THE RURAL UTILITIES SERVICE SHOULD REASSESS ITS RELIANCE ON UNIVERSAL SERVICE HIGH-COST SUPPORT TO LEVERAGE BROADBAND LOANS

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EXECUTIVE SUMMARY

The Federal Communications Commission (FCC) is considering significant reforms to the high-cost support program of the Federal Universal Service Fund (USF) that would ensure that subsidies are targeted in the most cost-effective manner possible to areas where there is no business case for broadband deployment. For the reasons explained in this paper, these long overdue reforms should not be deferred or diluted out of a concern that reform would adversely affect Rural Utilities Service (RUS) loan programs:

- First, contrary to recent statements made by RUS, it is very unlikely that proposed USF reforms will significantly increase the default rate on outstanding RUS broadband loans due to the graduated nature of proposed reforms and the demonstrated ability of firms to innovate and adapt to changing economic circumstances.

- Second, the risk of default pales in comparison to continuing harms perpetuated under the current system whereby RUS subsidies amplify the inefficient incentives inherent in the USF program, effectively creating a vicious cycle in which firms borrow money from the RUS to make inefficient investments, receive higher USF payments in return, and use the higher USF payments to justify still more loans for still more inefficient investments. The combination of the two programs thus provides far stronger incentives for socially undesirable investments than either of them separately, while placing taxpayers in the fundamentally unsound fiscal position of being the primary source of repayment on their own outstanding loans. Stopping this feedback loop is a benefit, not a cost, of USF reform.

As of December 2010, RUS' three rural broadband lending programs had more than $4.3 billion in outstanding loans, including $2.2 billion in RLEC loans made since 2008. The RUS qualifies borrowers based on their total anticipated revenues, including USF support, and reports that 99 percent of telephone companies receiving subsidized loans also receive USF subsidies. RLECs receive roughly $2.4 billion in USF support annually.

USF subsides to RLECs are calculated based on "embedded costs." Simply put, the higher a firm's costs, the more funds it receives from the USF. As the FCC has repeatedly recognized, this system gives RLECs an incentive to invest in inefficient infrastructures. In 2009, the new FCC leadership made clear that it would make USF reform a top priority, and in early 2011 it followed through with a *Notice of Proposed Rulemaking*. While the details of USF reform are not yet final, the FCC has made clear its intention to do away with the embedded cost rule and eliminate the inefficient incentives it creates. It is possible, as a result, that RLECs will eventually receive lower subsidies than if reform had not occurred.

Nevertheless, as this study shows, RUS' prediction of widespread defaults on outstanding RUS loans is, at best, highly speculative. USF reform aims primarily at increasing the effectiveness of the program, not reducing overall subsidies; it is certain to be implemented gradually and with a reasonable transition period; and, RLECs are well positioned to adjust to any cuts that do eventually occur. Particularly in cases where the investment for which the loan was made has already been completed, and USF funding to the carrier has increased, default is not likely to be a problem.

While USF reform will not be without consequence for the RUS loan program, the overall effect will be positive from a policy perspective. This study shows that RUS loan subsidies amplify significantly the inefficient incentives inherent in USF. Specifically, RUS expected USF subsidies to increase by $128 million annually as a result of the higher costs associated with the $2.23 billion in loans approved over the

last three years – enough to cover approximately 78 percent of the principal and interest payments on the loans, while leaving borrowers responsible for only about 22 cents on the dollar. The RUS broadband program, in other words, contributes significantly to the very problems the FCC is now trying to fix.

Accordingly, this study recommends that the RUS suspend new loans to recipients of USF funds or, at a minimum, stop leveraging USF support to qualify applicants for RUS loans. After the FCC concludes its USF reform proceeding and new rules are in place, Congress and RUS can reassess whether a loan program continues to be needed and if so, how that program can be better coordinated with the USF program to eliminate the problems inherent in the current RUS regime.

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I. INTRODUCTION

1. The Federal Communications Commission (FCC) is nearing completion of a rulemaking proceeding in which it is considering significant reforms to the high-cost support portion of the Federal Universal Service Fund (USF).[1] In July 2011, the Administrator of the Rural Utilities Service (RUS) met with the FCC staff, and the 46-page presentation used in the meeting (the *RUS Ex Parte Presentation*) subsequently was made public under the Commission's *ex parte* rules. It suggests that proposed USF reforms could lead to widespread defaults on the more than $4.3 billion in telecommunications and broadband loans issued or guaranteed by the RUS.[2] As the *ex parte* filing explains, when RUS evaluates the creditworthiness of potential borrowers, it assumes that USF funding will continue for the term of the loan, which may be 20 years or longer. The implication is that the FCC should reject or limit USF reforms that would harm the ability of RUS borrowers to pay back outstanding loans.

