

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of)
Federal-State Joint Board on) CC Docket No. 96-45
Universal Service)

Reply Comments of the Competition Policy Institute

May 7, 1996

**In the Matter of the Federal-State Joint Board on Universal Service
Reply Comments of the Competition Policy Institute**

The Competition Policy Institute (CPI) is a non-profit organization which advocates state and federal regulatory policies to bring competition to telecommunications and energy markets in ways that benefit consumers. CPI appreciates the opportunity to reply to the comments of other parties to this rulemaking.

Overview

Stripped of all but the essentials, the Commission and the States have two, *joint, simultaneous* obligations under the concept of “universal service”:

- To ensure that quality basic telecommunications service is offered in all geographic areas and to all consumers at rates which are just, reasonable and affordable; and
- To fashion a system of rates and explicit subsidies for basic telecommunications service which achieve this first obligation while enhancing competition in a “pro-competitive , de-regulatory national policy framework.”¹

The Commission and the States must attempt to adhere to each of these principles, even when they are in partial conflict. We comment on each aspect of this dual obligation.

The Just, Reasonable and Affordable Standard Congress connected the familiar “just and reasonable” standard with the “affordable” standard because it realized that some just rates may

¹Telecommunications Act of 1996, Report 104-458, introductory preface.

not be affordable, and some affordable rates may not be just. Because these two standards are conjoined in the statute, the standard of “affordable” limits levels for rates that are set at just and reasonable levels, and vice versa. Thus, rates for services included in universal service must be set at levels which are the lower of “just and reasonable” and “affordable”. Regulators cannot choose which standard applies at which time: they must be applied simultaneously to all universal service rates.

While the Telecommunications Act of 1996 makes special mention of rates for low-income consumers and consumers in rural, insular and high cost areas, the concept of just, reasonable and affordable universal service is not special to those customers. The Act requires that rates for services included within the definition of universal service meet both standards for all consumers. Congress was clear on this point:

“(i) Consumer Protection.--The Commission and the States should ensure that universal service is available at rates that are just, reasonable, and affordable.”²

We agree with the consumer intervenors such as CFA, AARP and CU³ that point out that keeping rates affordable for low-income consumers and those in rural and high cost areas does not relieve regulators from the responsibility of keeping rates just, reasonable and affordable for all other consumers as well. The requirements of Section 254 of the Act respecting some classes of consumers should be viewed not as the extent of regulators’ responsibility, but instead as a special case of that authority. Achieving affordable rates in rural areas and keeping rates affordable for

²Telecommunications Act of 1996, §254(I).

³Comments of AARP, CFA and CU, p.3.

low income consumers will require special mechanisms which the Commission and the States are authorized to establish by this section. But these are in addition to the general obligation to ensure that all rates are just, reasonable, and affordable.

There is other strong evidence about Congress's concern for the price of services included in the definition of universal service. Section 254(k) requires that "services included in the definition of universal services bear no more than a reasonable share of the joint and common costs of facilities used to provide those services." This language codifies the practice of most state commissions which have been causing joint and common costs to be shared by all users of the public switched network.

We are concerned that the Commission, in its Notice, has separated this cost allocation principle from the Joint Board's consideration of rates for universal service in this proceeding. We join other consumer commentators on this matter. It is true that the Act distinguishes State and Commission duties in developing cost allocation policies for joint and common costs. But rates derived (or implied) from the action of the FCC following a Joint Board recommendation are subject to the standard in this section. As we discuss later with respect to the CCLC and SLC, this neat division is neither possible nor desirable in this docket.

Enhancing Competition While the current system of support mechanisms and subsidies functioned in a monopoly environment, these mechanisms are not suitable for a competitive telecommunications industry generally and a competitive local exchange market in particular. Players in the telecommunications industry are identified today by a shorthand description of their primary business. But today's LECs, IXC's and CAPs will become tomorrow's full-service competitors in all markets. As long as players in these market segments were relatively restricted from each others' markets, it was feasible for inter-carrier prices to carry subsidies and other non-

economic costs. However, if these same players are permitted to enter each others' domains (LECs into long distance, IXC's providing local service) the distortions which these non-economic prices represent will be fatal to a developing competitive market.

Today's web of support mechanisms must be redesigned to function among competitors. This point is made clearly by NYNEX⁴ and many others. We also agree with AT&T⁵ and other new local exchange entrants: the current system of subsidies (including inter-carrier transactions like access rates priced above economic costs) results in a flow of revenues to incumbent LECs with little showing of need. This issue is especially important in the case of Tier 1 LECs in view of the future competitive relationship between new entrants and these large incumbent LECs.

