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### Credit Perspectives on U.S. Rural Local Exchange Carriers

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Standard & Poor's Ratings Services currently rates seven large rural local exchange carriers (RLECs) or diversified carriers with significant RLEC business. These rated entities serve about 80% of the 12 million rural access lines owned by rural carriers. Non-rural carriers such as regional Bell operating companies (RBOCs) and Sprint serve an estimated 28 million rural access lines. RLECs have historically had strong fundamentals, mainly due to limited competition and strong regulatory support. Ratings for these carriers range widely, from 'A' for ALLTEL Corp. to 'B' for Madison River Telephone Co. LLC, with the differentiating factors mainly being size, leverage, free cash flow prospects, market diversity, and history of solid operations. More recently, there are concerns that potential changes in regulatory support and growing wireless competition could affect RLECs negatively. Given the lengthy amount of time that may be required to implement universal service reform and that wireless competition will take time to develop, Standard & Poor's expects RLECs to maintain their stable business risk profile into 2005.

#### ■ Characteristics of RLECs

The RLEC industry is dominated by a few large carriers, with each having between 100,000 to nearly 3 million access lines distributed across markets in numerous states. While some of these large carriers, such as CenturyTel Inc. and Citizens Communications Co., are dedicated wireline service providers, others, such as ALLTEL and Telephone & Data Systems Inc. also have sizable wireless operations. The remaining carriers, estimated to be over 1,200, are mostly small operators with fewer than 10,000 access lines and concentrated in a few markets. Large RLECs typically rely on acquisitions of smaller RLECs and rural access lines divested by RBOCs to fuel growth. Small RLECs face stagnant growth or declining prospects due to the limited size of their markets and lack of access to capital. Some common characteristics of RLECs are as follows:

**Strong market positions:** RLECs generally serve high-cost markets characterized by low access line density (i.e., an average of 13 access lines per square mile versus an average of 100 access lines in non-rural markets) and long average loop length (average loop length of over 20,000 feet versus 10,000 feet in non-rural markets). About 80% of access lines are residential, with the remaining 20% business. The high costs of serving these markets, along with RLECs being exempted from the interconnection provision of the Telecommunications Act of 1996, have forestalled wireline-based competition. Whereas RBOCs have been losing about 1%-2% of their access lines per quarter in the past year, RLECs have generally maintained stable access lines. Wireless competition, although increasing, is still mostly confined to areas around major highway corridors. Competition from cable telephony is unlikely to be an issue for several years since rural cable operators have relatively limited network reach and are facing challenges in their core video business.

Solid regulatory support: The availability of affordable telecommunications services in rural areas remains an important social agenda. Support for RLECs has come in the form of financial support through the Universal Service Fund (USF) and political support at both the state and federal levels. An example of this support is the creation of an additional support mechanism (i.e., Interstate Common Line Support) within the federal USF by the FCC in 2001 to ensure that RLEC revenues are not affected by lower access rates.

Substantial dependence on network access revenues: Long-distance-related network access revenues have historically accounted for an average 50% of total revenues. RLECs have been able to offset the impact of lower access rates with USF subsidies that are available for this purpose.

### ■ **Rate-of-Return Versus Price-Cap Carriers**

RLECs are regulated by the FCC with respect to interstate matters (e.g., interstate network access rates, subscriber line charges, and federal universal service support) and by state public utility commissions with respect to intrastate matters (e.g., intrastate network access rates, local rates, service quality, and state universal service support). Under the rate-of-return (ROR) regulatory regime, various interstate and intrastate rates are set to allow a carrier to earn a stipulated ROR on an investment and expense base. Universal service support, available at the federal level and in some states, provides further assurance that an ROR carrier could earn this return. Under an incentive-based (i.e., price-cap or alternative) regulatory regime, a carrier tries to maximize its earnings with rates for various services capped (except for adjustments for inflation and productivity). For these carriers, universal service support is also available, albeit mainly to offset declines in network access rates. An ROR carrier, typically one that has an efficient cost structure, can elect to become an incentive-based carrier (though generally not the other way around) at the federal and state levels. Small RLECs tend to be under the ROR regulatory regime at both the federal and state levels, while large RLECs have significant access lines that are governed by incentive-based regulatory regime at one or both levels.