2. The likelihood that USF subsidies to small telephone companies will be reduced has been widely known for many years. The need for reform has been recognized literally from the day the current program was established, in 1997. Since then, the Commission has implemented several significant incremental reforms, and has frequently reiterated its dedication to fundamental reform. In 2009, the new FCC leadership made clear it would make USF reform a high priority, and in February 2011 the Commission voted unanimously to approve the *USF NPRM* that would fundamentally change the way USF subsidies are calculated and, in some cases, reduce the amount of support provided to telephone companies for providing traditional telephone service.

3. By leveraging USF funding to support increased lending, RUS loan programs effectively magnify the inefficient incentives of the USF program itself. As the FCC has long recognized, the USF program as currently structured gives rural telephone companies (Rural Local Exchange Carriers, or RLECs) incentives to overinvest in infrastructure: the more they spend, the larger the subsidies they receive. Thus, the current RUS rules create a self-reinforcing multiplier effect, in which USF subsidies not only support inefficient investments, but provide

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[1] Federal Communications Commission, *In the Matter of Connect America Fund*, WC Docket No. 10-90; *National Broadband Plan for Our Future*, GN Docket No. 09- 51; *Establishing Just and Reasonable Rates for Local Exchange Carriers*, WC Docket No. 07-135; *High-Cost Universal Service Support*, WC Docket No. 05-337; *Developing an Unified Intercarrier Compensation Regime*, CC Docket No. 01-92; *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45; and *Lifeline and Link-Up*, WC Docket No. 03-109, *Notice of Proposed Rulemaking and Further Notice of Proposed Rulemaking* (February 9, 2011) (*USF NPRM*). The focus of the USF NPRM is on the high-cost support program, not other components of the federal USF regime, such as the Schools and Libraries program, the Lifeline/LinkUp program, or the Rural Health Care program. Consequently, the focus of this paper is only high-cost support and not these other federal universal service programs.

[2] Notice of *Ex Parte* communications of the Rural Utilities Service regarding: *In the Matter(s) of the Connect America Fund*, WC Docket No. 10-90; *National Broadband Plan for Our Future*, GN Docket No. 09- 51; *Establishing Just and Reasonable Rates for Local Exchange Carriers*, WC Docket No. 07-135; *High-Cost Universal Service Support*, WC Docket No. 05-337; *Developing an Unified Intercarrier Compensation Regime*, CC Docket No. 01-92; *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45; and *Lifeline and Link-Up*, WC Docket No. 03-109 (July 29, 2011) (*RUS Ex Parte Presentation*).

the financial basis for RUS loans to support still more inefficient investments (which, in turn beget more USF subsidies, and so forth).

4. Even assuming that the RUS has issued billions of dollars in subsidized loans on the basis of faulty assumptions about the stability of USF funding, it does not follow that the reforms proposed by the FCC – including a reduction in USF funding to some RUS borrowers – will result in significant defaults on RUS loans. At this point, the exact contours of USF reform, and the corresponding impact on individual companies, are uncertain. Moreover, as explained below, RLECs have the ability to reduce costs and increase revenues, in response to a hypothetical reduction in USF support; and, RUS loans are well collateralized. Thus, the "sky is falling" scenario painted by the RUS is, at best, highly speculative.

5. With USF reform now nearing the finish line, the appropriate course for RUS is to adopt a moratorium on further loans to USF-subsidized companies until USF reform is complete, at which time the RUS program should be reevaluated and either reformed (to complement the new USF regime) or terminated (if it is no longer necessary). For example, the FCC is considering the use of a procurement model in which the winning bidder would receive a fixed amount of support to provide a defined level of broadband service to a defined area, which arguably would eliminate the need for any additional government support through RUS loan programs.

6. The remainder of this report is organized as follows. Section II describes the interaction between USF subsidies and RUS loans, and details the extent to which loan approvals are premised on continuing USF support for the RUS borrowers. Section III explains why USF subsidies are neither a sound indicator of an investment's social or private value nor a stable source of income upon which to premise an assessment of creditworthiness. Section IV explains why (a) implied risks to RUS's loan portfolio resulting from USF reform are likely overstated, and (b) any such risks are outweighed by the benefits that will accrue if RUS stops considering current USF subsidies in evaluating future loan applications. Section V explains why, as a result of this analysis, RUS should implement a moratorium on loans to USF-supported companies. Section VI presents a brief conclusion.