As a corollary, the Joint Board and Commission should not be unduly guided by the short-term exigencies of revenue recovery by incumbents, particularly Tier 1 LECs. Instead, it should construct a universal service system that will serve both during the transition to competition and beyond. Most importantly, regulators should rely on local exchange competition to help keep local rates just, reasonable and affordable.⁶ To do this, the Commission must adopt an approach which subsidizes only the efficient actions of providers to the extent that prices based on economic costs exceed affordable levels. The universal service system ultimately will fail if it mushrooms out of control because it attempts to keep inefficient companies "whole."⁷ We agree with the Staff of the Virginia Corporation Commission that "thinking about communications

⁴NYNEX Comments, p. 9.

⁵AT&T Comments, p. 3.

⁶This important point is made by the Washington Utilities and Transportation Commission. Comments, p. 2.

⁷See the Comments of Ad Hoc Telecommunications Users Committee, p. 6.

prices in terms of ‘cost recovery’ is out of date. [This thinking] is related to revenue requirement regulation.”⁸

Definition of Universal Service

Most of the proposals for designating services for the universal service support fell in a relatively narrow range. There was substantial support for using the Commission’s base suggestion, with commentors clarifying the assumed meaning of the Commission’s definition (e.g., that “usage” is included in local telephone service) or adding some discrete features (e.g., directory assistance).

It is especially important at the beginning of this new universal service regime that the Commission craft an achievable definition of universal service, concentrating on the core issues of affordability for today’s essential services. The definition should recognize the realities of today’s network usage, yet remain open for changes. The Telecommunications Act of 1996 makes provisions for change in the set of services included in universal service, permitting the Joint Board to recommend future modifications to the Commission.

CPI supports the position of those commentors⁹ that identified the following elements:

- Voice grade access to the public switched network¹⁰

⁸Comments of the Virginia State Corporation Commission Staff, p. 5.

⁹See, for example, Comments of the West Virginia Consumer Advocate, p. 6.

¹⁰We agree with several commentors that the definition of universal service must include not merely access, but also usage of the local network. We assume that the Commission intended that usage be included. While flat-rated local service is far and away the predominant service selected by residential consumers, there are some LEC service areas where measured service is widespread. For this reason, and because some LECs distinguish usage and access, even in their tariffs for flat-rated service, the FCC should explicitly include usage in the definition of universal service.

- Touch tone
- Single party service
- Access to emergency services (E911)
- Access to operator services
- Telecommunications Relay Service
- Annual “white pages” directory listing
- Directory assistance
- Equal access to long distance carriers¹¹

A periodic review will ensure that the definition of universal service keeps pace with changes in markets and within the industry. We also note that periodic review of the definition of universal service will be necessary to discharge the statutory responsibility that rates and availability of service in rural areas be comparable to urban areas.

Computing the USF Subsidy

Beginning in ¶31 of the Notice, the Commission seeks comment on the use of a proxy model to compute the universal service subsidy. CPI agrees strongly with those commentators that support the use of proxy cost model for calculating the cost on which a universal service subsidy shall be computed. There is considerable support for the use of a proxy cost model, ranging from MCI, USWest, Sprint, NASUCA, Washington UTC, Teleport, LDDS Worldcom and many others.

¹¹Blocking services (for toll and 900 number service), are sometimes perversely priced at high rate levels by LECs, so that the blocking feature itself becomes a “profit center.” Instead of subsidizing this “service” through the USF, we suggest that states require that blocking be priced at its economic cost. For low income customers, free blocking should be included within the Lifeline definition.

The advantages of using a proxy cost model are substantial:

- Universal service subsidies calculated using a cost model will not reward inefficient behavior of the carrier receiving the subsidy. A carrier that has incorrectly engineered a system, gold-plated it or managed it inefficiently will not be rewarded for that behavior by receiving a subsidy based on that inefficiency.
- It will not be possible to manipulate the cost data used in computing the subsidy.
- Using a proxy cost model will be administratively simpler. Since the subsidy will not be related to a given carrier's costs, the financial reporting and verification will be reduced.
- Finally, using a cost model as benchmark will provide a positive incentive toward efficiency since a carrier's subsidy is not reduced if it lowers its own costs.

We also agree with those commentators who observe that the Benchmark Cost Model¹² is preferred to the PacTel model.¹³ The PacTel model is difficult to validate because of its reliance on proprietary data and the susceptibility of such a system to manipulation. Although there remain some reservations about the current implementation of the Benchmark Cost Model, it seems clear that any shortcomings can be addressed.

¹²We refer here to the Benchmark Costing Model submitted by the Joint Sponsors in CC Docket No. 80-286 (Dec.1, 1995)

¹³See, for example, Comments of NASUCA, p. 20-21.

Affordability

The rate standard of “affordability” entered the debate over telecommunications reform legislation in recent years to express the congressional intent that rates for service not merely pass regulatory muster but remain at levels which all consumers can afford.

