Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Federal-State Joint Board on	)	
Universal Service	)	CC Docket No. 96-45
	)	
National Telephone Cooperative Association	)	
Petition for Reconsideration	)	

ORDER AND ORDER ON RECONSIDERATION

Adopted: January 4, 2005 **Released: January 10, 2005**

By the Commission:

I. INTRODUCTION

1. In this Order and Order on Reconsideration, we amend section 54.305 of the Commission's rules so that it does not apply to transfers of exchanges between non-rural carriers after the phase-down of interim hold-harmless support, and we grant a request by the National Telephone Cooperative Association (NTCA) to provide that rural carriers may receive "safety valve" support for investment made in the first year of operating acquired exchanges.[1] Based on the record before us, these actions better satisfy our policy goals of ensuring that acquiring carriers receive sufficient high-cost support and preserving the purpose of section 54.305 of discouraging carriers from transferring exchanges merely to increase their share of high-cost universal service support.

II. BACKGROUND

2. __Section 54.305__. Section 54.305 of the Commission's rules provides that a carrier acquiring exchanges from an unaffiliated carrier shall receive the same per-line levels of high-cost universal service support for which the acquired exchanges were eligible prior to their transfer.[2] Section

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[1] *See* 47 C.F.R. § 54.305; National Telephone Cooperative Association, Petition for Reconsideration and Clarification; CC Docket Nos. 96-46, 00-256, filed July 5, 2001 (NTCA Petition). The Commission adopted the safety valve support mechanism in the *Rural Task Force Order*. *See Federal-State Joint Board on Universal Service; Multi- Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, 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, 16 FCC Rcd 11244,11281-93, paras. 91-119 (2001), as corrected by Errata, CC Docket Nos. 96-45, 00-256 (Acc. Pol. Div. rel. June 1, 2001) (*Rural Task Force Order*).

[2] 47 C.F.R. § 54.305. For example, if a rural carrier purchases an exchange from a non-rural carrier that receives support based on the Commission's high-cost support mechanism for non-rural carriers the loops of the acquired exchange shall receive the same per-line support as calculated under the non-rural mechanism, regardless of the support the rural carrier purchasing the exchange may receive for any other exchanges. The mechanism for non-

(continued....)

54.305 was adopted in the *Universal Service First Report and Order* as an interim measure aimed at discouraging carriers from transferring exchanges merely to increase their share of high-cost universal service support.[3] The Commission was concerned that, while support is calculated for carriers based on separate rural and non-rural mechanisms, potential universal service payments may unduly influence a carrier's decision to purchase exchanges from other carriers.[4]

3. When the Commission adopted the forward-looking mechanism for non-rural carriers, it also adopted an interim hold-harmless provision to ensure that no sudden or undue disruption in consumer rates occurs during the transition to the forward-looking mechanism.[5] The Commission subsequently adopted measures requiring that interim hold-harmless support be phased down for non-rural carriers beginning January 1, 2001.[6] Interim hold-harmless support transferred to non-rural carriers pursuant to section 54.305 is also phased down, but interim hold-harmless support transferred to rural carriers is not.[7] The Commission sought comment on whether to continue to apply section 54.305 of its rules to transfers of exchanges between non-rural carriers following the phase-down of hold harmless support.[8] When the Commission sought comment on this rule change, it indicated a strong likelihood that it would adopt the

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rural carriers directs support to carriers based on the forward-looking economic cost of operating a given exchange. *See* 47 C.F.R. § 54.309. Rural carriers, on the other hand, receive high-cost loop support based on the extent to which their reported average cost per loop exceeds 115 percent of the nationwide average cost per loop. See 47 C.F.R. §§ 36.601-36.631.

[3] *See Federal-State Joint Board on Universal Service,* CC Docket No. 96- 45, Report and Order, 12 FCC Rcd 8776, 8942-43 (1997) (*Universal Service First Report and Order*), as corrected by Federal-State Joint Board on Universal Service, Errata, CC Docket No. 96-45, FCC 97-157 (rel. June 4, 1997*), affirmed in part, reversed in part and remanded in part sub nom. Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393 (5th Cir. 1999), *cert. denied*, 530 U.S. 1210 (2000), *cert. dismissed*, 531 U.S. 975 (2000).

[4] *See Universal Service First Report and Order,* 12 FCC Rcd at 8942-43 para. 308.

[5] *Federal-State Joint Board on Universal Service*, Ninth Report and Order, 14 FCC Rcd 20432, 20473, paras. 79 (*Ninth Report and Order*), *remanded*, *Qwest Corp. v. FCC*, 258 F.3d 1191 (10th Cir. 2001) (*Qwest*); *Federal-State Joint Board on Universal* Service, Order on Remand, Further Notice of Proposed Rulemaking, and Memorandum Opinion and Order, CC Docket 96-45, 18 FCC Rcd 22559 (2003) (*Tenth Circuit Remand Order*), *appeal pending sub nom. Qwest Communications International Inc. v. FCC & USA*, Tenth Cir. No. 03-9617; *SBC Communications Inc. v. FCC & USA*, Tenth Cir. No. 04-9518; and *Vermont Public Service Board v. FCC & USA,* Tenth Cir. No. 04-9519.

