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Committee on Small Business
Subcommittee on Rural Enterprises, Agriculture and Technology Policy

In the Matter of
"The Future of Rural Telecommunications: Is the Universal Service Fund Sustainable?"

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Chairman Graves, Ranking Member Ballance, members of the subcommittee, good afternoon, and thank you for the opportunity to address you concerning rural telephone issues and universal service funding concerns.

Curriculum vitae

I am Michael J. Balhoff of 1213 Shady Creek Road, Marriottsville, MD 21104. I head the Telecommunications Equity Research Group at Legg Mason, a Baltimore-based full-service investment firm. I cover equities in the incumbent local exchange carrier industry, including the regional Bell companies and rural telephone carriers. Our practice is most widely recognized for a focused coverage of rural telephone companies, and, to this point, we have sponsored the only annual investor conference dedicated to investments in rural telephone companies. We provide investment advice to a wide range of prominent institutional and private equity investors in addition to company managements, both across North America and Europe.

Besides publications on the regional Bell companies, I have authored major rural telephone reports, including *Harvesting New Values: Rural Local Exchange Industry* (Spring 1999); *Rural Local Exchange Carriers: New CLEC Initiatives* (Fall 1999); *Reshaping Rural Telephone Markets: Financial Perspectives on Integrating Acquired Access Lines* (Fall 2002); and the quarterly *The RLEC Monitor*. I speak regularly on telecommunications issues, including rural telecom matters, at conferences sponsored by The United States Telecommunications Association, OPASTCO (Organization for the Promotion and Support of Small Telecommunications Companies), NTCA (the National Telecommunications Cooperative Association), and NARUC (the National Association of Regulatory Utility Commissioners.) I have also made presentations several times to state commissioners of the Regional Oversight Committee, comprised of the 13 state public utility commissions overseeing the long-distance relief process for Qwest, as well as at this year's Annual Regulatory Policy Conference on "Fiscal Fitness: The Financial Condition of the Utility Industries and the Role of Regulation," which is a forum for federal and state regulators and industry leaders. Most recently, I presented at a special three hour seminar session of House and Senate staffers related to rural issues and intercarrier compensation.

I have a doctorate and four master's degrees, including an M.B.A. from the University of Maryland, am a CFA charterholder and am a member of the Baltimore Security Analysts Society. I have been named on four occasions as a *Wall Street Journal* All-Star Analyst for my recommendations in the telecommunications industry.

Focus of Testimony on Problems in the Universal Service System

My understanding is that you wish to define the problems in today's Universal Service Fund (USF) system so that you can work toward constructive solutions. The investment community agrees with you that there are problems with today's systems, and I will attempt to outline those issues further. At the same time, I want to parse my commentary by saying that I can provide insight as an informed member of the financial community, but I do not have the background or the information to provide sufficient insight from the vantage point of policymakers or engineers or regulatory experts. I see my charge today as offering a narrowed perspective on *how the investment community perceives the problems with a view to arriving at certain principles that might help in improving the solution set.*

The Investment Community

You might ask about which are the members of the financial community with whom we interact. We publish on telecommunications issues and visit frequently with large mutual funds, insurance companies, pension funds and banks. We therefore believe that we have an understanding of the concerns of equity and debt investors such as Fidelity Funds, Alliance, Putnam, CalPERS (California Public Employees' Retirement System), Capital Research, American Express, US Bancorp, Bank of America, Rural Telephone Finance Cooperative, and CoBank, among others. Organizations such as these generally account for about 60%–70% of the capitalization of the major rural telephone companies. We are also in regular dialogue with and provide insight to a broad range of more specialized professional investors or venture capital firms, including Welsh Carson Anderson & Stowe, The Carlyle Group, Fox Paine, The Quadrangle Group, and The Texas Pacific Group, among others. As a company, Legg Mason also interacts directly with individual investors through our retail brokers who are part of the Legg Mason retail system.

The Problems as Viewed by the Investment Community

In my view, the investment community perceives three problems related to universal service and telecommunications. The first problem is that the current contribution system appears to be overextended precariously. The second problem arises from the introduction of USF payments, beginning in 2001, to carriers other than the incumbent local telephone company. And the final issue is possibly the most complex and important from a financial point of view, and that is how the current system of intercarrier compensation—access charges and reciprocal compensation—might be reformed to better accommodate technology changes.

I will go through each of these issues briefly and then offer several financial principles that might help as you and other policymakers attempt to effect reforms.