II. RUS LEVERAGES USF SUBSIDIES TO APPROVE SUBSIDIZED LOANS

7. RUS operates three major loan programs to subsidize construction of telecommunications infrastructure, the Broadband Initiatives Program (BIP), the Rural Broadband Loan Program (BLP), and the Telecommunications Infrastructure Loan Program (TIP). While the TIP program technically can support traditional telecommunications infrastructure, as a practical matter all three programs are used solely to support broadband. The

TIP program dates to the late 1940s; the RBL program began during early 2000s; the BIP program was created by the American Recovery and Reinvestment Act of 2009.[3]

8. While the three programs differ in specifics, all three provide loans at below-market interest rates for the construction of broadband infrastructure facilities. The interest rate on most loans is the rate paid by the U.S. Treasury on loans of equivalent maturities.[4] In the case of guaranteed loans, RUS does not charge a fee for the guarantee.[5]

9. Firms wishing to apply for RUS loans – whether direct or guaranteed – must complete an application process in which RUS determines whether the loan qualifies under various eligibility criteria,[6] including whether "the security for the loan is reasonably adequate and the loan will be repaid on time."[7] In evaluating the applicant's ability to repay, RUS considers all revenues, including revenues from USF.[8] RUS regulations provide for adjusting an applicant's projected revenues for "any special or new characteristics or other considerations deemed necessary by the Administrator."[9] At any time in the past, RUS could have used this provision to take into account the likelihood that USF reform would affect borrowers' revenues, but it chose not to do so.

10. According to RUS, as of December 31, 2010, there was a total of $4.267 billion in principal outstanding on approximately 2,400 loans under the three main broadband programs,

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[3] For a comprehensive description of RUS' broadband subsidy programs, see Lennard G. Kruger, *Broadband Loan and Grant Programs in the USDA's Rural Utilities Service*, Congressional Research Service (October 7, 2010). For a more complete discussion of BIP, see Jeffrey A. Eisenach and Kevin W. Caves, *Evaluating the Cost-Effectiveness of RUS Broadband Subsidies: Three Case Studies*, Navigant Economics LLC (April 13, 2011) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1809002).

[4] As of September 2, 2011, the interest rate on 20-year Treasury bonds is 2.92 percent. By comparison, the authorized rate of return used by the FCC in calculating USF support is 11.25 percent. The difference represents a potential windfall for RLECs, especially those with high debt-to-equity levels, which is likely to be the case for many RUS borrowers.

[5] See generally 7 CFR § 1735 and 7 CFR §1738.

[6] RUS broadband loan and grant programs have been the subject of extensive criticism by the General Accounting Office, the Agriculture Department's Office of Inspector General, and by third-party analysts, most notably for funding broadband projects in areas where service is already available from unsubsidized private providers. See Eisenach and Caves (2011). See also *Statement of the Honorable Phyllis K. Fong, Inspector General, Before the Subcommittee on Communications and Technology, Committee on Energy and Commerce, U.S. House of Representatives* (February 10, 2011) at 3; see also U.S. Government Accountability Office, *Broadband Deployment Is Extensive throughout the United States, but It Is Difficult to Assess the Extent of Deployment Gaps in Rural Areas* (May 2006) at 34 (available at http://www.gao.gov/new.items/d06426.pdf).

[7] See e.g. 7 CFR §1735.51(a). For a description of the feasibility study conducted as part of the process, see 7 CFR §1737.70.

[8] See *RUS Ex Parte Presentation* at 15. *See also Rural Broadband Access Loan and Loan Guarantee Program, Application Guide – RUS Bulletin 1738-1* at 47 (available at http://www.rurdev.usda.gov/supportdocuments/Broadband%20Application%20Guide%203.14.11.pdf, viewed August 18, 2011). Indeed, as discussed further below, RUS counts as projected revenues any *increases* in USF support that are expected to result from the increased costs associated with RUS-financed investments.

[9] See 7 CFR § 1737(c)(2)

including $690 million in guaranteed loans.[10] The agency has not reported the amount of un-advanced commitments (i.e., loans which have been approved but funding has not yet been disbursed), but given the substantial increase in lending that occurred as a result of the BIP program (RUS approved approximately $1.2 billion in BIP loans during 2010,[11] but disbursed only a small fraction of this total.[12]), it clear that the size of the overall loan portfolio has grown.[13]

11. RUS reports that a substantial proportion of RUS broadband borrowers are also USF recipients. According to RUS, all but four of 480 TIP borrowers (99 percent) receive USF funds, along with 10 percent of RBL borrowers and 60 percent of BIP borrowers. Further, the RUS reports that TIP borrowers receive a substantial proportion of their operating revenues from USF – specifically, that over 70 percent of RUS borrowers receive more than 25 percent of their total operating revenues from USF.[14]

12. The *RUS Ex Parte Presentation* warns that USF reform could lead to an "increase in potential defaults"[15] and "affect the ability of the agency to make loans."[16] While USF reform could affect RUS' ability to make loans going forward using its current criteria, this paper demonstrates that RUS' concerns about a significant increase in defaults are overstated and should not be interposed as a barrier to USF reform. Indeed, for the same reasons the FCC seeks to reform USF, the changes in the RUS program that would be required to adapt to a new USF program would be beneficial.

