service areas are required to subsidize the basic service rates of customers in higher cost service areas. Or it could result in rate deaveraging through the introduction of substantial increases in basic service rates in high-cost areas where support is reduced or eliminated, potentially leading to unaffordable basic service rates in those areas. These parties' proposed changes would also jeopardize investment in network infrastructure because companies would lose funding currently used to maintain and augment the network used to provide basic service.

Q. HOW WOULD THE PROPOSALS OF STAFF, OCTA AND VERIZON DISCOURAGE INVESMENT IN NETWORK INFRASTRUCTURE?

A. The telecommunications industry needs funding certainty and stability over time. Investment in network infrastructure must consider the long-term revenue flows from those investments. A long-term, stable revenue outlook is essential for encouraging investment in Oregon. Uncertainty regarding future funding discourages infrastructure investment because, among other things, there is a long lead time for deploying additional network infrastructure and the unpredictability of funding would potentially create a situation in which capital expenditures and investment are committed to and commenced and then contemplated funding is eliminated or reduced. The Staff proposal introduces a high-level of uncertainty into not only the initial level of support but creates uncertainty of support levels from year to year.

Q. HOW WOULD THE PROPOSALS OF STAFF, OCTA AND VERIZON IMPACT ONGOING OPERATING EXPENSES AND EMPLOYMENT IN OREGON?

A. OUSF funding is utilized to offset and defray some of the costs associated with providing basic telephone service in the high costs areas within Oregon. With a reduction of OUSF funding, Frontier would have little choice but to evaluate alternatives to offset the lost revenue and/or to reduce its expenses associated with providing telephone service in Oregon. As noted above, this would include looking at increasing basic service rates and reducing investment. Other options would undoubtedly include Frontier looking at ways to reduce operating expenses in Oregon. Frontier currently has approximately 470 employees in Oregon, mostly personnel that install, maintain, repair and support service to customers. Any significant reduction in OUSF would require Frontier to evaluate implementing staffing reductions to offset the lost revenue, which could impact the breadth and quality of services Frontier provides to consumers.

Q. PLEASE SUMMARIZE HOW CONSUMERS IN OREGON WOULD BE HARMED BY THE PROPOSALS OF STAFF, OCTA AND VERIZON?

A. In short, if Frontier's OUSF funding is reduced, Frontier will be required to offset the lost revenues by one or more alternative measures, including the increase in basic service rates for consumers, the reduction or discontinuation of investment in infrastructure and facilities in Oregon, and the reduction of operating expenses through employee layoffs, as well as cuts to services. As a result, service quality could be adversely impacted.

<u>GENERAL COMMENTS</u>

Q. WHAT IS THE REGULATORY CONTEXT IN WHICH THE OUSF PROGRAM WAS CREATED AND IN WHICH IT OPERATES?

A. The OUSF was created in the context of rate of return ("ROR") regulation of Frontier and other Oregon ILECs. Under ROR regulation the Commission controls the upper limit of profits – "return" – of ILECs on their jurisdictionally intrastate telecommunications operations by determining the reasonable costs of such operations, including a return on investment. The total of those costs is the company's "revenue requirement." The Commission prescribes rates for the company's intrastate services designed to provide a fair opportunity to generate sufficient revenues to recover the revenue requirement or costs of providing service. This overall scheme of Commission-prescribed rates is often referred to as a company's "rate structure." A proceeding in which the Commission reviews a company's operation, authorizes a rate of return, determines a revenue requirement, and sets a new rate structure is a "general rate case."

Q. HOW DOES THE OUSF PROGRAM RELATE TO RATE OF RETURN REGULATION?

A. For companies like Frontier that are subject to ROR regulation, the OUSF is part of their Commission-prescribed rate structure. It substitutes payment from the OUSF for revenues that would otherwise be generated by rates charged to an ILEC's customers. Frontier NW is a good example of how this works.

Shortly before the creation of the OUSF, Frontier NW completed a general rate case, Docket No. UT 141. That proceeding resulted in changes to the Company's rate structure and an overall revenue reduction of $25 million. In creating the OUSF, the Commission moved implicit support for high-cost areas (that was previously included in the company's rate structure, established in a rate case) to an explicit support mechanism, the OUSF. As I noted in my direct testimony, the Commission required reductions in rates to offset the new OUSF support Frontier NW would receive. In other words, in creating the OUSF the Commission amended the rate structure it had prescribed in the company's general rate case and required Frontier NW to forego or otherwise discontinue generating revenue from higher rates on other services.

Similarly, the Commission's requirement of significant reductions in carrier common line and access charges to offset OUSF support has in effect amended Citizen's rate structure, which was created under ROR regulation.

Q. HOW DO THE PROPOSALS OF STAFF, VERIZON AND OCTA ADDRESS THE FACT THAT THE OUSF IS PART OF RATE OF RETURN REGULATION FOR FRONTIER AND OTHER ILECS?

A. The proposals of Staff, Verizon and OCTA do not address the fact that their proposed reductions or elimination of OUSF would effectively quash the Commission prescribed ROR regulation mechanism of Frontier being required to give up certain revenues as a condition of receiving OUSF support. They propose to reduce or eliminate the OUSF but fail to restore the prior rate structures that existed before Frontier was required to forgo alternative revenue as a condition of receiving OUSF support. Beyond that, OCTA and Verizon in particular want the Commission to take actions that are plainly beyond the scope of this docket and inconsistent with Oregon's present telecommunications regulation system.

Q. WHAT ARE THE MAJOR FEATURES OF STAFF'S PROPOSALS?

A. Staff seeks to arbitrarily limit the support of basic telephone service in high cost areas through several changed and new procedures that are inconsistent with the current regulatory framework and the OUSF program's role in it. Staff would abandon the OUSF program's function of replacing implicit support for basic telephone service in high cost areas with explicit support, on a revenue neutral basis. Instead, Staff advocates turning the OUSF into a grant making program to provide "additional money" to companies to make Staff approved "network improvements." Staff's proposals fail to recognize the prior investment in and ongoing operating costs associated with providing service in high cost areas in the state (such as longer loops, more technicians per line, longer travel times, and higher switching and transport costs per line), and it would introduce significant complexity, uncertainty and unpredictability into the OUSF program.

Staff highlights a reduction in the size of the OUSF from $44 million to $33 million (Staff/100, White/3, lines 9-12), but that is misleading. That reduction would result from just one of Staff's proposed changes: increasing the benchmark to $30. However, it is obvious that adopting all of Staff's proposals would reduce the support available for basic telephone service in high cost areas by a much more drastic amount, an amount that has not been quantified and based on a process that has only been vaguely defined. For example, just Staff's proposal to use a "simple" new cost "allocation" approach would very significantly reduce the cost per line figures used in the support calculations, which would result in large support cuts on top of those produced by the increased benchmark.

Staff asserts that its proposed changes to the OUSF program "can be implemented quickly" (Staff/100, White 1, lines 21-22), but in fact they would -- at best – require further proceedings before the Commission, as well as several internal administrative and operational changes by the companies. And, going forward, adoption of Staff's proposals would add numerous complex, time consuming, burdensome and possibly contentious activities to the OUSF program, including frequent updates to Staff's vague cost allocation formulas, annual operations reviews for each supported area in order to forecast yet-to-be defined "needs," and subsequent annual "audits" and "true ups."

Q. OTHER THAN THE IMPACT THAT INCREASING THE BENCHMARK FROM $21 TO $30 BENCHMARK WOULD HAVE ON FUNDING LEVELS, DO YOU

HAVE ANY OTHER CONCERNS WITH THE $30 BENCHMARK PROPOSED BY STAFF?

A. Yes. Staff attempts to rationalize the proposed increase in the cost benchmark from $21 to $30 based on the effect of inflation that has occurred since the benchmark was initially established. The current benchmark of $21 was established on the basis of the average of costs at the time the OUSF was established. While many costs have increased and the average cost per line of providing service in Oregon has risen, the fatal flaw of this logic is that Staff has proposed to update only the cost benchmark based on inflation and increased costs but has not acknowledged the similar inflation and increased cost per line component upon which the benchmark was initially established. It is entirely inconsistent to update the cost benchmark without updating the cost per line amount for high-cost areas.

Q. OVERALL, WHAT CHANGES DOES OCTA PROPOSE THE COMMISSION MAKE TO THE OUSF PROGRAM?

A. Most of OCTA's specific proposals affect the OUSF support calculation and distribution, and some relate to the OUSF support use issue. OCTA's numerous, often overlapping proposals would abandon the OUSF's function of replacing implicit support for high cost areas with competitively neutral, portable explicit support; would totally eliminate support for some companies and some customers; and would – for the remaining companies and customers – drastically reduce support. OCTA's proposals also would make administration of the OUSF program much more complex and burdensome, and would introduce instability and uncertainty into the support of affordable basic telephone service in high cost areas.

It is important to remember that OCTA's members compete with Frontier and other ILECs, primarily in the lower cost portions of the companies' service areas... Adoption of OCTA's proposals for slashing OUSF support would force the ILECs to attempt to recover the costs of serving high costs customers in the form of higher rates for low cost customers areas – the very customers for which the OCTA members compete, putting Frontier at a competitive disadvantage.

Q. VERIZON PROPOSES THAT THE OUSF SHOULD BE "ELIMINATED" (Verizon/100, Price/3, lines 23-25). SHOULD THE COMMISSION ADOPT THAT RECOMMENDATION?

A. No, it should not. First, the Commission should note that Verizon's proposal to eliminate the OUSF is a stark u-turn for Verizon. During the roughly nine years that Verizon owned and operated Verizon Northwest Inc., the company now named Frontier NW, it willingly accepted over $150 million in OUSF support. In the last full year of its ownership, 2009, Verizon received $11,770,277 from the OUSF. Verizon's witness fails to provide any explanation regarding the company's change in position or why OUSF was appropriate and necessary less than three years ago but is no longer appropriate today, except that today Verizon is presumably a net payer to the OUSF whereas previously it was a benefiting recipient of OUSF.

Moreover, even in terms of Verizon being a net payer to the OUSF, Verizon's largest presence in Oregon is its wireless company, which makes no contributions to the OUSF and is exempt by law from any requirement to do so. The Verizon competitive wireline companies that still operate in the state make OUSF contributions that amount to a very small fraction of the support Verizon received from the OUSF. Therefore, based on both its history as a OUSF fund recipient and the limited amount it currently contributes to the fund, it is difficult to understand the aggressive position by Verizon in this proceeding.

Beyond the requirements of the OUSF statute as to maintaining a OUSF program, the Commission should reject Verizon's new proposal because the OUSF is a key component of the Commission's ability to carry out its tasks in the current regulatory scheme, including ensuring that the ILECs it regulates are financially able to perform their carrier-of-last-resort (COLR) duties with reasonable and affordable rates in high-cost areas and to comply with the Commission's service quality, customer relations, emergency services and other obligations.