Standard & Poor's believes that the regulatory regime under which a carrier operates is an important factor in ratings, but is considered in conjunction with size, operating efficiency, and free cash flow prospects. This factor is less important for large RLECs, such as ALLTEL, CenturyTel, and Citizens Communications, that generate sizable free cash flows, have a history of solid executions, and already have significant exposure to the incentive-based regulatory regime. This factor may exert much greater influence on the ratings of smaller RLECs, such as FairPoint Communications Inc. and Madison River that have limited free cash flow prospects and rely to a greater extent on ROR regulations to enhance their profitability.

### ■ **Two Longer-Term Challenges Facing RLECs**

RLECs face two challenges that could affect their business risk profile in the longer term. These are potential changes to federal universal service support and increasing wireless competition.

#### **Potential Revision of Federal Universal Service Support.**

RLECs receive federal universal service support through financial subsidies disbursed from the federal USF, which is administered by the Universal Service Administrative Company (USAC) under an agreement with the FCC. The federal USF is funded by a percentage of interstate and international revenues collected from all

telecommunications carriers. This contribution percentage is adjusted quarterly, mostly by comparing projected quarterly federal USF needs (about \$1.6 billion for the third quarter of 2003) against projected quarterly interstate and international revenues (about \$19 billion for the third quarter of 2003). Projected demand takes into account such factors as inflation and change in demand units. The largest and most important component of the federal USF with respect to RLECs is high cost support (HCS), as it is through this mechanism that RLECs obtain direct support for interstate portions of loops, switching, and network access. For a carrier to receive federal USF subsidies, it must first be designated as an eligible telecommunications carrier (ETC) by state regulators. Rural carriers are currently net recipients of universal service support, which account for an estimated 10% to more than 20% of total RLEC revenues.

There is concern that HCS subsidies for RLECs may not be as robust in the future. A recent trend is that regional wireless carriers have started to aggressively apply for and receive ETC status in a number of states. Whereas the USAC projected competitive ETCs to require about \$19 million of HCS funding in the third quarter of 2002, this shot up to about \$63 million in the third quarter of 2003, with most of the growth due to regional wireless carriers. RLECs are worried that as greater demand is placed on HCS, the FCC will consider, among various options, limiting HCS subsidies to primary access lines or basing the level of subsidies on the costs of the most efficient carrier (including wireless) in a given market.

Standard & Poor's believes that material changes to federal universal service support for RLECs going into 2005 are unlikely for two reasons. First, the process for reforming federal universal service is likely to be a protracted one. This process involves the FCC coming up with initial recommendations, various interested parties providing input, and potential legislative and legal battles. The FCC is currently still at the stage of formulating recommendations. Second, the FCC could be distracted by election-year politics starting in 2004 and lasting into 2005.

### **Increasing Wireless Competition.**

Wireless competition is certain to increase in rural markets. Although there are about three wireless carriers on average in each rural market, the threat of wireless competition has, to date, been constrained by spotty wireless coverage. This situation could change if regional wireless carriers gain ETC status in more markets and use universal service support to meaningfully improve their networks. As wireless service becomes more widely available, RLECs could see accelerated minutes-of-use substitution in the near term and access line replacement in the longer term. Most RLECs that Standard & Poor's rates are already seeing wireless competition having some impact on their business. However, Standard & Poor's does not expect wireless competition to significantly increase in the near term for two reasons. First, regional wireless carriers, given their weak financial risk profile (i.e., high leverage and weak free cash flow prospects) and operating challenges (i.e., competition from national wireless carriers and implementation of wireless number portability), are more likely to undertake incremental instead of major network expansion activities. Second, it takes time for networks to be improved or built. There is an estimated time lag of 12-18 months between gaining ETC status and having a network up and running reliably.