III. USF SUBSIDIES ARE NOT A SOUND FOUNDATION FOR RUS LOAN GUARANTEES

13. RUS' current practice of leveraging USF subsidies to approve loans is flawed for two main reasons. First, as a matter of financial underwriting, RUS explicitly assumes that the subsidies constitute a stable source of revenue over the term of the loan, which may be 20 years

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[10] *RUS Ex Parte Presentation* at 12 and Letter from Jonathan Adelstein, Administrator, Rural Utilities Service, to Julius Genachowski, Chairman, Federal Communications Commission (November 9, 2010) (hereafter *Adelstein Letter*) at 1 (reporting 2,337 active loans as of November 2010).

[11] See http://www.rurdev.usda.gov/Reports/RBBreportV5ForWeb.pdf

[12] See Eisenach and Caves at 6.

[13] See *Adelstein Letter* at 1 ("The RUS telecommunications program currently has over $4.2 billion in outstanding principal, which will increase substantially with awards this year under the American Recovery and Reinvestment Act (ARRA).").

[14] It appears that this figure applies only to TIP borrowers. See *RUS Ex Parte Presentation* at 25.

[15] *RUS Ex Parte Presentation* at 31. The concern about potential defaults is based on an analysis of the potential effect of USF reform on TIER or "Times Interest Earned Ratio" of borrowers, which is calculated as: (Net Income (or Margins) + Total Fixed Charges)/Total Fixed Charges. As defined by RUS, the TIER is a rudimentary measure of a borrower's ability to repay. RUS issues loans to firms which, based on its loan feasibility study, can "maintain a TIER ratio of at least 1.0 during the Forecast Period," typically the first five years after issuance of the loan, See 7 CFR §1735.51(a), and then (typically) to achieve a higher TIER thereafter. RUS considers the long-term stability of borrowers because loan maturities generally mirror the useful life of the supported telecommunications infrastructure projects, which can be 20 years or more. See *RUS Ex Parte Presentation* at 14 (showing average maturities of between 16 and 21 years for the three main loan programs).

[16] *RUS Ex Parte Presentation* at 16.

or more. Second, as a matter of public policy, RUS effectively assumes that the increased USF subsidies that will result from the investment indicate the project is deserving of public support. Both assumptions are incorrect.

14. The USF subsidies at issue come primarily from the USF's High-Cost Fund (HCF), which spends approximately $4.3 billion annually, $3.05 billion of which goes to incumbent telephone companies (and the rest to competitive – primarily wireless – carriers). RLECs receive approximately $2.4 billion through three main programs, High Cost Loop Support (HCLS), Interstate Common Line Support (ICLS) and Local Switching Support (LSS).[17] Subsidies under these programs are based on the carriers' "embedded" cost (as opposed to "forward looking" cost). Thus, carriers receive subsidies based on how high their costs are relative to a national benchmark – the higher a carrier's costs, the higher the subsidy.[18]

15. From the beginning, the FCC has recognized the inefficient incentives associated with the use of embedded cost, stating in the 1997 *First Report and Order* creating the HFC program that, "The use of embedded cost would discourage prudent investment planning because carriers could receive support for inefficient as well as efficient investments."[19] Because it did not have sufficient data to implement a more efficient system (i.e., one based on forward-looking costs), however, it adopted the embedded cost approach on an interim basis, but promised to "commence a proceeding by October 1998 to establish forward-looking economic cost mechanisms for rural carriers."[20]

16. While the process of replacing the embedded cost approach has taken longer than anticipated, the FCC has never wavered in its conviction that the program as currently structured creates poor investment incentives, nor in its commitment to reform the HCF program,[21] and has on several occasions adopted incremental (though still significant) reforms in various aspects of

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[17] See *USF NPRM* at ¶20. See also National Broadband Plan at 141. Rural telephone companies also benefit from outdated intercarrier compensation regulations, which are also the focus of FCC reform efforts. The *RUS Ex Parte Presentation*, however, focuses exclusively on the impact of cutting USF subsidies.

[18] See Jeffrey A. Eisenach, "Universal Service Subsidies to Areas Served by Rural Telephony," Empiris LLC (November 2009) at 9-11 for a more complete explanation of the criteria used to set HCF funding levels (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1910599).