Q. VERIZON SAYS THAT IF THE OUSF IS NOT ELIMINATED OUTRIGHT IT SHOULD BE "COMPLETELY OVERHAULED" (Verizon/100, Price/3, lines 25-26). SHOULD THE COMMISISON "COMPLETELY OVERHAUL" THE OUSF PROGRAM AS VERIZON SUGGESTS?

A. No, it should not. Even if the Commission had the legal authority to order the type of complete OUSF overhaul Verizon wants, such changes could not be made in isolation. As I explained, the OUSF is an integral part of ROR regulation. In addition, regulation of ILECs consists of many additional aspects, including, but not limited to, the carrier-of-last-resort obligations I mentioned in my direct testimony, financial and operations reporting requirements, and regulation of service quality, customer relations, service terms and conditions, various marketing activities, and discontinuance of service offerings. If there were to be a "complete overhaul," it would need to be of the entire Oregon telecommunications regulatory framework. Any overhaul of OUSF would need to address issues ranging from the elimination of COLR duties to the elimination of market entry and exit restrictions; from the deregulation of rates, terms and conditions to ending government prescription of service quality parameters; and so on.

ISSUE: <u>WHAT CHANGES SHOULD BE MADE TO THE EXISTING OUSF RELATED TO THE CALCULATION, THE COLLECTION, AND THE DISTRIBUTION OF FUNDS?</u>

<u>Response to Staff</u>

Q. WHAT CHANGES DOES THE COMMISSION STAFF PROPOSE TO THE WAY IN WHICH THE AMOUNT OF OUSF SUPPORT IS CALCULATED?

A. I was able to identify several major changes proposed by the Staff, all designed to drive down the amount of the OUSF surcharge and/or the size of the OUSF.

Staff first proposes to predetermine the total amount of OUSF support by arbitrarily setting a "target surcharge." Staff then would manipulate the benchmark to achieve this goal. Staff would back into the benchmark in order to limit total OUSF support to the amount of funds generated by its predetermined surcharge rate. Staff also proposes to reduce the basic telephone service cost figures used in the support calculation by allocating much of the basic telephone service cost amounts to non-regulated services. Finally, Staff proposes to layer an additional cost cap device onto the process by using an annual grant application process.

Q. HOW WOULD ADOPTION OF THESE STAFF PROPOSALS AFFECT THE OUSF PROGRAM?

A. It would radically reduce OUSF support for basic telephone service in high cost areas, putting tremendous upward pressure on basic service rates, and it would make the OUSF program a much more burdensome and unpredictable process for all concerned. Staff's proposal would change the program's approach from a comprehensively cost-based, competitively neutral replacement of implicit support with explicit support into an *ad hoc* grant making program directed at new capital expenditures and a small subset of the companies' expenses.

Q. WHAT IS STAFF'S TARGET SURCHARGE PROPOSAL?

A. The Staff identifies that as "Step 1" in its new OUSF program administration. (Staff 100, White 22, lines 8-12.) the target surcharge level should be: 6.0% to 6.5%. (Staff 100, White/3, line 12.) Staff would use that target to set a new benchmark, along with a new process for determining the "needs of the companies." (Staff/100, White/18, lines12–15.) On page 18 of its testimony Staff says it would use the benchmark to "set the distribution level and *subsequently* the surcharge rate" (lines 13-15; emphasis added), but on page 22 Staff says it would *first* establish the target surcharge range and then determine the "a benchmark that will allow the surcharge to be in that range" (lines 8-10). And, even though Staff states that the target surcharge will be established in its Step 1, it also includes a Step 4 that would "calculate a new surcharge rate based upon the support requirements established in step three of this process." (Staff/100, White/23, lines 2-4.)

Regardless of whether the target surcharge is determined first or later, Staff does not provide a formula or mathematical description of how it would back into the benchmark.

Q. THE OUSF STATUTE STATES THAT "THE COMMISSION SHALL SEEK TO LIMIT THE DIFFERENCE BETWEEN THE PRICE A TELECOMMUNICATIONS UTILITY MAY CHARGE FOR BASIC

TELEPHONE SERVICE AND THE BENCHMARK."[2] IS STAFF'S PROPOSAL TO MANIPULATE THE BENCHMARK IN ORDER TO ENABLE A "TARGET SURCHARGE" CONSISTENT WITH THIS PROVISION?

A. No, it is not. Staff's proposal to back into a benchmark strays far from the legitimate purpose of the benchmark. In accordance with the support amount formula set forth in the statute, the benchmark should be determined up front, should be based on basic telephone service costs and should have a rational relationship to the Commission-set prices for basic telephone service.

Q. SHOULD THE COMMISSION ADOPT THE STAFF'S PROPOSALS TO BACK INTO THE OUSF SUPPORT LEVEL USING A PRE-SET SURCHARGE RATE?

A. No. The Commission should not adopt this proposal. It would be an arbitrary approach, and it would, among other things, deviate from the intended purposes of the OUSF fund and introduce significant unpredictability into the OUSF program and into the rates charged to consumers in high-cost areas.

Q. DOES STAFF PROPOSE A SPECIFIC DOLLAR AMOUNT FOR A NEW BENCHMARK?

A. No, it does not. And, under Staff's proposed changes to the OUSF program, the cost benchmark would potentially change every year.

Q. HOW COULD THE BENCHMARK BE MANIPULATED TO RESULT IN A SURCHARGE OF A PREDETERMINED AMOUNT?

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[2] RCW 759.245(3)(c).

A. The mathematical details aside, Staff could use the benchmark to predetermine and limit the total OUSF support amount for a given year by constraining the support per line calculation.

Under the OUSF statute and per the Commission's prior decisions, the amount of OUSF support per line equals the basic telephone service cost per line less certain federal support offsets less the benchmark. This calculation is performed for each non-rural ILEC wire center and for each rural ILEC study area. Each wire center where the resulting figure is greater than zero receives OUSF support. The support per line amounts are posted via a link on the Commission's OUSF webpage.[3] Under the current process, the total of the individual companies' support amounts is the total amount of funds the OUSF will need to distribute in the given year. Adding in the OUSF program's administrative costs yields the total amount of money that will need to be collected. Dividing this amount by the forecasted revenue base yields the necessary surcharge amount.[4]

In short, under the current approach, the Commission-established benchmark is a key factor in the calculations leading to the total fund size, which leads to the surcharge rate. Under Staff's proposal, the benchmark would somehow be set so that when it is plugged into the support per line calculation it produces figures that result in the total support conforming to the amount of revenue yielded by an arbitrary, predetermined surcharge rate.

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[3] http://www.oregon.gov/puc/ousf/Pages/Support.aspx

[4] Due to timing issues, the actual surcharge calculation is more complex, but those details are handled by a computer program. See, e.g., Order No. 12-205 in Docket UM 1594, June 5, 2012.

Q. HOW DOES STAFF PROPOSE TO USE A NEW "ALLOCATION" TO CHANGE THE DETERMINATION OF THE BASIC TELEPHONE SERVICE COSTS USED IN THE CALCULATIONS OF OUSF SUPPORT?

A. According to its Direct Testimony, Staff proposes to continue to use – as a starting point – the same cost figures that are currently being used, but to reduce them by allocating a significant portion to other services. (Staff/100, White/20, lines 4-5; White/16, lines 4-7.) This would be Staff's "Step 2."

At page 20, lines 3-6, of its direct testimony Staff explains that it proposes making "changes to the model output" by "allocating network cost to the services using the network based on Staff's simple method of allocation discussed in the Issue1 (D) section of Staff's testimony." In that Issue 1(D) section, Staff states that "a simple method of allocating joint network costs among broadband services and basic local service is to divide up the cost of the network equally among the services. If there were three services being offered, then basic local service would get one third of the cost." (Staff/11, White/16, l. 4-7.) In other words, under that simple Staff approach, the basic telephone service costs produced by the Commission's cost studies could be reduced by as much two-thirds. Obviously, this measure by itself would significantly reduce the amount of OUSF support available for high cost service areas.

Q. WHAT IS STAFF'S RATIONALE FOR THIS ALLOCATION?

A. Over several pages of its testimony, Staff reiterates its position that multiple services are provided over the "same network" that provides basic telephone service. Staff's testimony makes it clear that Staff has mainly in mind "broadband" services as another "user" of the "same network," while in a data request response Staff also mentioned video services as another network user. It is important to note that Frontier is providing broadband service to less than one-half of its telephone service customers. Moreover, Frontier NW, in its high cost exchanges where OUSF support is received, and Citizens do not provide video services over their networks.

Q. DOES STAFF CONTEND THAT THE BASIC SERVICE COST AMOUNTS PRESENTLY USED IN THE OUSF SUPPORT CALCULATIONS FOR FRONTIER INCLUDE THE COSTS OF PROVIDING BROADBAND SERVICE?

A. No, it does not. In fact, Staff states that a broadband capable network is "more expensive" than a network designed to provide basic telephone service (Staff/100, White/15, lines 12-16), which is the network modeled in the cost study used by the Commission for Frontier NW. For example, the forward-looking model upon which the current OUSF support calculations are based do not include the costs of DSLAMs or the transport and connectivity costs associated with the provision of broadband services. And Staff specifically excludes Citizens from its claim that the rural companies' costs include broadband costs (Staff/100, White/14, lines 4-6).

Q. IF THERE WERE BROADBAND COSTS IN ANY OF THE COMPANIES' DATA USED TO CALCULATE OUSF SUPPORT AMOUNTS, WOULD THAT MEAN THAT THE COMPANIES WERE RECEIVING EXTRA MONEY TO SUPPORT THEIR BROADBAND SERVICES?

A. No. Remember that for the ILECs the OUSF simply takes implicit support for basic telephone service in high cost areas out of the rates charged to the company's customers and replaces it with explicit support, and the Commission's revenue neutral rate reduction requirement means that the companies receive no more revenue for their intrastate regulated telecommunications services than they otherwise would have. The companies do not end up with "extra money" that would supposedly pay for broadband investment and expenses.

Q. IS STAFF'S "SAME NETWORK" COST ALLOCATION PROPOSAL FINANCIALLY VIABLE FOR THE COMPANIES?

A. No, it is not. On the contrary, this sort of approach would cause under recovery of costs and would necessitate the introduction of implicit subsidies back into their rate structures. The key fact in this situation is that not every customer subscribes to every service that might "use" the "same network." A couple of simple examples illustrate this.