Problem 1: The Current USF Contribution System is Increasingly Overextended

I believe that the problems with the current USF contribution system are reasonably well known. In summary, USF monies are collected from carriers such as long-distance companies and wireless service providers that generate interstate telecommunications revenues, consistent with the mandate in the Telecom Act's section 254. Those monies are then redistributed for the most part to other carriers or other parties (schools, libraries, health care institutions) that are deemed appropriate recipients because they operate in high cost regions.

The difficulty today is that quarterly interstate revenues that were once expanding year-over-year are now contracting over the year-ago periods. So, for example, the revenues against which the fund is drawn have gone from $20.5 billion in the first quarter of 2001 to $18.8 billion in the third quarter of 2003. At the same time, the size of the universal service fund has grown and is expanding for various reasons. In the current quarter, the contribution rate (calculated as the dollars needed to support USF demands divided by eligible interstate revenues) is now 9.5% compared with 5.9% in the first quarter of 2000. To be fair, the reforms of USF in 2001 caused the majority of that increase, but the effective contribution rate has risen from 8.8% in the third quarter of 2002 to its current level of 9.5% in the post-reform period, providing a better illustration of the organic growth in the fund requirements.

The major reform proposals involve broadening the contribution base from *interstate only* to include *intrastate and interstate* telecommunications revenues (which I believe would require Congressional action) or possibly to include some of the data revenues that are generated by cable television companies but are not part of the current assessment process. The political issue is whether to engage in a so-called "tax" of the Internet in this latter proposal. For the most part, I believe the fund contribution mechanisms can be reformed without jeopardizing the monies paid out to rural carriers, possibly depending on how some of the issues regarding the portability of USF are resolved, with the result that there is negligible financial harm to the small rural companies that currently receive USF payments. In my view, then, the key issues that must be resolved by policymakers are with respect to the contributors and not the recipients. If there is some concern on the part of the financial investor, it is about how policymakers resolve any perceived competitive disadvantage arising from a world in which some carriers are exempted from paying some or all USF monies, while the traditional payors continue to be obligated to make USF contributions.

Problem 2: Portable USF Needs More Attention

The second issue affecting USF today relates to non-incumbent carriers that are eligible for the first time to receive USF payments. This change was implemented in the USF reform included in the "Rural Task Force" Order of May 2001. The reform introduced "portable" USF payments based on (1) a state public utility commission determining that it was in the public interest that a non-incumbent carrier should be designated as an "eligible telecommunications carrier" (ETC), also known as a competitive ETC (CETC), (2) the payment of USF monies that mirrored the per-line payments made to the incumbent carrier in the interest of "competitive neutrality" and (3) a reduced set of obligations for the CETC compared with those imposed on the incumbent, with the reduced obligations based on the belief that "competition" is a valued outcome even if the obligations and financial characteristics are dissimilar.

Notably, the new practice has involved USF payments to many wireless carriers that are represented as being "competitors" to the incumbent carriers. I have seen some commentary even from the former members of the Rural Task Force, indicating that wireless carriers are not truly offering a "competitive" service since there is a different value proposition in wireless. This dispute is not for me to resolve, but I must note the apparent inconsistency in urban markets where regulators insist that there is insufficient residential competition since wireless services (nearly 150 million U.S. subscribers in total) are not included as "competitors" and UNE-P is therefore justified by state and federal regulators. By contrast, wireless is deemed to be a competitive service eligible for USF payments in rural regions. I believe that there are regulatory consistencies that beg for reconciliation.

Turning back to the universal service problem, it is my view that the new CETC policy could be construed as a decoupling from financial reality, with the potential for troubling consequences. By way of background, my understanding is that the legacy universal service policy was established so that rural or other high-cost consumers should benefit from having services and rates comparable to those in urban regions. In high cost areas, the policy has been to provide support payments from other lower cost regions to moderate the difference in costs in rural and insular geographies. To paraphrase, the government has said that there is no business case for providing telecommunications services in certain regions at certain rates, but, through federal and state intervention, the government will provide for the difference to ensure ubiquitous telecommunications services.

Against the legacy backdrop, the new post-2001 policy implements payments to CETCs, effectively declaring that it is in the public interest to create multiple business cases in a way that some have named “synthetic competition.” The criticism is that there is possibly not even a single business case (the original motive for the payment of USF), and new funding is being raised to support additional carriers, further burdening the payor into the USF. I may not fully appreciate the complexity of the public policy issues, but it seems that there was financial sense in the former system that tied USF to underlying costs (i.e. universal service as a cost-recovery mechanism), and that the separation of USF from costs by paying multiple carriers is an attempt to soar across a wide chasm and refashion what was a cost-recovery system into a system far-removed from costs.