## **■ Growth Prospects**

Growth prospects differ among large and small RLECs. Large RLECs will likely grow primarily by acquiring access lines and increasing DSL subscribers. Given their integration experience, strengthening balance sheets,

and good access to capital, they are well positioned to acquire some of the millions of rural access lines that RBOCs may divest, and potentially double their wireline business in the intermediate term. Their improving balance sheets and free cash flow prospects should also enable them to more effectively absorb the impact of wireless competition. Smaller RLECs face more challenges. With weaker balance sheets and more limited access to capital, they are less able to pursue growth opportunities. Over the longer term, wireless competition could pose a greater threat to their financial risk profiles.

### ■ Factors That Affect Ratings

Ratings on RLECs currently range from 'A' to 'B', with the large carriers having investment-grade ratings mainly due to their size, lower leverage, ability to generate sizable free cash flows, greater capacity to absorb execution missteps, and long history of solid operations under different regulatory regimes. Financial risk factors that are considered in ratings include leverage, liquidity, and free cash flow prospects. Business risk factors that are considered are as follows:

- Acquisition appetite: Given the difficulties of assessing whether a merger or an acquisition of lines will run into problems well beforehand, a number of factors are considered in the rating of an acquiring RLEC upon the announcement of a deal. These factors include past integration experience, the size and structure of the deal, and impact on financial leverage and liquidity. Standard & Poor's believes large RLECs are better able to absorb acquisition-related risks.
- Geographic market diversity: An RLEC that operates in numerous states is considered less risky than one with operations that are concentrated in a few states. This is because an RLEC with well-diversified markets is better able to withstand the impact of adverse regulatory changes or significantly increased wireless competition in any one state.
- Exposure to the competitive local exchange carrier (CLEC) business: Given the poor history of stand-alone CLECs and the mixed experiences of RLECs such as ALLTEL and FairPoint in operating their own CLEC businesses, Standard & Poor's views heavy involvement in CLEC-type activities by an RLEC unfavorably. An RLEC that has greater CLEC exposure has a weaker business risk profile.
- Regulatory regime: For smaller RLECs that have operated mostly under an ROR regulatory regime to date, any forced migration to an incentive-based regulatory regime could be negative for ratings.

Second Quarter 2003 RLEC Profile										
Company	Rating	Access Lines	Federal Regulatory Regime	State Regulatory Regime	RLEC EBITDA Margin	Leverage*	CLEC Exposure (% of revenues)	Acquisition Appetite	Market Diversity	Cushions Against Longer-Term Wireless Competition
ALLTEL Corp.	A/Negative/A-1	3.1M¶	Mostly ROR	Mostly incentive based	58%	1.9x\$	N.A.	High	High	Sizable free cash flows, market diversity, and own wireless business

CenturyTel Inc.	BBB+/Stable/A-2	2.4M	ROR and incentive based	ROR and incentive based	52%	2.7x§	2.0%	High	High	Sizable free cash flows and market diversity
Citizens Communications Co.	BBB/Negative/--	2.4M	Incentive based	Mostly ROR	52%	4.5x§	7.0%	Moderate to High	High	Sizable free cash flows and market diversity
FairPoint Communications Inc.	B+/Stable/--	252,000	ROR	Mostly ROR	52%	6.8x	0.0%	High	High	Market diversity
Madison River Telephone Co. LLC	B/Negative/--	207,000	ROR	ROR and incentive based	52%	6.8x	8.0%	Moderate	Low	Limited cushion
Telephone & Data Systems Inc.	A-/Negative/--	719,000	ROR	ROR and incentive based	52%	2.7x	6.2%	High	High	Market diversity and own wireless business
Valor Telecommunications LLC	B+/Stable/--	539,000	Incentive based	N.A.	About 50%	5.7x	0.0%	Moderate	Low	Limited cushion
*Leverage = gross debt/annualized EBITDA. ¶Includes CLEC lines. §Includes equity units as debt. N.A.--not available.										

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