For example, assume Telco provides three services over the "same network." Using Staff's "simple" allocation approach (Staff/100, White/16, lines 4-7), Telco's $30 cost per line is allocated equally among those services. The rate for each service is set at cost. Telco has five customers. Each customer subscribes to basic telephone service (Service A) and three customers subscribe to one or two additional services, as shown in the table below. Since not every customer subscribes to every service, Telco's total revenues of $90 fall $60 short of recovering its total costs of $150.

	COSTS ~ REVENUES ALLOCATED TO:			**Total "Same Network" Cost**
CUSTOMERS	**Service A**	**Service B**	**Service C**	
1	$10	$10	$10	$30
2	$10	-	-	$30
3	$10	$10	-	$30
4	$10	-	$10	$30
5	$10	-	-	$30
	$50	$20	$20	Total costs: $150
	Total revenues: $90			
	Shortfall: $60			

So, in an effort to cover its total costs, Telco is required to increase the rates for its Service B to $20, which creates implicit support of $10 (price of $20 less cost of $10).

And it increases the price of its Service C to $30, which creates implicit support of $20. *If* Telco's five customers continue to buy the same services despite the rate increases, then Telco will cover its "same network" costs – thanks to $60 of implicit support in its rate structure. But if any of its customers discontinue any service, then it is back to the drawing board on rate increases. Further, if Services B and C are competitive services, those higher rates may not be sustainable. Either way, Telco loses money.

CUSTOMERS	REVENUES, including implicit support			**Total "Same Network" Cost**
	Service A	**Service B**	**Service C**	
1	$10	$20	$30	$30
2	$10	-	-	$30
3	$10	$20	-	$30
4	$10	-	$30	$30
5	$10	-	-	$30
	$50	$40	$60	Total costs: $150
	Total revenues: $150 Implicit support: $60			

Q. SHOULD THE COMMISSION ADOPT STAFF'S COST ALLOCATION PROPOSAL?

A. No, it should not. In addition to being misguided on a stand alone basis, in the context of the OUSF program the proposal is arbitrary and ill founded and would contradict jurisdictional separations rules.

Furthermore, Staff's cost allocation proposal would have the perverse effect of creating a disincentive to make broadband investments in high cost service areas. An ILEC would be less likely to invest in a broadband capable network if it knew that its OUSF support in a particular service area or on a particular customer line would be significantly reduced or even eliminated by allocating basic telephone service costs to broadband services it was seeking to deploy.

Q. IN WHAT WAYS IS STAFF'S COST ALLOCATION PROPOSAL ARBITRARY AND ILL FOUNDED IN THE CONTEXT OF THE OUSF PROGRAM?

A. While it may be "simple" to create an allocation factor based just on a supposed number of different "services" using the "same network," such a proposal has no rational basis.

The proposal is ill founded because it makes no provision for adding the costs of the assumed other services to the already determined cost of basic local service. In other words, the proposed allocation is an apples and oranges proposition. The cost of basic telephone service that the Commission determined for Frontier NW for purposes of OUSF support does not include broadband or other service costs, yet Staff proposes to allocate up to two-thirds of the "same network" costs to broadband and other services.

Staff's proposal to allocate network costs to broadband services will discourage broadband investment in high-cost areas. For example, consider an area with a cost per line of $150. If an OUSF recipient knows that it not only needs to make substantial, additional investment to deploy broadband in that high-cost area but also knows that as a direct result of making broadband available in an area it is going to have half or more of its $150 cost per line removed from OUSF calculation, it recognizes that the allocation proposal creates a disincentive to deploy broadband to an area that is already difficult to economically justify. Moreover, from an OUSF standpoint, a company could potentially be better off discontinuing or shutting down its existing broadband service in high cost areas where it would otherwise be eligible for OUSF support that exceeds the incremental income from broadband services.

Q. HOW WOULD STAFF'S COST ALLOCATION PROPOSAL CONTRADICT JURISDICTIONAL SEPARATIONS RULES?

A. As I explained previously, OUSF support is part of the rate of return regulation rate structure for ILECs. The Commission is bound by FCC jurisdictional separations rules when determining the revenue requirements of companies, i.e., when determining the costs of companies' intrastate telecommunications operations. The Commission followed those rules when initially establishing Frontier's rate structures, and the effect of those rules carried forward when the companies made the required rate reductions to offset their OUSF support. Now Staff proposes to significantly reduce that OUSF support using a methodology that fails to consider the separations rules. Staff concedes that "enhancing the separations process is outside the scope of this phase of the docket" (Staff/100, White/16, lines18-19), but tries to justify ignoring those rules by arguing that they do not properly handle broadband costs (Staff/100, White/14). Nevertheless, the Commission is bound by those rules as they currently exist. The Commission could not evade the separations rules in a general rate case, and it should not attempt to evade them when modifying an ILEC's rate structure by setting OUSF support amounts.

Q. WHAT IS THE ADDITIONAL COST CAP DEVICE THAT STAFF PROPOSES?

A. Staff would impose a second cost cap by requiring each OUSF recipient to annually file a report forecasting how much support it "needs for the upcoming year." (Staff/100, White/22, lines 19-21.) This would, in effect, be Staff's Step 2b.

Step 3 would be to compare "the model results" cost figures – after applying Staff's new allocation adjustment -- with "what they [the companies] report they need." (Staff/100, White/22, lines 14 – 23.)

Q. WHAT CRITERIA DOES STAFF PROVIDE FOR ITS PROPOSED "NEEDS" FORECASTS?

A. Staff's testimony is vague at best, but from the testimony and the data request responses I conclude that Staff proposes the following "needs" or "uses" of OUSF funds:

- Offset "above average expenses"[5]
- Offset a "revenue requirement short fall"[6]
- "Additional money" for improving infrastructure and maintenance ~
  - of the Public Switched Telephone Network: local loop, interoffice facilities, switching;
  - proposed improvements;
  - previous improvements.[7]

Q. DOES STAFF EXPLAIN HOW IT WOULD BE DETERMINED THAT A COMPANY'S EXPENSES IN A GIVEN AREA ARE "ABOVE AVERAGE"?

A. No, it does not. It does not specify what "expenses" would qualify or how the "average" expenses level would be determined.

Q. DOES STAFF EXPLAIN THE "REVENUE REQUIREMENT SHORT FALL" USE?

A. In the cited response to Verizon's data request #17a, Staff stated that a "basic local service revenue short fall occurs when the combination of revenues from a company's customers and federal support does not cover the basic local service revenue requirement."

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[5] Staff/100, White/2, lines 20-22; White/28, lines 4-6.

[6] Responses to Verizon Data Requests, 2nd set, #12b, #17a.

[7] Staff/100, White/2, lines 20-22; White/26, lines 12-12; White/29, lines 3-5. Responses to Frontier Data Requests, 2nd Set, #10, and OTA Data Requests, 2nd Set, #7.

Q. DOES STAFF PROVIDE ANY SPECIFIC CRITERIA FOR DETERMINING WHAT INFRASTRUCTURE AND MAINTENANCE IMPROVEMENTS WOULD BE FUNDED OR WHAT AMOUNT OF "ADDITIONAL MONEY" WOULD BE PROVIDED BY THE OUSF?

A. No, it does not.

Q. AS TO INVESTMENTS THAT WOULD BE FUNDED UNDER STAFF'S PROPOSAL, DOES STAFF STATE WHETHER THE ENTIRE CAPITAL AMOUNT WOULD BE FUNDED IN A GIVEN YEAR OR WHETHER ONLY AN ANNUAL DEPRECIATION EXPENSE WOULD BE FUNDED IN THAT YEAR?

A. No, it does not.

Q. SHOULD THE COMMISSION ADOPT STAFF'S PROPOSAL FOR ANNUAL "NEEDS" FORECASTS THAT WOULD CAP COMPANIES' COST FIGURES USED TO CALCULATE OUSF SUPPORT?

A. No, it should not. Staff's proposal would abandon the OUSF's function of replacing implicit support of high cost service areas with competitively neutral, portable explicit support. Staff's proposal would turn the OUSF into a year-by-year grant making program, which would be complex, time consuming and resource demanding for the companies and the Commission. (Apparently the OUSF administrator has no role in Staff's proposed "needs" assessment process.) This cost cap #2 proposal is designed and expected to significantly reduce the companies' OUSF support, which would create pressure to increase rates and recreate the implicit support flows the OUSF was designed to replace. Also, Staff's proposal for this second cap is vague and incomplete and it is, therefore, an insufficient basis for a Commission decision to implement it.

Q. STAFF'S "STEP 5" "RECALIBRATION OF THE MODEL" IS BASED ON "THE PERCENT REDUCTION THAT OCCURS WHEN THE REPORTED REQUIREMENT IS COMPARED TO THE MODELED REQUIREMENT." (Staff/100, White/23, lines 6-9.) HOW WOULD THIS WORK?

A. When I first read Staff's direct testimony I interpreted this step as resulting in a permanent change to the cost model results that would lock in lower "needs" determinations by reducing the cost model figures to that "needs" amount. Thus, in the following year cap #1 (the cost model cap) would be lower, thereby ratcheting down a company's level of OUSF support over time. That, of course, would be a hugely undesirable development for the OUSF program.

However, Staff's response to a data request indicates that the "recalibration" proposal may just be an unnecessary step in its proposed annual two-cap cost study approach. In response to question #12a in Verizon's second set of data requests, Staff stated that the "last step in Staff's proposal is the scaling of the model-generated, per-line amounts to reflect the reductions that occurred in step 3 of staff's proposal. If step three shows that a company only needs 80% of the support it would receive based on the model, each support per line amount for that company would be multiplied by 0.8 to reduce that amount by 20%." This seems unnecessary. If Staff's cap #2 (the allowed "needs" and "uses" amount) turns out to be lower than cap #1 (the cost study figure, after Staff's allocation adjustments), then cap #2 could be directly used to set the company's OUSF support amount. Presumably the cap #2 figure would be a lump amount, so it would then be divided by the company's line count and that new "cost" figure then used in the cost less federal offsets less benchmark formula for determining the support per line.

Q. SHOULD THE COMMISSION ADOPT STAFF'S "RECALIBRATION OF THE MODEL" PROPOSAL?

A. No, it should not. If Staff in fact intends the ratcheting down process, that should be rejected on the grounds of arbitrariness and fundamental unfairness alone. If this "recalibration" proposal is just an unnecessary step, then there would be no reason to adopt it.

Q. WHAT CHANGES DOES THE STAFF PROPOSE WITH REGARD TO THE COLLECTION OF OUSF FUNDS?

A. Staff does not seek to significantly expand the scope of OUSF funding. Staff proposal does not include applying the OUSF surcharge to wireless service revenues. The only change proposed by Staff is that Oregon VoIP services should be assessed the OUSF surcharge (Staff/100, White/25, line 3 – White/26, line 3).