As a preliminary matter, we agree with AARP, CFA and CU¹⁴ that the Commission should view “affordability” in the sense of able to be purchased “without serious inconvenience.” This meaning, as contrasted to the absolute sense of “unable to be purchased” or “out-of-reach”, also comports best with the allied notion of “reasonable”. This is not to say that the Commission should not also consider telephone penetration rates when examining whether the price of universal service is affordable.

How then, should the Commission define “affordability” for operational purposes? As a starting point, the Commission should consider existing rates to be affordable and seek to develop a universal service funding mechanism which maintains overall rates no higher than current levels. This means that the support contained in the existing USF should not be reduced. (While penetration rates for low-income consumers are far too low, the correct approach to increase penetration rates is to focus efforts on existing Lifeline and Link-Up programs. Several commentors offered recommendations on how Lifeline and Link-Up subscription, and telephone penetration, can be increased.¹⁵)

Second, we suggest that the FCC defer to the States for a final determination of what constitutes “affordability.” The States that have made it their business for many years to keep local telephone

¹⁴Comments, p. 6.

¹⁵See, for example, Comments of the Public Utility Law Project.

rates affordable. They are well positioned to examine the many aspects of the price of telecommunications services and whether it is affordable. While state regulators have sometimes been criticized for setting rates “too low”, it is interesting to find that this very practice, of keeping rates affordable and rural rates in parity with urban rates, has now become national telecommunications law.

As a practical matter, the FCC will not be able to determine the achievable rate levels which will be deemed to be affordable by consumers in each circumstance, with each LEC, in each state. As several commentators pointed out, there is considerable variation in size of local calling area, demand for advanced services, expenditures on toll, etc.¹⁶ These differences are real and not susceptible to an average approach. Even if the FCC is prepared to step in and supplant state ratemaking, we doubt whether the effort is really feasible, at least not without severe consumer dissatisfaction.¹⁷

The CCLC and SLC

In the Notice, the Commission enquires whether the Carrier Common Line Charge (CCLC) rate element should be eliminated or reduced, with a compensating increase made to the Subscriber Line Charge (SLC). The discussion in ¶113 of the Notice seems to assume that the CCLC is entirely an implicit universal service support mechanism which the Communications Act of 1996 contemplated would be made “explicit”. The Commission also notes in this section of the Notice

¹⁶The data supplied by GTE in its comments is very instructive in this matter, demonstrating the substantial variation between average loop cost and average retail telecommunications revenue per household. Schedule 1, attached to Comments.

¹⁷We note the approach taken by MCI with respect to the state/federal role. As its primary recommendation in Comments, MCI offers a economically rational, comprehensive subsidy system based on the difference between forward looking costs of local service and a nation-wide average rate. The fund is collected by the Commission, but allocated to the States as a “block grant” to be distributed to eligible customers.

that the CCLC, being a usage-sensitive charge, collects non-traffic sensitive costs with a corresponding loss of economic efficiency.

CPI agrees with many commenting parties that the CCLC is not primarily a universal support mechanism. Instead, the CCLC, together with the SLC, collects the portion of joint and common costs of NTS plant allocated to interstate jurisdiction. The CCLC is paid by the access customers of the LECs that make use of those facilities when originating or terminating calls using the public switched network. The CCLC may have the *effect* of lowering rates for basic telecommunications users, but this does not make the payment a “subsidy”.

On the other hand, there certainly are problems with the CCLC. First, the costs recovered in this rate element are focussed on interexchange carriers purchasing access because of their interstate jurisdictional status. Second, the usage-sensitive recovery of non-usage-sensitive costs results in a loss of economic efficiency. Third, the LTS element within the CCLC, designed to ameliorate the effects of eliminating pooling, has a distorting effect. Finally, and importantly, the costs included in the separated interstate allocation are embedded, reported LEC costs, not necessarily efficient costs, recovered from their competitors or would-be competitors.

The Commission has referred the issue of the CCLC to the Joint Board for its consideration and recommendations. However, the Commission has also excluded the cost allocation provision of §254(k) from the Joint Board’s consideration in this case. CPI suggests that the Commission cannot divorce the CCLC issue from the statutory requirement in §254(k) that “services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of the facilities used to provide those services.” If, for example, the SLC were increased to recover the portion of the NTS common facilities now recovered in the federal jurisdiction, the entire “interstate” portion of the common loop would be paid (through the non-

avoidable SLC) by consumers that purchase the services within the definition of “universal service.” We cannot convince ourselves that Congress contemplated such an outcome when it restricted the allocation of these costs to a “reasonable share.”