[6] *See Federal-State Joint Board on Universal Service*, Thirteenth Report and Order and Further Notice of Proposed Rulemaking, CC Docket No. 96-45, 15 FCC 24422 (2000) (*Thirteenth Report and Order*). Specifically, the Commission determined that interim hold-harmless support, excluding long term support (LTS), would be phased down beginning January 1, 2001, through annual $1.00 reductions in each carrier's average monthly, per-line support until that support is eliminated. *See id.* at 24426, 24428, paras. 9, 12. The Commission consolidated LTS into Interstate Common Line Support (ICLS) and eliminated LTS as a distinct mechanism, effective July 1, 2004. *See Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, CC Docket No. 00-256, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Report and Order and Second Further Notice of Proposed Rulemaking, 19 FCC Rcd 4122, 4150-53 paras. 61-67 (2004), as corrected by Errata, CC Docket Nos. 96-45, 00-256, 19 FCC Rcd 6872 (Pricing Pol. Div. 2004).

[7] The Commission adopted the Joint Board's recommendation not to phase down interim hold-harmless support for exchanges transferred to rural carriers until it reexamines section 54.305 or until rural high-cost reform is complete. *See Thirteenth Report and Order*, 15 FCC Rcd at 24433, para. 21.

[8] *Id*. at 24434, paras. 23-24

proposed change.[9] No parties filed comments opposing this proposed rule change.[10]

4. In the *Rural Task Force Order*, the Commission found that section 54.305 should be retained, but modified it to provide safety valve support to rural carriers that make substantial investment after acquiring exchanges.[11] While the Commission reiterated its support for section 54.305's intended purpose of discouraging carriers from transferring exchanges merely to increase their share of high-cost universal service support, the Commission also recognized that section 54.305 may have the unintended consequence of discouraging rural carriers from acquiring high-cost exchanges from carriers with low average costs and preventing rural carriers from receiving support for new investments in recently-acquired high-cost exchanges.[12]

5. Specifically, the Commission found that safety valve support should be provided for up to 50 percent of any positive difference between the rural incumbent local exchange carrier's index year expense adjustment for the acquired exchanges and subsequent year expense adjustments.[13] The Commission further found that, for purposes of determining a rural carrier's safety valve support, the index year expense adjustment shall be defined as the high-cost loop support expense adjustment for the acquired exchanges calculated at the end of the company's first year of operating the exchanges.[14] The total safety valve support available to all eligible study areas is limited to no more than five percent of rural incumbent local exchange carrier support available from the annual high-cost loop fund.[15]

6. The Commission declined to define the index year expense adjustment as prior to the end of an acquiring carrier's first year of operations of the acquired exchanges.[16] Because rural carriers most often acquire high-cost exchanges from non-rural carriers operating in large study areas with lower average costs, the Commission concluded that it would be inappropriate for acquiring carriers to rely on the cost data of selling carriers in establishing the index year expense adjustment.[17] The Commission also stated that establishing the index year expense adjustment prior to the end of acquiring carriers' first year of operations also would result in additional filing requirements beyond those included in sections 36.611 and 36.612 of the Commission's rules.[18]

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[9] *See id*. at 24434 para. 24. ("We believe this rule change is necessary . . . because application of section 54.305 to transfers between non-rural carriers may impede operation of the forward-looking mechanism by preventing calculation of the forward-looking economic costs of operating a transferred exchange on an ongoing, quarterly basis.").

[10] *But see* NTCA Comments; Valor Reply Comments (requesting that the Commission repeal or amend section 54.305 as it applies to transfers of exchanges from non-rural to rural carriers).

[11] *See Rural Task Force Order*, 16 FCC Rcd at 11284, para. 97.

[12] *See id*. at 11284, para. 97.

[13] *See id*. at 11285, para. 98.

[14] *See id*. at 11285, para. 99.

[15] If the total amount of eligible safety valve support in a given year exceeds the five percent cap, the percentage used to calculate safety valve loop cost expense adjustment will be reduced until all safety valve support fits under the five percent cap. That is, in such years, carriers eligible for safety valve support will receive less than 50 percent of the positive difference between the subsequent year expense adjustment and the index year expense adjustment. *See id*. at 11288-89, paras. 107-109.

[16] *See id*. at 11287, para. 103.

[17] *See id*. at 11287, para. 103.

[18] *See id*. at 11287, para. 103; 47 C.F.R. §§ 36.611, 36.612.

7. *NTCA's Petition for Reconsideration*. On July 5, 2001, NTCA filed a petition for reconsideration in response to the *Rural Task Force Order*.[19] Among other things, NTCA requested that the Commission further amend its rules to provide safety valve support for the first year of operation of acquired exchanges.[20] NTCA argues that because acquiring carriers must wait until the end of their first year of operation to establish their index year expense adjustment and begin receiving safety valve support, the safety valve rules create a "considerable disincentive" for rural carriers to invest in that first year.[21] NTCA asserts that this has an adverse effect on both consumers and rural carriers, because carriers operating acquired exchanges frequently make substantial investments in the first year of operation in an effort to upgrade old and inefficient equipment, and the first year after acquisition is the most significant year for the acquiring carrier to establish a good working relationship with consumers in the acquired exchange.[22] NTCA claims that, "[w]ithout sufficient universal service support to assist rural carriers during the first year to implement necessary upgrades to acquired exchanges, the acquiring carrier's first year of operation can result in continued poor service and customer disdain."[23]