Q. SHOULD THE COMMISSION ADOPT STAFF'S PROPOSAL TO APPLY THE OUSF SURCHARGE TO OREGON VOIP SERVICES?

A. Yes, it should. It is very important that the Commission obtain contributions from all the services and providers authorized by the OUSF statute.[8]

Obviously Staff's package of proposals is driven by a desire to lower the level of the end user OUSF surcharge. Staff approaches this goal with its numerous devices to reduce the basic telephone service "cost" figures used in the OUSF support calculations, but appropriately expanding the OUSF's revenue base is also key factor affecting the

[8] ORS 759.425(4).

level of the surcharge. The total size of the OUSF has actually declined significantly over time. Staff states that the current size is $44 million (Staff/100, White/3, line 9), but when the rural companies joined the program almost ten years ago, the size of the fund was approximately $58 million.[9] While, as Staff described, the total support for the rural ILECs has increased some over the years, that increase has been more than offset by the decline in support to the non-rural ILECs due to their large line losses. Since the total fund size has significantly declined, the change that has actually been causing an increase in the surcharge rate is the shrinkage of the revenue base on which it has been assessed. The Commission should ensure that all the contributions due to the OUSF under law are in fact being collected.

Response to OCTA

Q. WHAT PROPOSALS DOES OCTA MAKE WITH REGARD TO THE CALCULATION AND DISTRIBUTION OF OUSF SUPPORT?

A. OCTA proposes about twenty devices to eliminate distribution of support all together, to severely reduce the calculated basic telephone service costs, to inflate the benchmark, to overstate the federal support offsets, and to eliminate or constrict support for some customers and services.

Q. WHAT PROPOSALS DOES OCTA MAKE TO ELIMINATE DISTRIBUTION OF SUPPORT ALL TOGETHER?

A. OCTA proposes to eliminate all support for non-rural ILECs (OCTA/100, Ankum/21, l. 4), i.e., for Frontier NW and Qwest. OCTA also proposes to eliminate all OUSF support

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[9] See Order 03-082, page 4, issued in UM 1017 on February 3, 2003.

for areas in which an "unsubsidized competitor" provides voice service (OCTA/100, Ankum/20, l. 20-21).

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL TO DENY SUPPORT FOR THE HIGH COST WIRE CENTERS OF NON-RURAL ILECS?

A. No, it should not. OCTA justifies this proposal by saying that non-rural ILECs are much larger than the rural ILECs and serve many exchanges in relatively high density (i.e., lower cost) areas of the state. This argument ignores the fact the Frontier NW does not receive OUSF support in those high density areas, and, due to its carrier-of-last-resort obligations, is required to provide service to its low density, high cost areas, as well. As noted in my initial testimony, Frontier provides service in sixty-eight wire centers in Oregon; however, Frontier only receives OUSF support in forty-nine of those exchanges which have been designated as "high cost." OCTA's proposal suggests that Frontier NW utilize revenues from its low cost customers to subsidize its high cost customers, instead of using OUSF support, as the Legislature intended. In other words, OCTA advocates returning to the implicit support ladened rate structures that the OUSF was created to correct. At best, under OCTA's proposal basic telephone service rates in the non-rural ILECs' high cost service areas would have to be substantially increased to mitigate the loss of OUSF support.

OCTA also suggests (OCTA/100, Ankum/83-93) that since Frontier has recently acquired additional access lines from Verizon (i.e., the Frontier NW Oregon operation), there are new scale and scope economies that should lower the costs of providing basic telephone service in high cost areas. First, it is important to note that Verizon is a much larger company than Frontier, with landline telephone, wireless and long distance operations that are substantially greater than Frontier and therefore, the scope and scale of Frontier's operations in Oregon, are less than what Verizon enjoys. Moreover, to the extent any such scope or scale savings exist, any such expense reductions would be just one variable in determining the cost of providing basic local service. Many of the other costs of providing basic local service have gone up. As I stated in my direct testimony, for example, from 2000 to 2011 Frontier NW's investment per access line increased by 233% and operating expense per access line increased by 173%. If the Commission were to update the non-rural ILECs' cost model it would need to update all values for investment, operating expenses, access lines and the like.

OCTA's arguments do not provide any basis for eliminating OUSF support for the non-rural ILECs' high cost wire centers.

Q. SHOULD THE COMMISSION RESTRICT OUSF SUPPORT TO AREAS NOT SERVED BY COMPETITORS?

A. No, it should not. OCTA claims that the OUSF currently distorts the competitive marketplace by giving an advantage to ILECs. In reality there is no such advantage. Unsubsidized competitors can come into an ILEC's high cost wire center and selectively serve customers in the higher density town centers where costs to provide service are lower, while ignoring potential customers in the higher cost outlying areas of the wire center. ILECs, on the other hand, as a result of their carrier of last resort and other regulatory obligations, must serve all potential customers within the area. It is the ILECs that are competitively hampered because they are required, as a condition of receiving OUSF support, to provide service to all customers, including the highest cost, most difficult to serve customer locations. Other carriers, including the OCTA members, are not at a competitive disadvantage because they are free to get OUSF support, if they agree to take on COLR-like obligations. That process is the competitive neutrality inherent in the OUSF funding mechanism.

Moreover, OCTA's proposal – as well as Verizon's similar proposal – would entail significant difficulties with determining exactly where competitors' voice services are available, and it would be particularly difficult to determine basic telephone service costs for all of the individual locales not served by competitors.

Q. WHAT PROPOSALS DOES OCTA MAKE TO REDUCE THE CALCULATED COSTS OF BASIC TELEPHONE SERVICE?

A. For all ILECs, OCTA proposes to attribute much of the costs to broadband services, thereby reducing the "cost" of basic telephone service used in the OUSF support calculation. (OCTA/100, Ankum/21, l. 9-10.) For the rural ILECS, OCTA's proposals include reducing the cost of capital. (OCTA/100, Ankum/21, l. 6). OCTA also proposes to eliminate switching costs from the determination of the cost of basic telephone service for all the companies (OCTA/100; Ankum/102, l. 14 – Ankum/103, l. 13.)

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL TO ATTRIBUTE BASIC TELEPHONE SERVICE COSTS TO BROADBAND SERVICES?

A. No, it should not. OCTA argues that the networks operated by the ILECs are generally used to provide both OUSF-supported basic telephone services and non-supported services such as broadband internet connections. Contrary to this assertion, the FCC Synthesis Model results that were adopted by the Commission for the non-rural companies when the fund was established in 2000 utilized pre-2000 cost, traffic and line data**,** which, of course, did not include the types or magnitude of broadband facilities and investment on which OCTA bases its proposal. In order for network costs to be allocated to more than one service, first those total costs would need to be updated to reflect current costs of a network capable of providing those multiple services. It would be improper to allocate costs to a service that was not included in the total network capabilities to start with.

Further, the OCTA proposal to allocate costs based on relative revenue is arbitrary, unrelated to the actual costs of providing those services, and ignores the FCC's jurisdictional separation rules. This is yet another proposal that would inject significant uncertainty into the OUSF process, because, at best, the cost per line would need to be reset frequently due to evolving revenue streams.

Similar to Staff's previously discussed cost allocation proposal, OCTA's proposal would deter broadband investments in high cost service areas because ILEC's would be less likely to make such investments if they knew that their OUSF support would be significantly reduced or even eliminated by allocating basic telephone service costs to the new broadband services.

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL TO REDUCE THE COST OF CAPITAL USED IN THE DETERMINATION OF THE RURAL ILECS' COST OF BASIC TELEPHONE SERVICE?

A. No, it should not. Rural carriers face significant risks in building a network to serve customers in low density areas that may not even ultimately subscribe to service. This risk is evidenced by, among other facts, the scarcity of basic telephone service providers in these areas. A risk-appropriate and sufficient cost of capital is necessary for these ILEC operations. Before the cost of capital (rate of return) could be changed, the

Commission would need to address this issue in another phase of this docket to gather proper evidence regarding the specific rate of return required. The Commission could not merely rely on the anecdotes provided by OCTA.

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL TO EXCLUDE SWITCHING COSTS FROM THE DETERMINATION OF THE COST OF BASIC TELEPHONE SERVICE?

A. No, it should not. While OCTA makes this proposal in its discussion of Issue 2 regarding the "use" of OUSF support, it really goes to the heart of calculating the cost of basic telephone service. Switching costs are clearly an integral part of basic telephone service. Without switching functionality, a customer would not be able to place a call, and there would be no basic telephone service. Local exchange calling is explicitly listed as a component in the Commission's definition of basic telephone service.[10] The FCC Synthesis Model used to determine the non-rural ILEC's basic telephone service costs included switching. The Commission approved and adopted that model, and, therefore, concluded that switching costs need to be included in the OUSF calculations.

Q. WHAT PROPOSALS DOES OCTA MAKE TO INFLATE THE BENCHMARK?

A. OCTA makes four proposals to change the benchmark: set it at two standard deviations above the current benchmark; use a separate, higher benchmark for business lines; set the benchmark at a level that would zero out support in areas supposedly served by competitors; and increase the cost-based benchmark level by "adding the average broadband revenue per line." (OCTA/100, Ankum/21, l. 12-28)

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[10] OAR 860-032-0260.

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL TO INCREASE THE BENCHMARK BY TWO STANDARD DEVIATIONS?

A. No, it should not. This OCTA proposal to arbitrarily raise the benchmark to the weighted average cost of the non-rural wire centers plus two standard deviations (Ankum/6, line 10, and pages 49-50) would wipe out all support received by Citizens to serve its high cost wire centers (Exhibit OCTA/102), and reduce total rural ILEC support by 80%, down to about $3 million. (OCTA/100/Ankum/50, l. 2-4.) Curiously enough, OCTA proposes this benchmark change for both non-rural and rural ILECs, even though OCTA already proposed to eliminate the non-rural companies from the OUSF all together.

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL TO USE A HIGHER BENCHMARK FOR BUSINESS LINES?

A. No, it should not. This proposal relies on the premise that business customers have higher thresholds of affordability compared to residential customers and can pay higher rates. The issue of affordability has nothing to do with determining the cost of providing basic local service and should be disregarded. The Commission's current approach of using a single benchmark is correct.

In addition, trying to implement the OCTA proposal would be administratively burdensome and result in inaccurate per line support payments because the grade of service provided over a given line can change as the identity of a customer served over that line changes.

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL TO MANIPULATE THE BENCHMARK TO ELIMINATE SUPPORT IN AREAS SUPPOSEDLY SERVED BY A COMPETITOR?