[19] *See* Federal Communications Commission, *In the Matter of Federal-State Joint Board on Universal Service, Report and Order*, CC Docket No. 96-45 (May 8, 1997) at ¶228 (hereafter *First Report and Order*).

[20] *See First Report and Order* at ¶252.

[21] In May 2001, the Commission voted to impose an indexed cap on portions of the HCF, adopted various other reforms to control the fund's spending, and retained the embedded cost approach for five years, until 2006. See Federal Communications Commission, *Fourteenth Report and Order, Twenty-Second Order on Reconsideration, and Further Notice of Proposed Rulemaking in CC Docket No. 96-45, and Report and Order in CC Docket No. 00-256* (May 23, 2001). On August 11, 2006, the Commissioned issued a Public Notice on behalf of the Federal-State Board on Universal Service seeking comment on the use of reverse auctions to determine USF support levels. See *Federal-State Joint Board on Universal Service Seeks Comment on the Merits of Using Auctions to Determine High-Cost Universal Service Support*, FCC 06J-1 (August 11, 2006).

the program, even as it has considered more fundamental reform proposals.[22] USF reform was a top FCC priority throughout the 2000's, and the Commission came very close to approving a sweeping reform plan in late 2008.[23] Indeed, the RUS believed the likelihood of USF reform was sufficiently serious in late 2008 that it submitted comments to the FCC expressing its "concern" about effects of the proposed reforms on the "financial stability" of companies awaiting further disbursements from RUS-approved loans.[24]

17. The current Commission has made USF reform one of its top priorities. The National Broadband Plan, issued in March 2010, offered a comprehensive framework for USF reform, and the FCC followed through in April 2010 with a *Notice of Inquiry*[25] and in February 2011 with the *USF NPRM*. Key members of Congress have expressed strong support for the FCC's efforts.[26]

18. In short, reform of USF subsidies to small telephone companies has effectively been in process throughout the last 15 years. During this period, the FCC has taken numerous steps to limit HCF spending, and has consistently pursued a policy of adopting fundamental reforms that would further reduce the level of support received by RUS borrowers. RUS has

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[22] *See, e.g.,* Federal Communications Commission, *Second Report and Order and Further Notice of Proposed Rulemaking in CC Docket No. 00-256, Fifteenth Report and Order in CC Docket No. 96-45, and Report and Order in CC Docket Nos. 98-77 and 98-166* (Released November 8, 2001).

[23] FCC Commissioner Robert McDowell has testified before Congress that four of the five FCC commissioners were prepared to adopt fundamental USF reform in late 2008, but the Chairman chose not to circulate the proposal for a vote. See http://democrats.energycommerce.house.gov/sites/default/files/image_uploads/Transcript_CAT_05.13.11.pdf at 42 and 50.

[24] See *Rural Utilities Service Reply Comments on the FCC Proposals for Intercarrier Compensation and Universal Service Reform*, WC Docket No. 05-0337, CC Docket No. 96-45, CC Docket No. 01-92 (December 22, 2008) at 1-2 ("In a recent study of 350 borrowers reporting to RUS as of December 31, 2007, we calculate that 265 of those borrowers need more than $20 per month per customer to remain financially viable. Those 265 borrowers have approximately $2.1 billion in loans outstanding to RUS. Further, 137 of these borrowers need over $50 per month per customer. Depending on the severity of any revenue reduction, borrowers may be adversely impacted in terms of their ability to make debt service payments…. RUS is concerned that 'frozen High Cost Support,' particularly at the company level, may prove detrimental to our ability to advance these loans funds, as the financial stability of these companies will become uncertain. A recent analysis of borrowers receiving loans shows that 53% of those loans would not be feasible with frozen USF.")

[25] See *In the Matter of Connect America Fund*, WC Docket No. 10-90, GN Docket No. 09-51, WC Docket No. 05-337 (April 21, 2010), esp. at ¶51 ("[T] today we seek comment on capping legacy high-cost support provided to incumbent telephone companies at 2010 levels, which would have the effect of creating an overall ceiling for the legacy high-cost program."). In releasing the notice, Chairman Genachowski commented that "Today's Notices suggest commonsense reforms to cap growth and cut inefficient funding of voice networks." See http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-10-58A2.pdf.

[26] See Remarks of Rep. Greg Walden, Chairman, House Energy and Commerce Subcommittee on Communications and Technology before the Oregon Telecommunications Association & Washington Telecommunications Association (June 7, 2011) ("I am encouraged by the FCC efforts on both intercarrier compensation reform and Universal Service Fund reform, and I appreciate the hard work of Chairman Genachowski, the other FCC Commissioners, and the FCC staff on these issues.") (available at http://energycommerce.house.gov/News/PRArticle.aspx?NewsID=8682).

been fully aware of these actions. Under these circumstances, RUS' decision to treat USF subsidies as a stable source of revenue for repayment for loans with maturities of 20 years or longer is at best highly questionable.