8. NTCA's petition requests that the Commission amend its rules to permit carriers to receive safety valve support for the first year of operation of acquired exchanges. NTCA proposes that the selling carrier's expense adjustment at the time of the sale be used as the index year expense adjustment to determine safety valve support for the first year of operation of the acquired exchanges.[24] In subsequent years, the index year expense adjustment would be the acquiring carrier's expense adjustment calculated at the end of the company's first year of operating the acquired exchanges and safety valve support would be calculated the same as it is calculated under the current rules.[25] NTCA asserts that this would create the proper incentive for rural carriers to invest in the acquired exchanges without delay and provide consumers with improved service within the first year after acquisition. NTCA argues that the Commission's concerns regarding the inappropriateness of acquiring carriers relying on the cost data of selling carriers to establish the index year expense adjustment would be mitigated significantly because the selling carrier's expense adjustment would be used for determining the safety valve support only for the first year.[26]

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[19] Although the Commission resolved certain portions of NTCA's request for reconsideration of the *Rural Task Force Order* in earlier orders, the Commission specifically deferred any resolution of NTCA's request to amend its rules to provide safety valve support for the first year of investment in acquired exchanges. *See Federal-State Joint Board on Universal Service; Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, CC Docket Nos. 96-45, 00-256, Order on Reconsideration, 17 FCC Rcd 11472 (2002) (addressing petitions for reconsideration filed by the Coalition of Rural Telephone Companies, the Competitive Universal Service Coalition, the Illinois Commerce Commission, and NTCA). The Commission also corrected on its own motion an issue raised by NTCA. *See Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Twenty-Third Order on Reconsideration, 16 FC Rcd 14097 (2001) (correcting calculation of safety net additive support). This order fully resolves NTCA's petition.

[20] *See* NTCA Petition at 4-8; *supra* note 1.

[21] *See id*. at 1.

[22] *See id*. at 4.

[23] *See id*. at 5.

[24] For the first year of operation only, the acquiring carrier's first year expense adjustment would be compared to the seller's index year expense adjustment to determine any positive difference eligible for safety valve support in the acquiring carrier's first year of operation. *See id*. at 6.

[25] *See id*. at 6.

[26] *See id*. at 6-7. NTCA also argues that state regulatory review and competitive pressures prevent rural carriers from investing unwisely in acquired exchanges. *Id*. at 8.

III. DISCUSSION

9. We amend section 54.305 of the Commission's rules so that it does not apply to transfers of exchanges between non-rural carriers after the phase-down of interim hold-harmless support.[27] The Commission adopted section 54.305 "as a stopgap measure to prevent carriers receiving support based on the size of their study areas and embedded costs from 'placing unreasonable reliance upon potential universal service support in deciding whether to purchase exchanges[.]'"[28] The Commission anticipated that the rule would no longer be necessary once all carriers receive support based on forward-looking economic costs.[29] When all non-rural carriers receive support based on forward-looking economic costs once the phase-down of interim hold-harmless support is complete, we find that the need for section 54.305 will no longer exist with regard to transfers between non-rural carriers. Accordingly, after the complete phase-down of interim hold-harmless support, section 54.305 will not be applicable to the sale or transfer of exchanges between non-rural carriers.

10. We agree with NTCA that we should amend section 54.305 of our rules to provide that rural carriers that acquire high-cost exchanges may receive safety valve support for the investment made in the first year of operating the acquired exchanges. We conclude that this modification to the existing safety valve mechanism is necessary to provide appropriate incentives for rural carriers operating recently acquired exchanges to invest in rural infrastructure. Accordingly, we amend section 54.305 to provide that the index year expense adjustment for purposes of determining safety valve support for the first year of operation shall be defined as the seller's expense adjustment for the twelve-month period prior to the transfer of the exchanges.

11. While we continue to believe that section 54.305 serves the important purpose of discouraging carriers from transferring exchanges merely to increase their share of high-cost support, we are persuaded that the current safety valve rules may have the unintended effect of discouraging investment in newly acquired exchanges during the first year of operation.[30] The current rules not only prevent carriers from receiving safety valve support for any investments made in their first year of operation, but also may encourage carriers to keep first year investment as low as possible in order to maximize safety valve support in subsequent years.[31] Because safety valve support is calculated by taking fifty percent of the difference between the expense adjustment in the index year and the expense

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[27] No non-rural carriers received interim hold-harmless high-cost loop support for 2004. With the consolidation of LTS into ICLS, no carriers will receive interim hold-harmless LTS support in the Third Quarter of 2004 or thereafter. *See supra* note 6.

[28] *Thirteenth Report and Order*, 15 FCC Rcd 24434, para. 23 (quoting *First Universal Service Report and Order*, 12 FCC Rcd at 8942-43, para. 308).

[29] *See First Universal Service Report and Order*, 12 FCC Rcd at 8942-43, para. 308 ("We note that, when all carriers receive support based on forward-looking economic costs, the level of support will not be a primary factor in a carrier's decision to purchase exchanges because the carrier's support will not be based on the size of the study area nor embedded costs.).")