A. No, it should not. This is just an alternative method that OCTA is proposing to reduce the fund size where unsubsidized competitors exist. It should be rejected for the same reasons that the Commission should reject OCTA's "unsubsidized competitor" proposal that I previously discussed.

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL TO ADD BROADBAND REVENUES TO THE COST-BASED BENCHMARK LEVEL?

A. No, it should not. This is yet another twist on OCTA's proposal to reduce the fund size by inappropriately allocating basic telephone service costs to a non-regulated service. This proposal should be rejected for the reasons I previously stated in response to OCTA's proposal to allocate costs to broadband services.

Q. HOW DO OCTA'S PROPOSALS OVERSTATE THE FEDERAL SUPPORT OFFSETS USED IN THE OUSF SUPPORT PER LINE CALCULATION?

A. OCTA proposes to make cost offsets for Interstate Access Support, Connect America Fund Intercarrier Compensation, and Incremental Support funding. (OCTA/100, Ankum/21, l. 29 – Ankum/22, l. 6.)

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSALS FOR THE FEDERAL SUPPORT OFFSETS?

A. No, it should not. The Interstate Access Support (IAS) mechanism was set up by the FCC to help offset interstate access charge reductions for price cap companies. Making it an offset in the OUSF support calculation would be double counting. Only price cap carriers and competitive carriers serving in the service area of a price cap carrier are eligible to receive IAS. This type of support is not targeted to the recovery of local loop costs and is instead an interstate access charge recovery mechanism. This is another effort by OCTA to arbitrarily reduce the size of the OUSF.

Connect America Fund Intercarrier Compensation ("CAF ICC") represents an explicit federal subsidy funding mechanism available to a Price Cap or ROR carrier to compensate the carrier for a percentage of the excess of their annual "Eligible Recovery Amount" less the annual amount of expected tariffed Access Recovery Charge ("ARC") revenues to be collected from end user customers. The "Eligible Recovery Amount" primarily consists of the total switched access revenue reductions for the current year as required under the FCC ICC Order. Therefore, CAF ICC is not a federal USF High Cost Loop Support fund, and by design its life is temporary. Much like the purpose of the IAS funding, the CAF ICC funding compensates a carrier for intrastate access rate reductions that cannot be fully recovered through end users in the current rate year in the form of tariffed ARC charge revenue. As future intrastate and interstate switched access rate reductions are implemented by the carriers in accordance with the FCC's ICC Orders, the continued cumulative revenue impacts of annual increases in the allowed tariffed ARC end user charges will reduce this temporary federal CAF ICC subsidy revenue down to zero.

The CAF Incremental Support (IS) is an explicit broadband capital development fund, which comes with specific obligations on the carrier to deploy capital funding to construct broadband networks specifically designed to target un-served locations within the carrier's serving areas. This is not a federal USF High Cost Loop Support fund and in this case the funding dollars do not even represent a revenue to the carriers, but simply a capital funding contribution in aid to construction from the FCC to help partially offset the significant capital dollars committed to be spent by the carriers to construct broadband network infrastructure into previously unserved locations.

Q. WHAT OTHER PROPOSALS DOES OCTA MAKE TO ELIMINATE OR CONSTRICT SUPPORT FOR SOME CUSTOMERS AND SERVICES?

A. OCTA further proposes to eliminate support for second line basic telephone service and to provide less support for business primary line service. (OCTA/100, Ankum/20, l. 22 – Ankum/21, l. 3.)

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL TO ELIMINATE SUPPORT FOR BASIC TELEPHONE SERVICE RESIDENTIAL AND BUSINESS SECOND LINE SERVICES?

A. No, it should not. The Commission has already addressed this issue in its Order No. 00-312 and its policy decisions regarding the types of lines that should be supported are still valid. If OCTA's proposal were adopted, ILECs would then have to raise basic telephone service rates for the lines not supported, assuming the Commission would allow it. That would put the ILECs at a disadvantage compared to the competitive providers. OCTA has provided no estimate of the impact of this proposal on the size of the OUSF.

Funding is necessary for all types of lines (i.e., primary residential, non-primary residential lines and business lines). Frontier and other ILEC recipients of OUSF support have carrier of last resort obligations for all of these types of lines and all of those types of lines are subject to Commission pricing regulation.

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL TO PROVIDE LESS SUPPORT FOR BUSINESS BASIC TELEPHONE SERVICE?

A. No, it should not. This proposal is similar to OCTA's proposal to adopt a separate benchmark for business lines, which was just another way to reduce support for business lines, and, as all OCTA's proposals do, to reduce the fund size. The proposal should be rejected for the reasons I previously stated.

OCTA also re-raises the argument that the subsidy gives the ILEC a competitive advantage. Again, the OCTA members may opt in for the same OUSF support if they agree to the Commission's competitively neutral conditions for receiving such support.

Regardless of whether support for business lines is eliminated or reduced, the end result is the same; the ILECs would have to raise basic telephone service rates for the lines not supported. Even if the Commission were to allow such rate increases, that would put the ILECs at a disadvantage compared to their competitors.

Q. DOES OCTA MAKE ANY PROPOSAL WITH REGARD TO THE COLLECTION OF OUSF FUNDS?

A. I did not see any such proposal in OCTA's direct testimony.

<u>Response to Verizon</u>

Q. HAVE YOU EVALUATED VERIZON'S PROPOSALS FOR DETERMINING HOW MUCH OUSF SUPPORT SHOULD BE AVAILABLE IN A GIVEN AREA?

A. Yes. While Verizon's direct testimony does not employ headers linked to the issues list for this proceeding, it touches most directly on this issue beginning at Verizon/100, Price/42.

Q. WHAT CHANGES DOES VERIZON PROPOSE THE COMMISSION MAKE TO CALCULATION OF THE COSTS OF BASIC TELEPHONE SERVICE, WHICH FORM THE BASIS OF THE OUSF SUPPORT CALCULATION?

A. At Verizon/100, Price/44, line 17 through Price/45, line, Verizon tells the Commission that it either should copy the FCC and use competitive bidding or "a methodology patterned after the new costing approach the FCC is currently developing . . .." Next, at Price/46, lines 13 to 17, Verizon says that the Commission should determine costs not on an ILEC company-wide basis but only "in those areas where OUSF support will be targeted." And then at Price/47, lines 2 to 5, Verizon says that – absent a competitive bidding process – a company seeking OUSF support should be required to provide a "reliable cost study that demonstrates the cost of providing basic telephone service in that area, as contemplated by ORS 759.425(3)(a)."

Q. SHOULD THE COMMISSION SWITCH TO COMPETITIVE BIDDING AS THE MEANS OF DETERMINING THE COST OF BASIC LOCAL SERVICE IN A GIVEN AREA?

A. No. It would be detrimental for the Commission to abandon its current approach and substitute competitive bidding. The situation in Oregon indicates that a competitive bidding approach would not work here. To date only two non-ILECs[11] have chosen to receive OUSF support and undertake the obligations the Commission imposes in return. And these two companies have only done so in very limited markets.[12] Thus, it is unlikely that there would be multiple bidders for the vast majority of Oregon's high cost service areas, resulting in even higher required levels of OUSF support. Also, it should be borne in mind that in a competitive bidding scenario, the amount of support required

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[11] Warm Springs Telecommunications Company and Comspan Communications, Inc.

[12] The CenturyLink Warm Springs exchange and the Frontier NW Bandon, Coquille, Myrtle Point and Reedsport exchanges.

by the low bidder could well be higher than what is provided by the OUSF as it is currently operated.

Q. SHOULD THE COMMISSION ADOPT VERIZON'S PROPOSAL TO CREATE A NEW COST STUDY PATTERNED ON WHAT THE FCC IS DEVELOPING?

A. No. That proposal is by its own terms not capable of adoption by the Commission in this proceeding. Since the FCC has not completed development of its new cost study, there is no study currently available for the Commission to adopt. Even if there were an available study, the Commission would need to evaluate and tailor that national study to Oregon.

Q. SHOULD THE COMMISSION ADOPT VERIZON'S PROPOSAL TO ABANDON THE COST STUDIES THE COMMISSION CURRENTLY UTILIZES AND INSTEAD REQUIRE COMPANIES TO SUBMIT SEPARATE COSTS STUDIES FOR EACH LOCALE FOR WHICH OUSF SUPPORT IS SOUGHT?

A. No. For Frontier NW the Commission already uses a study that determined the cost of providing basic telephone service at the wire center level. Adopting Verizon's proposal would require the Commission to go through a time and resource intensive, complex process to decide upon a new cost study that would ultimately do the same thing.

Q. HOW DOES VERIZON PROPOSE THAT THE COMMISSION CHANGE THE WAY OUSF SUPPORT IS DISTRIBUTED?

A. In effect, Verizon proposes a kind of *ad hoc* and presumably on-going, dynamic disaggregation of OUSF support at very granular geographic levels, and the specifics of this disaggregation would be controlled by the deployment of wireless and cable company voice services.

At several places in its direct testimony, Verizon proposes that OUSF support only be distributed to companies that provide basic telephone service to locations where there is no equivalent wireless or cable service available. For example, at Price/45, lines 16-17, Verizon proposes that the Commission eliminate OUSF support for all areas "where one or more unsubsidized providers are already providing voice service . . .."

Verizon devotes much of its fifty-six pages of direct testimony to claiming that "voice service" is available from wireless and cable companies at *almost* all customer locations in the state. For example, at Price/35 Verizon offers a table purporting to show that 83.2% of "OUSF eligible" wire centers get Verizon Wireless service. One would think that Verizon's admission that there are Oregon locales without an alternative voice service provider would literally preclude application of this approach to geographically limiting OUSF support. However, in its testimony Verizon presses on with this notion, and I can only conclude that what it is really proposing is that the Commission force the ILECs to search out each discrete customer location where a wireless or cable equivalent of basic telephone service is not available, submit new cost studies specific to each such location, and receive OUSF support only for such locations.

Q. SHOULD THE COMMISSION ADOPT VERIZON'S PROPOSAL TO DISTRIBUTE OUSF SUPPORT ONLY TO LOCATIONS WHERE THERE IS NO WIRELESS OR CABLE VOICE SERVICE?

A. No – for a number of reasons, including the following.

First, as I described previously, the OUSF is a part of the rate structure set under ROR regulation for Frontier and other companies, and its function in that role does not depend on the presence of competitors' services.

Verizon's proposal might be seen as a way to do what has been referred to as "disaggregation of support" below the study area or even wire center level. While such a more granular approach to identifying high cost service areas may have some appeal, Verizon's proposal would be an unworkable way to go about it. Exclusion of funding to areas where there is an unsubsidized competitor would require a very granular and dynamic analysis. For example, if an unsubsidized competitor provides service to an industrial park outside a community but does not provide service to the adjacent households, it will require a very granular analysis to determine support areas. Further, this would presumably require an on-going analysis.