19. In addition to representing questionable fiduciary judgment, RUS' policy of lending money on the basis of USF subsidies effectively magnifies the inefficient incentives that have plagued the current HCF since its inception. In language that echoes concerns it first identified when the program was created in 1997, the Commission highlighted the incentives problem in its unanimously-approved February 2011 *USF NPRM*:

> As currently structured, [the HCF] funding mechanisms *provide poor incentives for rate-of-return carriers to operate and invest efficiently*.… HCLS, for example, *creates incentives for companies to outspend their peers* in order to receive more funding under the current capped formula. For all three programs, *there are few, if any, benchmarks for determining whether network investment is justified or appropriate, allowing a company to spend millions of dollars to build a state-of-the art network that may serve only a few customers*.[27]

Specifically, the Commission presented evidence showing that "even as [high-cost RLECs] experienced increasing rates of access line loss, their investment in net plant continued to increase. This may suggest that these companies continue to invest and upgrade their networks more than otherwise would be considered prudent for a company that is losing customers."[28]

20. Thus, rather than signaling the social value of a particular infrastructure project, HCF subsidies under the current system may instead indicate nothing more than an individual firm's success in making investments – however unjustified or inappropriate – solely to increase its USF support. By tying RUS loans directly to USF support, RUS effectively creates a vicious circle: The more a firm invests in inefficient infrastructure, the more it gets in USF support; the more it gets in USF support, the more it can qualify for in RUS loans; the more it can qualify for in RUS loans, the more it can invest; and, the more it invests, the more it gets in USF support.[29]

21. A table in the *RUS Ex Parte Presentation* (reproduced as Exhibit One below)[30] provides a basis for estimating the significance of the interaction between USF subsidies and RUS loans as incentives for inefficient investment. The table appears to show that the 113 loans made to TIP borrowers in 2008-2011 (totaling $2.23 billion) were expected to result in more than

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[27] *USF NPRM* at ¶21 (emphasis added). See also *USF NPRM* at ¶171 ("[T]he rate-of-return regulatory framework provides universal service support to both a well-run company operating as efficiently as possible given the geography and demography of its service area, and a company with high costs due to or exacerbated by imprudent investment decisions, bloated corporate overhead, or an inefficient operating structure.")

[28] *USF NPRM* at ¶178.

[29] The incentive this cycle provides for inefficient investment creates an additional harm in that it penalizes those LECs that are more prudent in their investments. These companies receive less USF support and consequently are less attractive borrowers to RUS.

[30] *RUS Ex Parte Presentation* at 38.

doubling the annual USF subsidies received by the borrowers, from $107.4 million (the "pre-loan amount USF" shown in the right-hand column) to $235.7 million (the "amount of RUS USF projection" shown in the middle column), an increase of $128 million.[31]

EXHIBIT ONE

Existing and RUS Projected USF (thousands)

Reduction in RUS USF Projection	FY 2010-11 Amount of RUS USF Projection	FY 2010-11 Preloan Amount USF
0% Reduction	$235,683	$107,415
10%	$212,115	
15%	$200,331	
20%	$188,546	
25%	$176,762	
30%	$164,978	
40%	$141,410	
50%	$117,842	

Based on an average maturity of 20 years and an average interest rate of 4.16 percent, I estimate the annual interest and principal payments on the $2.23 billion in loans at issue (those approved between 2008 and 2010) was approximately $165 million/year. Thus, the increased USF subsidies produced by the RUS-financed investments ($128 million/year) covered over three quarters of the annual interest and principal payments on the loans ($128 million/$165 million = 78 percent), leaving borrowers themselves responsible for less than 25 percent of the payments, even though they earn 100 percent of the resulting profits.[32] The combination of the two programs thus provides far stronger incentives for socially undesirable investments than either of them separately, while placing taxpayers in the fundamentally unsound fiscal position of being the primary source of repayment on their own outstanding loans. Especially at a time when Congress is rightly focused on sound fiscal management, these programs are ripe for reform.

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[31] The last page of the *RUS Ex Parte Presentation* contradicts the table on p. 38, and seems to indicate that RUS' projection of $128 million in increased USF support was based solely on the $867 million in loans made during 2010-11 (YTD). If this were correct, the increased USF payments would be approximately double the annual payments on the RUS loans. Accordingly, we assume the information on p. 38 is correct.