[30] *See* NTCA Petition at 6 ("The proposed rule changes will create the proper incentive for rural carriers to invest in the acquired exchange without delay and provide consumers living in these . . . exchanges with improved service within the first year after acquisition."); CenturyTel Comments at 3 ("Although most of the rules adopted in the RTF Order encourage rural investment, failure to permit acquiring carriers to receive safety valve support for first year investment has the effect of discouraging immediate post-acquisition investment in newly acquired exchanges.").

[31] *See* CenturyTel Comments at 3 ("Moreover, as Legg Mason has noted, the safety valve mechanism has the perverse effect of inducing carriers to postpone investment until the second year of operation in an effort to keep the first year expense adjustment low with a more pronounced difference in subsequent years, which will yield higher support payments.").

adjustment in subsequent years, a lower index year expense adjustment would result in more safety valve support than a higher index year expense adjustment.

12. We are persuaded that the current safety valve formula may prevent rural carriers that make substantial investment in acquired exchanges from receiving the full benefits intended under the safety valve mechanism. One commenter notes that state commissions may require companies to make needed investments and upgrade facilities as a condition of approval of the transfer.[32] If a state commission requires investment in the first year, the acquiring carrier may make substantial investments to enhance the network infrastructure, but would be unable to receive any additional support for that first-year investment.

13. We conclude that making safety valve support available for investment made in the first year of operation is more consistent with the purpose of the safety valve mechanism to provide additional support to rural carriers that acquire high-cost exchanges and make post-transaction investments to enhance network infrastructure than the current rule.[33] Providing safety valve support for first year investment will provide the proper incentives, and carriers will not delay investment solely because our rules would provide more safety valve support in subsequent years. Carriers that make investments in the first year of operation will receive safety valve support for the investments they make in the acquired exchanges.

14. We find that NTCA's proposal to use the selling carrier's expense adjustment for the index year expense adjustment is a reasonable way to calculate safety valve support for the first year. Although the Commission previously said that it would be inappropriate to rely on the cost data of selling carriers in establishing the index year expense adjustment, upon reconsideration, we find that the benefits of providing safety valve support for first year investment outweigh any risks of using the seller's expense adjustment in this limited manner. We agree with NTCA that concerns regarding reliance on the seller's cost data are mitigated because the selling carrier's expense adjustment would be used only for the first year.[34] We also note that the Commission based its concerns on the fact that "rural carriers most often acquire high-cost exchanges from non-rural carriers operating in large study areas with lower average costs."[35] Because non-rural support is targeted to high-cost wire centers, however, the selling carrier's

[32] *See* CenturyTel Comments at 5 ("Additionally, state commissions that are aware of past infrastructure neglect by larger selling carriers may request or require companies buying those properties to make needed investments, replace switches, deploy broadband, or meet higher quality standards. For example, as part of CenturyTel's acquisition of several rural exchanges from a large carrier, the Wisconsin state commission required CentryTel to replace the seller's outdated switches, as one of the conditions of its approval of the transfer."). Worldcom claims that "there is no evidence that a one-year delay would in any way harm customers in the acquired exchanges, particularly since the types of upgrade projects that the safety valve mechanism is intended to support are unlikely to be planned and engineered to any significant degree prior to the end of the first year." Worldcom Comments at 3-4. CenturyTel states, however, that a year or more may lapse between the time the seller decides to sell the exchanges and the actual closing. *See* CenturyTel Comments at 4. This probably would provide time for the acquiring carrier to plan upgrades for the first year, particularly if they were required as a condition of the sale.

[33] *See Rural Task Force Order*, 16 FCC Rcd at11284, para. 97.

[34] *See* NTCA Petition at 7 ("The Commission's concerns would therefore be mitigated significantly by the fact that the seller's cost data, is only used for a first year comparison and consumers are provided with immediate relief during the critical first year after acquisition."); *see also* CenturyTel Comments at 6 ("CenturyTel fully supports the NTCA proposal to use the seller's costs as an interim baseline to compensate safety valve support during the first year following an acquisition of rural [sic] lines by a rural carrier. Century believes that the limitations that NTCA proposes will ameliorate any threat to the universal service fund that the use of the seller's costs might otherwise create.").

[35] *See Rural Task Force Order*, 16 FCC Rcd at11287, para. 103.

expense adjustment for transferred high-cost exchanges will be higher than the average support per line in the non-rural study area.[36]

15. We disagree with commenters that claim that this limited use of the seller's expense adjustment to provide safety valve support for investment in the first year of operating an acquired exchange would create a "substantial risk that the acquiring carrier would receive more support than necessary,"[37] and would "drive up the price of the exchange."[38] Section 54.305 will continue to limit the acquiring carrier's support to the per line amount the selling carrier received and the additional safety valve support for post-acquisition investment, which is limited to fifty percent of the difference between the index year and subsequent year expense adjustments. Such limitation effectively prevents the acquiring carrier from receiving more support than necessary. Moreover, the total amount of safety valve support available to all eligible study areas is limited to no more than five percent of rural incumbent local exchange carrier support available from the annual high-cost loop fund.[39] We do not believe that the additional safety valve support provided in the first year will encourage carriers to transfer exchanges merely to increase their share of high-cost support.