Furthermore, such disaggregation of OUSF support would have to be accompanied by a corresponding further deaveraging of unbundled network element rates in order to maintain competitive neutrality.

In addition, deployment changes, service discontinuations and other modifications by competitors could be constantly changing the basis for geographic disaggregation called for by Verizon's approach.

Lastly, it must be borne in mind that a competitor's offering of voice service is not subject to carrier-of-last-resort obligations. The competitors' option to provide service to a lucrative subset of customers in an area is very different than having an obligation to serve an entire area.

Q. HOW WOULD VERIZON'S PROPOSAL "DISAGGREGATE" OUSF SUPPORT?

A. In the context of telecommunications service costs, "disaggregation" refers to determining those costs at a geographic level smaller than a company's entire service area – in particular, at levels smaller than an exchange or wire center. The "donut and the hole" example of the Mapleton wire center in CenturyLink's direct testimony (CTL/100, Felz/5-6) illustrates how such disaggregation could be done. A wire center could be disaggregated into two parts: the "hole" (i.e., the main town area) and the "donut" (i.e., the rest of the wire center surrounding the town). The costs of providing basic telephone service in each area would be separately determined. Since the population density in the donut area is much less and the loop facility lengths are much greater than in the hole area, the basic telephone service cost in the donut area would be much higher. Picking numbers purely for illustrative purposes, it may be the case that on a total wire center basis the average monthly cost per line would be $100, while on a disaggregated basis, the monthly cost per line in the hole area would be $30 and the monthly cost per line in the donut area would be $300. Disaggregating OUSF support would mean that a much higher support payment would be available in the donut area, and a smaller support amount would be available in the hole area.

Industry discussions of possible disaggregation have usually involved small fairly readily determined geographic units such as census blocks, but Verizon's proposal would be much more granular. Under Verizon's "no unsubsidized competitor" approach, the ILECs and the Commission would have to first determine the precise extent of wireless and cable company voice service availability in a given wire center at very low geographic levels (perhaps at individual customer premises) and then have to figure out what the cost of basic telephone service is in each part of the wire center where such services are not available. It is highly unlikely that those areas would neatly correspond with census block area boundaries.

Q. COULD VERIZON'S DISAGGREGATION PROPOSAL BE READILY IMPLEMENTED?

A. No, it could not. Verizon's inspiration for its proposal is a passage it quotes from the FCC's *USF/ICC Transformation Order* that pertains to situations "where an unsubsidized competitor – or a combination of unsubsidized competitors – offers voice and broadband service throughout an incumbent carrier's *study area*." (Verizon/100, Price/42, l. 9-13; emphasis added.) Unlike this FCC *study area* based approach, Verizon's proposal for the OUSF would – as I described – operate at a very granular geographic level below the wire center level and much below a study area level.

Bear in mind that, under Verizon's proposals, the burden of proving the absence of competitors' voice service falls on the OUSF support recipient. The competitors would have no obligation to provide information, and the Commission apparently would have no authority to compel its production given that the Commission does not regulate wireless carriers or cable TV companies. Beyond the challenges of mapping the customer locations where competitors' voice services are not actually available, Verizon's proposal would require an extremely difficult and time and resource intensive effort to determine the basic telephone service costs in the unserved areas. Moreover, Frontier NW could not utilize the existing cost study, since it did not determine costs below the wire center level. Therefore, a new cost study would have to be developed and accepted by the Commission. This would also be the case for the rural ILECs, since their current cost study does not produce results at this granular a level.

Q. HOW WOULD DISAGGREGATION OF OUSF SUPPORT NECESSITATE REVISIONS TO UNBUNDLED NETWORK ELEMENT (UNE) RATES?

A. The OUSF program includes a mechanism for sharing support amounts between ILECs and CLECs[13] that use ILEC unbundled network elements (UNEs) to provide basic telephone service. Per the Commission's decisions in its UM 963/UT 148 proceeding, the rates for Frontier NW's local loop UNEs are deaveraged into three groups ("zones") of wire centers. If the OUSF support were disaggregated below the wire center level, then these deaveraged UNE loop rates would have be revised accordingly in order to maintain the accuracy and competitive neutrality of the support sharing mechanism.

Q. DOES VERIZON MAKE ANY ADDITIONAL PROPOSALS FOR CHANGES TO HOW OUSF SUPPORT IS DISTRIBUTED?

A. Yes. It proposes several additional changes, including that only primary residential lines should be supported, that no business lines should be supported, and that the benchmark should be substantially increased. (See Verizon/100, Price/48-54.)

Q. SHOULD THE COMMISSION ADOPT VERIZON'S PROPOSAL TO ELIMINATE OUSF SUPPORT FOR ALL BUSINESS LINES AND FOR SECONDARY RESIDENTIAL LINES?

A. No, it should not. Even assuming such exclusions were allowed by the OUSF statute, as a procedural matter the Commission would have to open a rulemaking to change its definition of "basic telephone service." As a policy matter, the decisions the Commission made on this point in Order No. 00-312 (p. 20) are still valid. The ILECs still have carrier-of-last-resort obligations for all these services, and their rates are subject to Commission regulation.

[13] "Competitive local exchange carrier;" "competitive telecommunications provider" under Oregon law.

Q. HOW DOES VERIZON PROPOSE THE COMMISSION CHANGE THE BENCHMARK?

A. It is important to note that Verizon seems to "jump the track" and change the very nature of the benchmark. Verizon proposes that the Commission use an "affordable rate" benchmark rather than the current cost benchmark. The current OUSF is based on a cost benchmark but Verizon somehow converts this to something very different- a revenue benchmark. Verizon mentions two figures from the FCC that might be used: a $37.36 rural rate, which is set at two standard deviations more than the FCC-determined national average "flat rate for local service;" and a $30 "residential rate ceiling." Verizon also seems to suggest that the Commission could come up with an Oregon-specific figure, as it (Verizon) cites rate benchmarks from a few other states, which range from $24 to $35. Some of those figures include extended area service (EAS) charges, the federal subscriber line charge, other surcharges, and "fees and taxes."

Even if the Commission were to adopt a rate benchmark rather than a cost benchmark, there are significant flaws in their calculation of a rate benchmark. First, they propose to include the SLC, something that is already accounted for as a reduction in the cost of local service calculation. Verizon's proposal to include the SLC amount in a rate benchmark results in double-counting. Second, the FCC's rate benchmark upon which Verizon's proposal is based includes applicable taxes and surcharges, such as E911 and Telecommunications Relay surcharges. Verizon's proposal for a benchmark is not only an apples and oranges comparison of a rate benchmark to a cost benchmark, the FCC revenue benchmark includes components such as taxes and surcharges that are not included in the cost per line to which they will be compared.

Q. SHOULD THE COMMISSION INCREASE THE BENCHMARK AS PROPOSED BY VERIZON?

A. No, it should not. The Commission should not just copy an FCC figure, and Verizon's testimony does not constitute evidence sufficient to support any Oregon-specific figure. Moreover, even if the FCC's figures were accepted as a guideline, the current $21 benchmark amount would be appropriate, as demonstrated in CenturyLink's direct testimony (CTL/100, Felz/16-17).

Q. IN RELATION TO ITS BENCHMARK PROPOSAL, VERIZON URGES THE COMMISSION TO REQUIRE COMPANIES TO INCREASE RETAIL RATES (Verizon/100, Price/51-53). SHOULD THE COMMISSION ADOPT THIS VERIZON PROPOSAL?

A. No. In the previously cited testimony passage, Verizon asserts that OUSF recipients that have basic service rates below the benchmark – and especially below the higher benchmark figures that Verizon advocates - -are somehow receiving a windfall. Verizon is simply mistaken on this point. Such a windfall would only exist if a company's OUSF support were calculated as cost less its basic telephone service rate. But OUSF support is calculated as cost less the benchmark, so a company's basic service rate is irrelevant to the amount of OUSF support it receives. Verizon in effect acknowledges this fact when it proposes that the Commission should impute revenues a company would receive if its basic telephone service rate were set at the level of the benchmark. (Verizon 100/Price 52, line 21 to Price/53, line 2) Because of how the benchmark is used in the OUSF support calculation, such an imputation step is unnecessary.

Q. WOULD ADOPTING VERIZON'S APPROACH RESULT IN IMPLICIT SUBSIDIES IN FRONTIER'S RATE STRUCTURES?

A. If the amount of OUSF support received by Frontier were eliminated or decreased as Verizon's many proposals are designed to do, then rate increases would be needed to offset that loss. Those increases would return the companies' rate structures to the situation that existed before the OUSF was created: using implicit support from lower cost areas to subsidize service in higher cost areas. Even if the Commission allowed the companies to deaverage the basic telephone service rates and charge higher prices in higher cost areas, there still would inevitably be some implicit support in the rate structure because the service costs in some areas are so high that they could not be covered by affordable deaveraged rates.

Q. DOES VERIZON PROPOSE ANY CHANGE TO THE WAY IN WHICH OUSF FUNDS ARE COLLECTED?

A. No. I did not note any Verizon proposal to, for example, increase the revenue base from which OUSF funds are collected.

ISSUE: <u>WHAT CHANGES SHOULD BE MADE TO THE EXISTING OUSF RELATED TO HOW FUNDS ARE USED?</u>

<u>Response to Staff</u>

Q. DOES STAFF PROPOSE ANY CHANGES TO THE OUSF PROGRAM WITH REGARD TO HOW THE FUNDS ARE USED?

A. Yes. Staff's cost cap #2 that I discussed previously constitutes proposed micromanagement of how companies use OUSF support. In addition, in the "Issue 2:

Use of the Funds" portion of its direct testimony, Staff agrees with a statement in an "overturned" Commission order that "OUSF distributions for the non-rural companies should be used to improve the infrastructure and the level of maintenance in the high cost areas." (Staff/100, White/29, lines 3-5.) Since, as I have discussed, the OUSF should not be converted into Staff's vision of an annual grant making program aimed at a limited set of investments and expenses, the Commission should not adopt Staff's proposal as a regulation of the "use" of OUSF support.

<u>Response to OCTA</u>

Q. WHAT CHANGES DOES OCTA PROPOSE WITH REGARD TO THE USE OF OUSF SUPPORT?

A. OCTA wants the Commission to limit the "use" of OUSF support to primary residential lines, "or at most" primary residential and business lines. OCTA concedes that the Commission would need to accomplish this goal in a new rulemaking docket. OCTA also wants the Commission to "limit use of OUSF disbursements to loop related investments and expenses that are reasonably apportioned to single line residential and business voice service." (OCTA/100, Ankum/93, l. 12- 19.)