[32] I calculated the annual payment on $2.23 billion using the average 20-year Treasury Bond rate for 2008-2010 (see http://www.federalreserve.gov/Releases/h15/data.htm), assuming level payments over a 20-year period, and also assuming, conservatively, no opportunities for favorable refinancing. Looking to the future, the *USF NPRM* proposes to limit the extent to which Connect America Fund broadband subsidies duplicate the support provided by other agencies. See *USF NPRM* at ¶323 ("We propose to require additional applicant certifications to avoid funding the deployment of broadband in an area where broadband deployment is funded by other sources (i.e., other federal or state broadband grants to the same or other carriers in a given area.").

IV. USF REFORM SHOULD NOT CAUSE SIGNIFICANT DEFAULTS ON OUTSTANDING LOANS

22. The *RUS Ex Parte Presentation* presents a static analysis of the projected effects of immediate, across-the-board reductions in USF subsidies ranging from five percent to as much as 50 percent in USF revenues or, even more severely five to 50 percent of Net Operating Revenues. Based on these assumptions, it projects the proportion of outstanding loans that would fall below various TIER ratios. For example, it claims that, for the 38 loans made in FY 2009, an across-the-board 20 percent reduction in USF subsidies would cause 19 (45 percent) of the borrowers to fall below the 1.25 percent TIER standard preferred by RUS,[33] and that 13 would fall below the minimum desired TIER of 1.0.[34]

23. RUS' calculations are neither representative nor realistic. While any analysis of potential defaults is necessarily speculative given the uncertainty about the details of the FCC's new regime, USF reform is unlikely to result in significantly increased defaults for three primary reasons, two of which have to do with USF reform itself and the third of which relates to the nature of RUS borrowers. First, while the FCC has made clear its intention to *reform* USF subsidies, it has been equally clear that it does not intend to significantly reduce the total level of high-cost support below current levels. Instead, its goal in the short run is to distribute funds more equitably;[35] and, in the long run it seeks to repurpose subsidies into a new "Connect America Fund" that would be focused on supporting broadband in areas where there is no business case for broadband investment absent subsidies.[36] While the precise impact on current RUS borrowers is unknown, there does not seem to be any basis for predicting that RUS borrowers, individually or as a group, will lose so much support that they will not be able to repay their RUS loans.

24. Second, the FCC has also been clear that any USF reforms it adopts will be incremental and gradual in nature.

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[33] *RUS Ex Parte Presentation* at 37.

[34] *RUS Ex Parte Presentation* at 37. It should be noted that the RUS analysis is limited to the RLEC-heavy TIP program, and does not include loans from either the BPL or BIP programs, many of which involve borrowers that do not receive USF support.

[35] See, e.g., *USF NPRM* at ¶21 ("We seek comment on …[r]educing the reimbursement rates for the current high-cost loop program, in order to distribute funding—which has been capped since the 1990s—in a more equitable manner among rural carriers. Today, high-cost loop support largely goes to companies that have accelerated network upgrades throughout their territory, leaving nothing available for other smaller companies that choose to upgrade their networks more incrementally.")

[36] *USF NPRM* at ¶23 ("We seek comment on the appropriate size of these programs. We propose that, together with remaining high-cost support, total disbursements remain no greater than the high-cost program would be under current rules. We seek comment, however, on whether total disbursements should be lower in the future to minimize the burden on consumers. In light of the high costs that would be required to ensure ubiquitous mobile coverage and very-high-speed broadband for every American and the length of the transition to the proposed Connect America Fund, we also seek comment on whether additional investments in universal service may be needed to accelerate network deployment.")

> As we proceed with USF and ICC reform, we intend to avoid sudden changes or "flash cuts" in our policies, acknowledging the benefits of measured transitions that enable stakeholders to adapt to changing circumstances and minimize disruption.[37]

The earliest date at which the FCC proposes to implement significant reforms in the HFC is 2012 and these reforms likely would be phased in over a period of several years. To the extent prior-year RUS loans were premised on increases in USF support resulting from the increased investment, the vast majority of those investments have already occurred, and the increased USF support presumably has already materialized.[38]

25. Third, to the extent the proposed reforms ultimately result in reductions in USF support for some RLECs, those reductions would not necessarily flow through to the RLECs' bottom lines, nor affect the companies' ability to service their RUS loans. Instead, RLECs would react the way that all other providers in the marketplace react to changing circumstances – by adapting their strategies in ways that attempt to reduce costs and increase revenues. For example, many RUS borrowers not only provide voice and broadband services, but they also provide multichannel video services over their supported facilities.[39]

26. Finally, it should also be noted that borrowers whose TIER ratios fall below the desired level do not necessarily default on their loans. Indeed, about one in four TIP borrowers had TIERs below 1.25 in each of the last three years, and about one in five had TIERs below 1.0.[40] Yet the default rate on RUS borrowing is below one percent.[41]

V. RUS SHOULD IMPLEMENT A MORATORIUM ON LOANS TO USF-SUPPORTED COMPANIES

27. After many years of attempting to implement much-needed reforms in USF, the FCC is finally on the verge of making fundamental changes. RUS now argues that such reforms threaten to throw large numbers of RUS borrowers into default, implicitly suggesting that such reforms should be delayed, diluted or dropped.