16. Moreover, we find that NTCA's proposal to use the selling carrier's expense adjustment for the index year expense adjustment is an administratively efficient way to calculate safety valve support for the first year and preferable to other proposed alternatives.[40] Using the selling carrier's expense adjustment prior to the sale will not impose any additional filing requirements on carriers and should be readily available from the Universal Service Administrative Company (USAC).[41]

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[36] *See Ninth Report and Order*, 14 FCC Rcd at 20470-73, 20476-78, paras. 68-76, 82-86. In the *Ninth Report and Order*, the Commission adopted rules targeting high-cost model support and interim hold-harmless support to high-cost wire centers based on the cost estimates generated by the Commission's forward-looking cost model. *See Federal-State Joint Board on Universal Service, Forward-Looking Mechanism for High Cost Support for Non-Rural LECs*, Tenth Report and Order, CC Docket Nos. 96-45, 97-160, 14 FCC Rcd 20156 (1999) (*Tenth Report and Order*), *affirmed*, *Qwest*, 258 F.3d 1191. The court did not remand the targeting rules. *See supra* note 5.

[37] Worldcom Comments at 3.

[38] AT&T Opposition at 4.

[39] *See supra* para. 5.

[40] The Commission previously rejected proposals that would permit acquiring carriers to rely on projected costs to establish their index year expense adjustment, because "[s]uch a proposal would provide acquiring carriers with incentives to underestimate their expenses in the index year in order to maximize future safety valve support." *Rural Task Force Order*, 16 FCC at 11287, para. 103. Using projected costs also would impose additional administrative burdens because support amounts would have to be trued-up. In reply comments, NTCA proposed another alternative, which we reject below. *See* para. 17

[41] In the *Rural Task Force Order*, the Commission stated that "[e]stablishing the index year expense adjustment prior to the end of acquiring carriers' first year of operations also would result in additional filing requirements beyond those included in sections 36.611 and 36.612 of our rules." *Rural Task Force Order*, 16 FCC Rcd at 11287, para. 103. This statement refers to the proposal rejected by the Commission to rely on projected expenses to establish the acquiring carrier's index year expense adjustment. Relying on the selling carrier's expense adjustment would not require the seller to file any additional information. It is not significant that the Commission eliminated the quarterly filing of cost data requirement for non-rural carriers in the *Rural Task Force Order*, as AT&T suggests. *See* AT&T Opposition at 4 ("Not only has the [*Rural Task Force Order*] eliminated nonrural LEC quarterly reporting of expense data, but such annual reporting as does occur is inapposite because nonrural LECs report their expenses on a study area level rather than related to the particular exchanges that have been sold."). *See Rural Task Force Order*, 16 FCC Rcd at 11270, para. 59. We are not persuaded by AT&T's claim that "NTCA's proposal could not be implemented because it is premised on defining the first (index) year expense adjustment as the selling carrier's expense adjustment at the time of the sale." *See* AT&T Opposition at 4. AT&T argues that we should not

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17. In response to AT&T's argument that it is not appropriate to use the seller's expense data because non-rural carriers report their expenses at the study area level,[42] NTCA proposed an alternative method of calculating safety valve support. Specifically, NTCA suggests that the methodologies used to adjust the rate bases of regulated rate of return companies after a sale could be used to determine the rate base of the plant sold, and this amount could be used to determine safety valve support.[43] We find that this alternative would impose considerable administrative burdens on the Commission. Rural carriers most often acquire high-cost exchanges from price-cap regulated non-rural carriers that are not likely to be regulated as rate-of-return carriers by the state commission. Many states do not regulate the rates of small rural carriers. If the Commission had to determine the rate base of the sold exchanges, it would have to engage in a lengthy process of verifying the reasonableness of the companies' cost allocations, unless it simply accepted the data the companies provided at face value. It also is not clear that using the seller's embedded costs to estimate the index year expense adjustment would be preferable to using the seller's actual expense adjustment, even if the information were readily available and verifiable. The expense adjustment for most non-rural carriers is based on forward-looking economic cost as estimated by the Commission's universal service model.[44] Although some non-rural carriers received hold-harmless support based on embedded costs, the support was targeted to high-cost wire centers based on the model's cost estimates. Safety valve support is designed to provide support in addition to that "transferred" from the seller pursuant to section 54.305; it is more appropriate to use the seller's actual expense adjustment to determine safety valve support for the first year than to use an estimate of the what the seller's embedded cost support may have been under rules that are no longer applicable to non-rural carriers.

18. Our action today does not modify the existing safety valve mechanism as set forth in the *Rural Task Force Order* for support beginning in an acquiring carrier's second year of operation. For the second year of operation, the acquiring carrier will use its first-year costs to determine a new index year expense adjustment, and from its second year onwards will receive 50 percent of the differential between its new index year expense adjustment and subsequent year expense adjustments, as per the current safety valve mechanism. In addition, the total amount of safety valve support available to all eligible study areas will continue be limited to no more than five percent of rural incumbent local exchange carrier

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use the seller's expense adjustment, but offers no reason why we cannot. In contrast, the National Exchange Carrier Association (NECA) argues that NTCA's proposal is workable and reasonable. *See* NECA Reply Comments at 3. We agree. Because non-rural support is targeted to wire centers, USAC should be able to easily identify the per-line support amounts the seller was receiving for the acquired exchanges.