Q. SHOULD THE COMMISSION PROHIBIT THE "USE" OF OUSF SUPPORT FOR SECOND LINE RESIDENTIAL SERVICE OR FOR PRIMARY OR SECOND LINE BUSINESS SERVICE?

A. No, it should not. The reasons I discussed previously with regard to OCTA's proposal to introduce such a prohibition in the Issue 1 portion of its testimony also apply to this "use" restriction proposal.

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL TO PROVIDE LESS SUPPORT FOR BUSINESS BASIC TELEPHONE SERVICE?

A. No, it should not, for the same reasons that I explained previously with regard to the first issue in this case.

Q. WHAT IS OCTA'S PROPOSAL FOR LIMITING THE "USE" OF OUSF SUPPORT TO CERTAIN "LOOP RELATED INVESTMENTS"?

A. OCTA proposes to limit support to loop related investments and expenses that are apportioned to single line voice services, but it provides no details on how this would be accomplished. It only asks the Commission to impose new and burdensome reporting requirements on the ILECs to demonstrate to the Commission's satisfaction that costs are allocated "correctly." OCTA also proposes that local switching costs not be supported, as I have previously discussed.

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSED INVESTMENT "USE" RESTRICTIONS?

A. No, it should not. The OUSF program currently works well as it is designed. There is no need for additional, costly and burdensome reporting. This proposal is just a variation on OCTA's cost allocation proposal, which I previously discussed. Both are without merit and should be rejected.

<u>Response to Verizon</u>

Q. DOES VERIZON PROPOSE ANY CHANGE TO THE EXISTING OUSF RELATED TO HOW FUNDS ARE USED?

A. No, not beyond its proposals to eliminate or at least enormously decrease the geographic areas for which OUSF support is available. I did not note any Verizon proposal for new rules about how companies may use the funds.

Q. SHOULD THE COMMISSION IMPOSE ANY SPECIFIC REGULATIONS ON THE OPERATIONAL USE OF OUSF SUPPORT?

A. No regulations are warranted for ILEC recipients of OUSF support. The OUSF is not an infrastructure subsidy grants program, and the "use" of OUSF support should not be regulated as if it were. The purpose of the OUSF is to remove implicit support from the ILECs' rate structures and replace it with explicit support that is also available to competitive providers.

The ILECs are already subject to Commission oversight and numerous rules that address the quality of basic telephone and other intrastate regulated services. Service quality is a function of infrastructure improvement and maintenance. If the companies are not using their regulated intrastate telecommunications revenues, including OUSF support, to install and maintain necessary infrastructure for the provision of basic telephone service (in high cost areas or elsewhere), the Commission will become aware of it through its service quality monitoring. In addition, the Commission Staff conducts proactive field audits of the companies' network facilities. There is no reason to create new regulations for the "use" of the OUSF subset of the ILECs' revenues.

ISSUE: <u>WHAT CHANGES SHOULD BE MADE TO THE EXISTING OUSF RELATED TO TRANSPARENCY AND ACCOUNTABILITY?</u>

<u>Response to Staff</u>

Q. WHAT CHANGES TO THE OUSF PROGRAM DOES STAFF PROPOSE RELATED TO "TRANSPARENCY" AND "ACCOUNTABILITY"?

A. Staff proposes vague but obviously extensive new report and audit requirements and procedures. The new required reports would be the flipside of the annual "needs" forecasts Staff wants to require. The reported expenditures would be "audited to verify the company's estimates and make true-ups as necessary." (Staff/11, White/33, lines 16-17.)

Q. DOES STAFF DESCRIBE THE CONTENT REQUIREMENTS FOR THESE NEW ANNUAL REPORTS?

A. No, not in any detail. Staff refers to the interim reports submitted by Qwest and Frontier NW pursuant to Order 12-065 issued in this docket. Those reports cover certain investments made in high cost wire centers and certain direct expenses attributed to those areas. Staff indicates that the approaches the companies used for the expense portion of the reports were not fully acceptable. Staff says that if the companies do not produce information acceptable to Staff, "then the level of expenses should be set at a Staff determined amount." (Staff/100, White/33, lines 2-4.) Staff does not request the Commission to authorize any specific criteria by which to set the level of expenses.

Q. HOW DO THE INTERIM REPORTS RELATE TO THE COST OF BASIC TELEPHONE SERVICE?

A. The interim reports are based on a subset of current financial data recorded in the ILECs general ledgers. They do not synch up with the forward looking cost model approach that was used to estimate the ILECs' costs of providing basic telephone service. The interim reports only include capital investments made in the current report year in local loop, central office and interoffice facilities located in OUSF high cost wire centers. Second, they only include allocated *direct* expenses for central office, cable and wire, and network operations in those wire centers. .

The treatment of direct expenses in the interim reports also omits significant amounts that are not "direct" expenses of a given high cost wire center but which are in fact part of the total cost of providing basic telephone service. For example, shared and common costs are obviously excluded from the direct costs report. Also not accounted for are taxes and return on investment.

Rather than trying to track the cost of basic telephone service cost as previously adopted by the Commission, Staff's proposals for the annual "needs" forecast and the subsequent report and audit processes would change the OUSF into a quasi-grant making program directed at only new incremental capital expenditures and only a small subset of the companies' real expenses.

Q. DOES STAFF EXPLAIN THE "TRUE-UPS" THAT COULD RESULT FROM ITS AUDITS OF THE COMPANIES' NEW ANNUAL REPORTS?

A. No, it does not. Presumably Staff would want refunds from companies that spent less on allowed "uses" than their OUSF support. Staff does not say whether companies could receive additional support if their actual investments and expenses exceeded their forecasts.

Q. SHOULD THE COMMISSION ADOPT STAFF'S PROPOSAL FOR ANNUAL REPORTS AND AUDITS?

A. No, it should not. That proposal is part of Staff's flawed approach to changing the cost calculations and the support level determinations, and they should all be rejected. Even if the annual report and audit proposals were considered on a stand alone basis, they should be rejected because, as I have described, they are disconnected from the approach to determining costs that the OUSF program appropriately uses at present. Moreover, there is no need to require additional reports of the ILECs, because the Commission's oversight of the ILECs and its existing reporting requirements provide a very sufficient basis on which the Commission may judge whether the ILECs are using their intrastate regulated revenues to provide adequate basic telephone service in high cost areas of the state.

Response to OCTA

Q. WHAT CHANGES DOES OCTA PROPOSE RELATED TO THIS THIRD ISSUE?

A. OCTA proposes (Ankum/104-115) that (1) reviews of the OUSF be conducted by the Commission every three years, including a review of areas served by unsubsidized competitors and/or revisions to the fund cap; (2) funding should sunset after three years unless the Commission determines it is still necessary; and (3) the Commission should enlarge and make permanent the reporting requirements from Order 12-065.

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL FOR OUSF REVIEWS?

A. No. The rural ILECs' costs are already being reviewed by the Commission every three years. Adding the non-rural ILECs into the mix would significantly complicate, lengthen and delay the reviews.

In particular, OCTA would have the Commission review the identification of areas not served by unsubsidized competitors. As I mentioned above, significant resources would need to be expended on such a review, as reliable data regarding the location of competitors' voice services is not readily available. OCTA also proposes that the reviews examine numerous other issues, such as cost calculations, federal support, the benchmark, prices for services, how the funds are being used, level of competition, etc. Under OCTA's proposal, the Commission Staff and ILEC resources would be tied up for many months working on the review. That would not be an efficient use of either the Commission's or the ILECs' time, considering that the OUSF has functioned as intended for the past twelve years without any such changes or interference.

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL TO SUNSET FUNDING AFTER THREE YEARS?

A. No. This proposal once again ignores the ongoing COLR obligations of the ILECs to provide basic telephone service to their high cost customers. Further, it would take funding from the ILECs that the Commission already approved to replace revenue-neutral rate reductions the companies took to offset their OUSF support. The OUSF recipients need stability and predictability. OCTA's proposal would inject unnecessary instability and unpredictability into the program, to the detriment of achieving the OUSF's objectives.

Q. SHOULD THE COMMISSION ADOPT OCTA'S PROPOSAL TO ENLARGE REPORTING REQUIREMENTS AND MAKE THEM PERMANENT?

A. No. Existing reports are sufficient to ensure transparency and accountability for the OUSF. OCTA proposes significant burdensome report enhancements that are not necessary, including wire center level line counts for supported and broadband services, revenue detail for all services, federal and state support distributions, and descriptions of all reported investments with the percent attributable to basic service. Further, reporting requirements which include broadband services are clearly outside the scope of this proceeding.[14]

While OCTA's proposed report contents are wholly unjustified, even the interim reporting requirements are unwarranted and should not be made permanent.

Response to Verizon

Q. DOES VERIZON PROPOSE ANY CHANGES TO THE EXISTING OUSF AS TO SUPPORT RECIPIENTS REPORTING ON THEIR SPECIFIC USES OF THE FUNDS?

A. No. I did not note any such proposals in Verizon's direct testimony.

OTHER ASSERTIONS AND PROPOSALS

Q. THE STAFF PROPOSES TO "ELIMINATE THE REVENUE NEUTRAL REQUIREMENT" (Staff 100/White 26, line 6). WOULD ADOPTING THIS PROPOSAL BE USEFUL TO THE OUSF PROGRAM?

A. No, it would not. There are a couple of aspects to this Staff proposal. First, as further explained by Staff in response to a data request[15], Staff means that the ILECs should not be barred for eternity from increasing any of the rates they have decreased due to the Commission's past revenue neutral rate reduction mandates. But Staff does not intend the companies to have complete freedom to increase such rates. Rather, the companies would have to go through the normal Commission procedures for approval of rate increases. Those could range from processing a minor tariff advice letter to litigating a

[14] Ruling of Administrative Law Judge Arlow, January 17, 2013, Docket UM 1481.

[15] Responses to Frontier data requests, 2nd set, #11 and #12.

general rate case. That is no change at all. The companies have always had the right to pursue such rate change proposals.

Second, Staff states that the OUSF's "emphasis" should not be on reducing basic telephone service rates but on "providing the companies with the additional money that they need to" make network "improvements" that will "enhance revenue streams" and – somehow – "reduce the amount of OUSF support that is required." (Staff 100/White 26, lines 4 – 18.) Frontier is not seeking to use OUSF support to further reduce basic telephone service rates. And, as I have described, the Staff's proposals to severely reduce OUSF support levels from what they would be under the program as it currently operates would not actually provide the companies with any "additional money."