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[37] *USF NRPM* at ¶12.

[38] RUS loans generally require that construction be complete within three years of when funds become available. See *Broadband Application Guide* at 7.

[39] See, e.g., Co-op lands $70M loan for broadband buildout, Montana Standard (July 28, 2011) ($70 million RUS loan will enable 3 Rivers Telephone Cooperative to "introduce a new, digital television service that is carried over fiber-optic lines.") (available at http://mtstandard.com/news/state-and-regional/co-op-lands-m-loan-for-broadband-build-out/article_0983ad2e-b8c5-11e0-85db-001cc4c002e0.html).

[40] *RUS Ex Parte Presentation* at 27.

[41] See *Adelstein Letter* at 2. In the event of a default, RUS' regulations require that it obtain a first lien on *all* of its borrowers' assets. Accordingly, the Office of Management and Budget projects that, even for the very low percentage of loans expected to default, taxpayers would recover between 76 percent and 100 percent of the outstanding principal. See Office of Management and Budget, *Federal Credit Supplement, Budget of the United States Government, Fiscal Year 2012*, at 25.

28. The analysis above shows that RUS' predictions of significant defaults on outstanding loans are speculative. For borrowers who have completed their RUS-subsidized projects, and who have thus begun receiving the additional USF support RUS counted on for loan repayment, the FCC's transitional approach to reform will ensure that any cuts (from current levels) are done in a way that allows borrowers to "adapt to changing circumstances."

29. For projects not yet underway, the RUS is correct that new RUS-financed investments will no longer automatically generate large increases in USF support, and that the FCC therefore cannot be counted on as a source of repayment dollars for RUS loans on a going forward basis. This, however, is a desirable result, as it means that the vicious cycle of USF/RUS support for economically unjustifiable investments will finally be broken.

30. A strong argument can be made that RUS should have stopped counting USF revenues (or at least discounted those revenues) in its loan qualification calculations some time ago. Yet, despite the imminence of FCC action, it has continued making loans, including $260 million in new loans to 12 rural telephone companies announced by the Secretary of Agriculture on July 27, 2011 and August 22, 2011.[42] While the RUS does not reveal the basis for its loan decisions, there is every reason to believe that it qualified the new loans on the assumption that USF subsidies to the new borrowers – which totaled roughly $35 million in 2010 – will increase dramatically as a result of their new investments. The best that can be said of this assumption is that it seems unrealistic under the circumstances.

31. The only reasonable assumption for the RUS to make at this stage is that USF revenues can no longer be counted upon to service future loans, whose maturities stretch two decades or more into the future. Fiduciary responsibility thus requires that the agency stop making loans on the assumption that USF funds – especially increases in USF funds – will be available to pay principal and interest. Accordingly, the agency should implement an immediate moratorium on further loans to USF-supported entities, or require such entities to qualify for any further loans without relying on USF subsidies. After the FCC concludes its proceeding and new rules are in place, Congress and RUS can reassess whether a loan program continues to be needed and if so, how that program can be better coordinated with the USF program to eliminate the problems inherent in the current RUS regime.

VI. CONCLUSION

32. The RUS broadband loan program has been troubled throughout its history, with independent auditors repeatedly criticizing the agency's failure to target funding to areas without pre-existing broadband services. As demonstrated above, RUS loans also exacerbate the underlying inefficiencies in the USF program, effectively rewarding companies that make

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[42] See http://www.usda.gov/wps/portal/usda/usdahome?contentidonly=true&contentid=2011/07/0322.xml and http://www.usda.gov/wps/portal/usda/usdahome?contentidonly=true&contentid=2011/08/0375.xml. Note that one loan, to the Coleman County Telephone Cooperative Inc. for $22,540,000, appears to have been announced twice.

excessive investments in unnecessary infrastructure. With USF reform now nearing the finish line, it is likely that the flawed criteria that have heretofore allowed RUS borrowers to fund uneconomic loans with increased subsidies from the FCC will soon be reformed. Further RUS loan activity should be put on hold at least until those reforms are in place.