[42] *See* AT&T Opposition at 4. ("Thus, there is no available exchange-level expense data that is germane for the property sold.").

[43] *See* NTCA Reply to Oppositions to Petition for Reconsideration (NTCA Reply) at 4-5. NTCA proposes that the difference between the revenue requirement for the net plant at the time of sale and the revenue requirement for the net plant in service one year later be used as the expense adjustment for the first year for calculating safety valve support. Safety valve support is calculated by comparing expense adjustments, not revenue requirements. If NTCA is suggesting that we now use revenue requirements instead of expense adjustments to determine safety valve support, we find that this would not be appropriate because the revenue requirement includes more than the costs associated with loop plant and is recovered through rates, as well as universal service support. We address in this order why we decline to use the rate base of the plant sold to estimate an expense adjustment for the sold plant for purposes of determining safety valve support for the first year. NTCA further proposes that the expense adjustment for the first year be added to existing expense adjustment rules "to continue to capture the investments made by the acquiring company in the first year." NTCA Reply at 5. We note that this proposal goes beyond NTCA's proposal in its petition and would alter the balance the Commission sought in retaining section 54.305 of its rules and adding the safety valve mechanism.

[44] *See* 47 C.F.R. § 36.631(c)-(d); 47 C.F.R. § 54.309.

support available from the annual high-cost loop fund.[45] To the extent that rural carriers receive less than the indexed cap on the high-cost loop fund, the five percent cap on the safety valve mechanism shall continue to be based on the lesser amount. In effect, we conclude that the existing safety valve mechanism for acquiring carriers should be preserved and shall function as before, with the sole modification being that rural acquiring carriers can receive safety valve support in their first year of operation, as set forth in this order.

IV. PROCEDURAL MATTERS

A. Paperwork Reduction Act

19. The action contained herein has been analyzed with respect to the Paperwork Reduction Act of 1995 (PRA) and found to impose no new or modified reporting and/or recordkeeping requirements or burdens on the public.

B. Supplemental Final Regulatory Flexibility Analysis

20. In compliance with the Regulatory Flexibility Act (RFA),[46] this Supplemental Final Regulatory Flexibility Analysis (Supplemental FRFA) supplements the Final Regulatory Flexibility Analysis (FRFA) included in the *Rural Task Force Order*,[47] to the extent that changes to that Order adopted here on reconsideration require changes in the conclusions reached in the FRFA. As required by the RFA,[48] that previous FRFA was preceded by an Initial Regulatory Flexibility Analysis (IRFA) incorporated in the Further Notice of Proposed Rulemaking, which sought public comment on the proposals in the Further Notice.[49]

1. Need for, and Objective of, the Order

21. Section 254 of the Communications Act of 1934, as amended by the 1996 Act, requires the Commission to promulgate rules to preserve and advance universal service support.[50] In the *Rural Task Force Order*, the Commission modified section 54.305 of the Commission's rules to provide safety valve support to rural carriers that make substantial investment after acquiring exchanges. For purposes of determining a rural carrier's safety valve support, the index year expense adjustment was defined as the high-cost loop support expense adjustment for the acquired exchanges calculated at the end of the company's first year of operating the exchanges. In this Order, we amend section 54.305 of the Commission's rules to provide that rural carriers may receive safety valve support for investment made in the first year of operating acquired exchanges.

2. Summary of Significant Issues Raised by the Public

22. No petition for reconsideration was submitted directly in response to the previous FRFA.

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[45] *See supra* para. 5

[46] *See* 5 U.S.C. § 604. The RFA, *see* 5 U.S.C. §§ 601-612, has been amended by the Contract with America Advancement Act of 1996, Pub. L. No. 104-121, 110 Stat. 847 (1996) (CWAAA). Title II of the CWAAA is the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA).

[47] *Rural Task Force Order*, 16 FCC Rcd at 11327-34, paras. 212-236.

[48] 5 U.S.C. § 603.

[49] *Federal-State Joint Board on Universal Service*, Further Notice of Proposed Rulemaking, CC Docket No. 96-45, 16 FCC Rcd 6141, 6143-49, paras. 9-29 (2001).

[50] 47 U.S.C. § 254.

On reconsideration, however, NTCA argued that reconsideration of section 54.305 of the Commission's rules was needed to create the proper incentive for rural carriers to invest in acquired exchanges in the first year after acquisition. NTCA proposed that the selling carrier's expense adjustment at the time of the sale be used as the index year expense adjustment to determine safety valve support for the first year of operation of the acquired exchanges.