Q. ON PAGES 14-17 OF HIS TESTIMONY, OCTA WITNESS ANKUM DISCUSSES THE SIZE OF THE OUSF RELATIVE TO THE UNIVERSAL SERVICE FUNDS IN OTHER STATES. SHOULD THE COMMISSION BASE CHANGES TO THE OUSF PROGRAM ON SUCH COMPARISONS?

A. No, it should not. Comparisons to other states are not even possibly useful unless the Commission has thorough knowledge of the circumstances under which those other funds were created, how they operate, and how changes have been made over time. For instance, there could be significant differences in how initial fund support levels were established and the amounts of implicit subsidies that were removed from rates, as well as the revenue base to which the funding surcharge or tax is applied.

With regard to the size of the OUSF, on an overall basis the decrease in annual support requirements for the non-rural companies over the life of the fund has more than offset the recent increase for rural companies.

The non-rural ILECs' annual draw from the fund has decreased by approximately \$18.7 million or 40% in 2012, from an initial level of \$46.2 million in 2001[16]. This downward trend will likely continue to decline due to ongoing line losses.

For the rural ILECs, Staff's initial forecast for annual OUSF distributions in Docket UM 1017 was approximately \$9.4 million, effective in late 2003. Under the 2012 review of the rural ILECs' costs, the amount of support for rural ILECs was set at approximately \$15.6 million[17], which was an increase of \$6.2 million over the initial fund level established in 2003. Over the life of the rural company portion of the fund, it has grown at a modest 5.8% compound annual growth rate. After not receiving any increase in the previous triennial review, the rural affiliates of the non-rural ILECs – including Citizens -- received a modest 19% increase from the January 2012 levels.

Despite the recent increase in the rural ILEC support requirements, the overall fund size continues to trend downward, without any changes to the calculation, collection or distribution methodologies that were originally established by the Commission. As a result, there is no reason to panic and make significant changes to the OUSF that will potentially impact the ability of the ILECs to provide basic telephone service at reasonable and affordable rates. For the non-rural ILECs in particular, their reduction in OUSF support has already been substantial and should not be exacerbated by adopting OCTA's, Verizon's or Staff's proposals.

Q. ON PAGE 17 OF HIS TESTIMONY, OCTA WITNESS ANKUM ARGUES FOR SHRINKING THE OUSF BY CLAIMING IT HAS NOT AND WILL NOT

[16] CTL/100, Felz/8, lines 12-14 and FRONTIER/100, Lee/7, line 14. Frontier NW estimates 2012 OUSF support at \$11.1 million.

[17] Per the Memorandum of Understanding adopted in Order No. 12-309.

CONTRIBUTE TO HIGH TELEPHONE SERVICE PENTRATION RATES. SHOULD THE COMMISISON BASE ANY OUSF PROGRAM CHANGES ON THIS ARGUMENT?

A. No. The telephone penetration rate statistics from the FCC's Telephone Subscribership Report include telecommunications services provided by competitive local exchange carriers, such as internet protocol (IP) based services, as well as wireless carriers, not just ILECs. As I indicated in my direct testimony, ILEC market share of traditional telephony services in Oregon has declined to only 59%.[18]. When you factor in wireless only households, the ILEC market share is considerably less. As a result, the ability of ILECs to influence statewide telephone service penetration rates in any material manner is minimal.

Moreover, attaining some "high" penetration rate is not an objective of the OUSF. Rather, the OUSF helps maintain COLR companies' basic telephone service rates in high cost areas at affordable levels. Additional programs like the Federal Lifeline and Oregon Telephone Assistance Program (OTAP) that assist the lower income population affect the penetration rate. The size of the OUSF is not an issue here either.

Q. IF THE SIZE OF THE FUND IS NOT THE PROBLEM, WHY HAS THE OUSF SURCHARGE RATE INCREASED?

A. Simply put, the intrastate revenue base to which the surcharge has been applied has declined over time. When the most recent rural ILEC funding requirement was established, Staff prepared a baseline forecast of the net inflows and outflows of the OUSF. An increase in the surcharge was required to support the new funding level

[18] FRONTIER/100, Lee/6, lines 13-15 shows the non-ILEC market share of 41%.

because Staff's forecast shows that the estimated revenue base on which the surcharge rate is applied is expected to decline from 2012 to 2015 at a compound annual rate of negative 6.25%. As I indicated in my direct testimony, the Commission should ensure that all firms to which the OUSF contribution law applies are in fact making the required contributions to the Fund.

An already declining fund size should not be reduced further in order to set the surcharge at an arbitrary level. Those ILECs that depend on OUSF support to fulfill their obligation to serve high cost customers should not be penalized because the surcharge rate has increased. Staff's forecast shows that ILECs' intrastate retail revenues are already declining at a significant rate, and now parties are proposing to reduce ILEC revenues further by arbitrarily cutting the size of the OUSF.

CONCLUSION

Q. PLEASE SUMMARIZE THE CHANGES TO THE OUSF PROPOSED BY STAFF, OCTA AND VERIZON.

A. Those parties make dozens of often overlapping proposals to effect changes ranging from eliminating the OUSF all together to doing a "complete overhaul" and from severely reducing support levels to banning support for certain companies, areas and customers. Those parties pursue their objectives of radically shrinking the OUSF and the support it provides by making changes within the OUSF support per line calculations and by imposing numerous other limits and exclusions on the program in general. In addition to hugely weakening OUSF support, those parties' propose changes that would make administration of the program much more cumbersome, burdensome, costly and time consuming.

Q. IN SUMMARY, WHAT ACTION SHOULD THE COMMISSION TAKE ON THESE PARTIES' PROPOSALS FOR CHANGES TO THE OUSF SUPPORT CALCULATION?

A. The Commission should reject the Staff, OCTA and Verizon proposals to radically change each of the three elements of the support per line calculation: (1) cost of basic telephone service, (2) federal support offsets, and (3) the benchmark. These proposals are flawed in numerous respects, including failing to account for the regulatory system in which the OUSF was created and operates (including FCC separations rules); being vague and incomplete; lacking sufficient evidentiary support; being arbitrary, illogical, complex, cumbersome, unworkable, and unpredictable; causing upward pressure on rates, especially for basic telephone service; and reintroducing implicit subsidies into rate structures.

Q. IN SUMMARY, WHAT ACTION SHOULD THE COMMISSION TAKE ON THESE PARTIES' OTHER PROPOSALS FOR CHANGES TO THE OUSF PROGRAM?

A. The Commission should reject the proposals Staff, OCTA and Verizon make for change to the OUSF program such as banning support for non-rural ILEC high cost areas, eliminating support for some types of customers and services, changing the OUSF to an annual grant making program, and imposing voluminous and detailed new reporting requirements. As detailed in this reply testimony, they are flawed in numerous respects, including going beyond what is allowable under current law; being vague and incomplete; lacking sufficient evidentiary support; being arbitrary, illogical, complex, cumbersome, unworkable, and unpredictable; causing upward pressure on rates, especially for basic telephone service; and reintroducing implicit subsidies into rate structures.

Q. WHAT ACTION SHOULD THE COMMISSION TAKE IN THIS PROCEEDING?

A. The Commission should affirm the current purpose and design of the OUSF program. The only change in the program's operation should be increased attention to making certain that all legally required contributions to the OUSF are in fact being made.

> *Historically, telecommunications rates have included many implicit subsidies of one service by other services. That approach is inconsistent with open competition. The natural tendency of new carriers is to provide service only for the most profitable services, leaving high-cost services to be provided by incumbent carriers. The universal service program is designed to reduce or eliminate implicit subsidies and instead use explicit subsidies for the services that need support. The subsidies will be portable among the carriers that provide the supported services.*
>
> Order No. 03-082, page 1, docket UM 1017 (Feb. 3, 2003)

That statement by the Commission correctly described the regulatory situation in which the OUSF was created and it correctly described the purpose and function of the OUSF program. That description still applies. The statute has not changed. The carrier-of-last-resort and other service obligations of the ILECs – especially for high cost areas – have not changed.

The OUSF program properly determines areas where support is available and the amount of support to be provided. It follows the statutory formula in a straight forward way: basic telephone service cost for a given wire center, less federal support specific to loop costs or basic telephone service, less a pre-determined benchmark. For the ILECs, the program has appropriately operated on a revenue neutral basis, since OUSF support by design replaces revenues that would otherwise come from implicit support in the companies' intrastate rate structures. The amount of support available is predictable. The program is appropriately competitively neutral, by offering other companies the same support an ILEC receives for a given wire center and by sharing support with companies that use ILEC unbundled network elements.

Normal service quality and other reporting by the ILECs, as well as normal Commission oversight of their operations, has ensured and will continue to ensure that the ILECs are appropriately devoting their intrastate telecommunications revenues, including OUSF support, to providing sufficient basic telephone service. There is no need or justification for adding more regulatory reporting. Also, the availability of affordable basic telephone service continues to be assured by the Commission's oversight of the companies' prices.

The areas of Oregon served by Frontier vary greatly in terms of terrain and density and, therefore, vary greatly in the cost to serve. Despite these cost differences, Frontier and other OUSF recipients, through the explicit support provided by the OUSF, have been able to maintain reasonable and affordable rates to consumers in the highest cost service areas of Oregon. Prior to the introduction of voice competition, Frontier was able to maintain affordable rates by averaging rates among its service areas, resulting in implicit support flowing from low-cost areas to high-cost areas. With the introduction of voice competition in its highest density, lowest cost service areas, the implicit support mechanism was replaced with an explicit support mechanism to ensure that rates could remain affordable in high-cost areas. That support mechanism was made available to all carriers willing to accept the associated obligations. Proposals by Staff, OCTA and Verizon would severely reduce or eliminate the level of explicit support available to carriers burdened with those obligations. The loss of those revenues would put carriers facing these losses in the untenable position of trying to recover the costs of fulfilling carrier of last resort obligations through implicit support from customers in low cost areas, while trying to compete with carriers that have no such obligations and only serve less costly areas.

The proposals of Staff, OCTA and Verizon would result in direct harm to customers in both Oregon's high-cost and low-cost service areas, would discourage investment in network infrastructure, and would force companies to consider other cost-savings measures to offset the lost OUSF support. The Commission should not adopt proposals to reduce the level of support but should rather expand the base of contributing carriers to help maintain the level of the OUSF surcharge.

Q. DOES THIS CONCLUDE YOUR REPLY TESTIMONY?

A. Yes, it does.

CERTIFICATE OF SERVICE
UM 1481

I certify that on the 30th day of January 2013, I served the foregoing Reply Testimony of R. Kirk Lee on behalf of Frontier Communications on the following persons via electronic mail with a hard copy to the PUC Filing Center;

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Dated this 30th day of January, 2013

Renee M. Willer

Renee Willer
State Regulatory Manager – Frontier Communications