There appear to be other issues for policymakers in resolving the CETC issues, including standardization of ETC approval processes across multiple states and the need for comparable obligations for recipients of USF, but these issues do not seem to have the same financial import as the issues I raised above and are therefore beyond my area of focus.

Problem 3: Intercarrier Compensation is the Most Complex Pending Reform
The third problem, in my opinion, arises from technology changes and how they affect the legacy access charges paid by long-distance companies to local companies for originating or terminating calls. I believe that this is the most important long-term problem from a financial point of view for various carriers, including rural telephone companies. At first, access charges do not appear to be related to universal service payments, but I believe that USF is one of the linchpins in resolving the intercarrier compensation question.

We can best explain the crisis by beginning with the Regional Bell operating companies (RBOCs) that have expressed an urgent need to change the intercarrier compensation system for access charges and, to a lesser extent, for reciprocal compensation. The RBOCs are notably concerned about the traffic bypass that is increasingly occurring through IP services that are exempt from access charges. Their view, simply stated, is that competitive neutrality requires that the intercarrier regime be simplified, possibly through a “bill-and-keep” scheme whereby the consumer is billed for all of the services it receives and intercarrier charges are eliminated. The RBOCs do not want to be disadvantaged by an access regime that leaves them with a cost structure—because of regulation—that is higher than the costs of their competitors.

One of the problems in resolving intercarrier compensation is that bill-and-keep works poorly for the 1,300 U.S. rural carriers. The difficult issue for rural carriers (defined here as NECA pool rate-of-return carriers) is that their per-minute long-distance charges that are paid by the long-distance carriers to the local companies are approximately 2.2 cents compared with 0.55 cents per minute paid to the RBOCs by the long-distance carriers and 0.95 cents per minute paid to rural price cap LECs. And intrastate rates per minute often are even higher in rural regions. If additional access payments are shifted from the long-distance carriers to the consumer under a bill-and-keep approach, urban bills are likely to remain close to the current levels, but monthly rural rates are estimated to rise by $40 on average or as much $170 in certain extreme circumstances. Such increases in a bill-and-keep environment would prove untenable to the rural customer. Some industry players have therefore suggested that the policy dictum “comparable rates and comparable services” is the basis for shifting such excessive rates from the consumer to an increased USF fund.

This is the rub. We believe that, if regulators wrestle with the rapidly changing IP world and how it affects the legacy intercarrier compensation system, USF could very possibly again increase, possibly by 30%. Further, such a change in intercarrier compensation to increased USF would exacerbate the first two problems outlined above. First, the USF contribution method must be carefully and securely crafted to cope with potential increases, not simply to the current rate of increase, but also to a more dramatic change in intercarrier compensation. Second, the portable USF arrangement as currently construed could result in higher revenues in USF payments to CETCs that at the same time could benefit from lowered terminating obligations, making today’s arbitrage even more extreme.

Financial Principles for the Reform of USF

I do not have good solutions for these problems, but I note that I am aware of industry players—RBOCs, long-distance carriers and rural telephone companies—that have begun to discuss resolutions of these complex and thorny problems. I think that these efforts probably are most constructive since the companies themselves understand subtleties that likely escape the financial community, the regulators and the legislators. Still, I will suggest some simple views from the vantage point of a financial institution—Legg Mason—that has been active in issues related to universal service. I have three principles that I consider important.

Financial sense is key to investment

I think that financial input is key, since capital flows at attractive prices are necessary in capital intensive industries such as telecom. Parenthetically I might note that policymakers occasionally dismiss the investment community or corporations in the reform process. In the extreme, some people view investors as self-serving, greedy, oppressive, willing to engage in fraud and opposed to public policy goals. In fact, good corporations, banks, financial analysts, venture capitalists and mutual funds are interested in serving the same public that you serve and want to do so in a constructive, honest and productive manner. And we believe we have something to add to the discussion since capital is critical in advancing the public interest today and in the future.

The problem we have in the financial community is that our job is to make money and we cannot commit capital if the rules are unpredictable or the system is in some ways biased. Further, if the regulatory system is distorted, the price of investment capital rises for companies, undercutting your goals. Our mutual funds, banks and pension plans are bound by laws as immutable as gravity—the value of stocks or bonds go up or they go down. Simply stated, investment realities need to be considered in reforms so that unreasonable arbitrage or disintermediation of funds is limited.

The message for you in the reform process is that the financial community should be considered as part of the process that involves long-term investment. If you set the wrong rules, we cannot participate or we will be compelled to charge higher rates. If you set good rules, we will dedicate capital.