3. Description and Estimate of the Number of Small Entities to Which this Order Will Apply

23. The RFA requires an agency to describe any significant alternatives that it has considered in developing its approach, which may include the following four alternatives (among others): "(1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rule, or any part thereof, for such small entities."[51]

24. In the FRFA at paragraphs 218-229 of the *Rural Task Force Order*, we described and estimated the number of small entities that would be affected by the new universal service rules for rural carriers. These entities consisted of local exchange carriers, competitive access providers, cellular licensees, broadband personal communications service (PCS), rural radiotelephone service specialized mobile radio (SMR), fixed microwave services, and 39 GHz licensees. The rule amendment adopted herein may apply to the same entities affected by the rules adopted in that order. We therefore incorporate by reference paragraphs 218-229 of the *Rural Task Force Order*.

4. Description of Projected Reporting, Recordkeeping, and Other Compliance Requirements

25. The rule amendment adopted in this Order contains no new reporting, recordkeeping, or other compliance requirements.

5. Steps Taken to Minimize the Significant Economic Impact on Small Entities, and Significant Alternatives Considered

26. In the *Rural Task Force Order*, we described the steps taken to minimize the significant economic impact on small entities consistent with the stated objectives associated with the adopted plan for providing high-cost support to rural carriers. Because many of the same issues are presented in this Order, we incorporate by reference paragraphs 233-235 of the *Rural Task Force Order*.[52] In this Order, we amend section 54.305 of our rules consistent with the intent of the Commission in adopting the safety valve mechanism to provide additional support to rural carriers that make substantial investment after acquiring exchanges. The adopted rule, however, may have prevented rural carriers that make substantial investment in acquired exchanges from receiving the full benefits intended under the safety valve mechanism. As discussed above,[53] the alternative option of denying the request for reconsideration on this issue was considered and deemed to be inconsistent with Commission's intent in adopting the safety valve mechanism.

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[51] 5 U.S.C. § 603(c)(1) – (c)(4).

[52] *Rural Task Force Order*, 16 FCC Rcd at 11333-34, paras. 233-235.

[53] *See supra* paras. 11-15.

6. Report to Congress

27. The Commission will send a copy of this Order, including this Supplemental FRFA, in a report to be sent to Congress pursuant to the Congressional Review Act, *see* 5 U.S.C. § 801(a)(1)(A). In addition, the Commission will send a copy of this Order, including the Supplemental FRFA, to the Chief Counsel for Advocacy of the Small Business Administration. A copy of the Order and Supplemental FRFA (or summaries thereof) will also be published in the Federal Register. *See* 5 U.S.C. § 604(b).

V. ORDERING CLAUSES

28. Accordingly, IT IS ORDERED that, pursuant to the authority contained in sections 1, 4(i), 4(j), 214, and 254 of the Communications Act of 1934, as amended, 47 U.S.C §§ 151, 154(i), 154(j), 214, and 254, and section 1.425 of the Commission's rules, 47 C.F.R. § 1.425, this ORDER is ADOPTED.

29. IT IS FURTHER ORDERED that, pursuant to the authority contained in sections 1, 4(i), 4(j), 214, 218-220, 254, and 405 of the Communications Act of 1934, as amended, 47 U.S.C §§ 151, 154(i), 154(j), 214, 218-220, 254, and 405, and section 1.429 of the Commission's rules, 47 C.F.R. § 1.429, the petition for reconsideration filed by National Telephone Cooperative Association on July 5, 2001 is GRANTED IN PART, to the extent discussed herein.

30. IT IS FURTHER ORDERED that Part 54 of the Commission's rules, 47 C.F.R. Part 54, IS AMENDED as set forth in Appendix A attached hereto, effective thirty (30) days after publication in the Federal Register.

31. IT IS FURTHER ORDERED that the Commission's Consumer and Governmental Affairs Bureau, Reference Information Center, SHALL SEND a copy of this Order, including the Final Supplemental Regulatory Flexibility Analysis, to the Chief Counsel for Advocacy of the Small Business Administration.

FEDERAL COMMUNICATIONS COMMISSION

Marlene H. Dortch
Secretary

APPENDIX
FINAL RULES

Part 54 of Title 47 of the Code of Federal Regulations is amended as follows:

PART 54 –UNIVERSAL SERVICE

Subpart D—Universal Service Support for High Cost Areas

1. Section 54.305 is amended by revising paragraphs (a), (b), (c), (d), and (e), and (f) to read as follows:

§ 54.305 Sale or transfer of exchanges.

(a) The provisions of this section are not applicable to the sale or transfer of exchanges between non-rural carriers after the complete phase-down of interim hold-harmless support, pursuant to section 54.311 of this part, for the non-rural carriers subject to the transaction.

(b) Except as provided in paragraph (c) of this section, a carrier that acquires telephone exchanges from an unaffiliated carrier shall receive universal service support for the acquired exchanges at the same per-line support levels for which those exchanges were eligible prior to the transfer of the exchanges. If the acquired exchanges are incorporated into an existing rural incumbent local exchange carrier study area, the rural incumbent local exchange carrier shall maintain the costs associated with the acquired exchanges separate from the costs associated with its pre-acquisition study area. The transferred exchanges may be eligible for safety valve support for loop related costs pursuant to paragraph (d) of this section.

(c) A carrier that has entered into a binding agreement to buy or acquire exchanges from an unaffiliated carrier prior to May 7, 1997 will receive universal service support for the newly acquired lines based upon the average cost of all of its lines, both those newly acquired and those it had prior to execution of the sales agreement.

(d) Transferred exchanges in study areas operated by rural telephone companies that are subject to the limitations on loop-related universal service support in paragraph (b) of this section may be eligible for a safety valve loop cost expense adjustment based on the difference between the rural incumbent local exchange carrier's index year expense adjustment and subsequent year loop cost expense adjustments for the acquired exchanges. Safety valve loop cost expense adjustments shall only be available to rural incumbent local exchange carriers that, in the absence of restrictions on high-cost loop support in § 54.305(b), would qualify for high-cost loop support for the acquired exchanges under § 36.631 of this chapter.

(1) For carriers that buy or acquire telephone exchanges on or after January 10, 2005 from an unaffiliated carrier, the index year expense adjustment for the acquiring carrier’s first year of operation shall equal the selling carrier’s loop-related expense adjustment for the transferred exchanges for the 12-month period prior to the transfer of the exchanges. At the acquiring carrier's option, the first year of operation for the transferred exchanges, for purposes of calculating safety valve support, shall commence at the beginning of either the first calendar year or the next calendar quarter following the transfer of exchanges. For the first year of operation, a loop cost expense adjustment, using the costs of the acquired exchanges submitted in accordance with §§ 36.611 and 36.612 of this chapter, shall be calculated pursuant to § 36.631 of this chapter and then compared to the index year expense adjustment. Safety valve support for the first period of operation will then be calculated pursuant to paragraph (d)(3) of this section. The index year expense adjustment for years after the first year of operation shall be determined

using cost data for the first year of operation of the transferred exchanges. Such cost data for the first year of operation shall be calculated in accordance with §§ 36.611, 36.612 and 36.631 of this chapter. For each year, ending on the same calendar quarter as the first year of operation, a loop cost expense adjustment, using the loop costs of the acquired exchanges, shall be submitted and calculated pursuant to §§ 36.611, 36.612, and 36.631 of this chapter and will be compared to the index year expense adjustment. Safety valve support for the second year of operation and thereafter will then be calculated pursuant to paragraph (d)(3) of this section.

(2) For carriers that bought or acquired exchanges from an unaffiliated carrier before January 10, 2005, and are not subject to the exception in paragraph (c) of this section, the index year expense adjustment for acquired exchange(s) shall be equal to the rural incumbent local exchange carrier's high-cost loop expense adjustment for the acquired exchanges calculated for the carrier's first year of operation of the acquired exchange(s). At the carrier's option, the first year of operation of the transferred exchanges shall commence at the beginning of either the first calendar year or the next calendar quarter following the transfer of exchanges. The index year expense adjustment shall be determined using cost data for the acquired exchange(s) submitted in accordance with §§ 36.611 and 36.612 of this chapter and shall be calculated in accordance with § 36.631 of this chapter. The index year expense adjustment for rural telephone companies that have operated exchanges subject to this section for more than a full year on the effective date of this paragraph shall be based on loop cost data submitted in accordance with § 36.612 of this chapter for the year ending on the nearest calendar quarter following the effective date of this paragraph. For each subsequent year, ending on the same calendar quarter as the index year, a loop cost expense adjustment, using the costs of the acquired exchanges, will be calculated pursuant to § 36.631 of this chapter and will be compared to the index year expense adjustment. Safety valve support is calculated pursuant to paragraph (d)(3) of this section.

(3) Up to fifty (50) percent of any positive difference between the transferred exchanges loop cost expense adjustment and the index year expense adjustment will be designated as the transferred exchange's safety valve loop cost expense adjustment and will be available in addition to the per-line loop-related support transferred from the selling carrier to the acquiring carrier pursuant to § 54.305(b). In no event shall a study area's safety valve loop cost expense adjustment exceed the difference between the carrier's study area loop cost expense adjustment calculated pursuant to § 36.631 of this chapter and transferred support amounts available to the acquired exchange(s) under paragraph (b) of this section. Safety valve support shall not transfer with acquired exchanges.

(e) The sum of the safety valve loop cost expense adjustment for all eligible study areas operated by rural telephone companies shall not exceed five (5) percent of the total rural incumbent local exchange carrier portion of the annual nationwide loop cost expense adjustment calculated pursuant to § 36.603 of this chapter. The five (5) percent cap on the safety valve mechanism shall be based on the lesser of the rural incumbent local exchange carrier portion of the annual nationwide loop cost expense adjustment calculated pursuant to § 36.603 of this chapter or the sum of rural incumbent local exchange carrier expense adjustments calculated pursuant to § 36.631 of this chapter. The percentage multiplier used to derive study area safety valve loop cost expense adjustments for rural telephone companies shall be the lesser of fifty (50) percent or a percentage calculated to produce the maximum total safety valve loop cost expense adjustment for all eligible study areas pursuant to this paragraph. The safety valve loop cost expense adjustment of an individual rural incumbent local exchange carrier also may be further reduced as described in paragraph (d)(3) of this section.

(f) Once an acquisition is complete, the acquiring rural incumbent local exchange carrier shall provide written notice to the Administrator that it has acquired access lines that may be eligible for safety valve support. Rural telephone companies also shall provide written notice to the Administrator defining their index year for those years after the first year of operation for purposes of calculating the safety valve loop cost expense adjustment.