Engage in as little regulation as possible

Investors generally assign a valuation discount to industries that are heavily regulated. This is the case for monopolies where investors perceive that the upside potential is capped or for utilities in which competition is being “artificially” introduced.

During the 1990s, for example, in spite of the monopoly status of the RBOCs, the equity values of the companies generally traded at a 10%–25% discount relative to the average valuation on the overall market. For the most part, the discount reflected limited upside compared with that generated by other investments.

In the wake of the Telecom Act, the discount on the RBOCs’ securities has become pronounced for a multitude of reasons, including weak fundamentals, a shifting set of technologies, confusion over the strategic direction of the companies, and, I believe, the problems associated with regulatory policies that set deep discounting of RBOC plant. The best illustration of the valuation adjustments—rightly or wrongly—made by investors was the sharp drop (approximately 6%) in RBOC stock prices on February 20 when the FCC’s Triennial Review Order was announced, but there are other examples.

Our opinion is that investors once attempted to choose the winners and the losers in light of shifting regulatory decisions. Not long ago, investors committed large amounts of capital to CLECs that benefited from reciprocal compensation revenues in the late 1990s (a regime that changed subsequently), to DSL standalone services based on favorable collocation rules (that have evolved), and to long-distance companies that benefited from UNE-P discounts (that are in the process of changing). More recently, I believe that a fundamental investor shift has occurred in the wake of the collapse in the capital markets and notably in telecom securities in 2000, 2001 and 2002. Investors have become more wary of business plans that are premised on, or affected by, regulatory artifices, believing now that much of regulation is ephemeral and less worthy of serious capital commitments. As a result, the vast majority of telecommunications stocks remains under pressure, including the stocks of those carriers that have benefited from some regulatory favor, *because investors are more inclined today to commit to real business plans and do not want to risk capital in an artificial environment.* Investors want reduced regulation that is rational and predictable.

Establish reforms on actual costs of the businesses
Investors do not believe that all regulation is onerous. In fact, most investors recognize the value of policy commitments, for example, in the case of rural telephone companies. I suggest that the rural and/or independent carriers such as Alltel, CenturyTel, Citizens, TDS, Commonwealth Telephone, SureWest, CT Communications and a host of small public and private carriers have performed relatively well in the capital markets since the beginning of 2000.

The reasons are several. First, investors see that the regions the rural carriers serve are high-cost and that policymakers have a well-proven system for evaluating costs and providing support payments. In this case, the artificial aspects are understandable and predictable. A second reason is that the regulatory environment is judged to be constructive as state and federal public utility commissions have worked with the rural carriers to find solutions rather than attempt to destabilize their operating environments. Third, the theory of a high-cost region in the minds of investors translates into a more predictable environment from a competitive point of view.

The concerns about CETCs and about intercarrier compensation, however, are growing to be more important. Investors are increasingly asking about whether the regulators have wrestled with the underlying realities about universal service and competition. In 2001, the National Regulatory Research Institute (NRRI), which serves as the research arm of the National Association of Regulatory Utility Commissioners (NARUC), published a document entitled *Balancing Competition and Universal Service: The Role of the Regulator Five Years After the Telecommunications Act.* That document suggested that there is an inherent contradiction between the Telecom Act's goals of competition and universal service in high-cost regions. The document proposes an alternating or phased approach between "the conflicting goals of the Act" so that universal services are constrained to essential programs and there are curbs on expanding the definition of universal service (see pages 42-44) while incenting competition in other services. While we may dispute various insights in that paper, we can agree with key premises, including (1) universal service has been remarkably effective to this point, and (2) expansion of the definitions of universal service can bring complex and unintended consequences.

Our strong opinion is that the capital markets will commit to support of businesses where the costs are understood and the policy is clear. If there is a decoupling of the cost analysis or if there are arbitrages introduced into the marketplace, the capital markets will require a higher return (higher-cost of capital) to participate. We suggest that regulators and legislators should well understand their goals for universal service and the risks associated with altering the system. We believe, in short, that it is dangerous to create systems that are not well founded on costs and that create distortions in the fundamental business case and the incentives for capital deployment.

Conclusion

I thank you for the opportunity to make this presentation to your subcommittee. My summary observations are that there are three key problems arising from the universal service system: (1) the mechanisms for collecting USF monies must be reformed, (2) the CETC question must be carefully examined and founded on more defensible cost analyses, and (3) the intercarrier compensation system is in need of an industry reform. My suggestion is that the financial dynamics be carefully considered so that the reforms allow for appropriate incentives to invest in a stable set of businesses that are minimally based on regulatory interventions. Thank you for your time.