We agree with the overwhelming majority of state commissions and consumer advocates that the SLC should not be increased at this time. The Missouri PSC makes the point that it is not required that the Commission examine these issues now and argues that changes to the CCLC and the SLC should be considered outside the tight time frames imposed on the Commission by the Act.¹⁸ The Florida Public Service Commission suggests that the CCLC issue be dealt with in a “calmer environment.”¹⁹ The Texas PUC observes that changes in the SLC should not be considered until the required *incremental* cost studies are performed.²⁰ The Texas Office of Public Utility Counsel provides another observation about the SLC: its days are numbered since it cannot be assessed on the lines of competing loop providers and will become impossible to sustain in a competitive environment.²¹

If the Commission wishes to review the status of the CCLC (which we believe it should), this should be done in one or both of two upcoming dockets: the review of the access charge structure or the docket in which the Commission considers its obligations under §254(k).²² However, if the Commission is intent on addressing the CCLC in this docket, we recommend that it consider carefully the discussion in the Comments of MCI that shifting CCLC revenues to the SLC

¹⁸Missouri PSC Comments, p. 20.

¹⁹Comments of Florida PSC, p. 23.

²⁰Texas PUC Comments, p. 17.

²¹Comments of the Texas Office of Public Utility Counsel, p. 10.

²²Notice, footnote 32.

continues to collect revenues in excess of the relevant economic costs.²³ MCI's proposal computes the needed subsidy based on the difference between TSLRIC costs and current rates (including the SLC) and then recovers the subsidy through the universal service assessment on all telecommunications providers. This approach obviates the need for the CCLC entirely, without shifting costs into the SLC, or equivalently, into local rates.

Allocation of the Universal Service Obligation

The Telecommunications Act of 1996 requires that contributions to the federal USF be made by all telecommunications carriers in a manner which is equitable and non-discriminatory. In the comments, the commission has been offered a variety of bases on which to apportion the contributions. These include:

- Gross telecommunications revenues
- Gross retail telecommunications revenues
- Net telecommunications revenues
- Access lines
- Hybrid systems of access lines and revenues

CPI recommends that the Commission use net telecommunications revenues as the appropriate method for allocating support. This system is discussed in ¶123 of the Notice and was adopted by the Commission in its Regulatory Fees order. A wide spectrum of parties also advocate this method, including CompTel, Teleport Communications Group, Telecommunications Resellers Association, MCI, Maine PUC, Montana PSC, et al.

²³MCI Comments, p. 15.

The Universal Service contribution is essentially a tax on all telecommunications companies. To make a tax fair, its levy is often based on the value of the commodity to the taxpayer. In this case, carriers supporting universal service are paying a portion of the cost of a telecommunications network in which they are sellers and buyers of services. The “value” of using this network is approximated by the revenues derived, less input costs. In other words, using net telecommunications revenues closely approximates the “value added” portion of a provider’s use of the network. Using revenues less payments made to other telecommunications carriers also has the advantage of avoiding double counting services, once at wholesale and once at retail.²⁴

As a practical matter, using net telecommunications revenues as an allocator means that providers will deduct access payments, interconnection payments, and, in the case of resale, the payments made to an underlying carrier when computing USF responsibility. Understandably, some providers of access services would prefer to avoid counting access revenues when computing the allocation of USF responsibility and instead base the allocation on “retail” revenues.

USWest asserts that the use of net revenues would not be equitable and non-discriminatory. The company argues that, if the Commission uses “net” revenues, LECs should be permitted to deduct the “imputed” cost of access from their interexchange revenues, in the same way that an IXC would deduct payments made to providers of access.²⁵

We disagree with USWest’s analysis. If USWest wishes to deduct costs of “imputed access” from its interexchange revenues under the theory that this imputed access is similar to a payment

²⁴We agree with the analysis of the Telecommunications Resellers Association, Comments, p. 6, in supporting the use of an allocator which nets out payments to other carriers. The “double counting” problem becomes “triple counting” if a reseller chooses to resell services itself.

²⁵USWest Comments, page 19 and Appendix B.

made to another provider, then it must also add the value of this “imputed access” to its wholesale (access) revenues. Otherwise, USWest is deducting the cost of a product which never existed. The result of this double entry returns us to the start. Stated another way, unless imputed access is added back to wholesale (access) revenues, the sum of all the bases for assessment will not add up to the total net revenues for telecommunications services.

We would also point out that, unless the Commission adopts a “net revenues” approach, local and toll resellers will be severely over-taxed. Since a reseller operates on a margin between wholesale and retail price of a finished service, a large percentage of a reseller’s revenues are paid to the underlying carrier. Unless payments to other carriers are eliminated, a reseller’s USF share will be based on total revenues, most of which are costs to the reseller, thereby overstating the value of its use of the network to the reseller. AT&T, which advocates retail revenues as an allocator, recommends that such an adjustment be made for resellers.²⁶

We agree with several commentors that the current system of universal service support, which uses a line-based allocator, discriminates against small users (and carriers serving small users). It should be replaced with a system which apportions the responsibility for universal service support on a more equitable basis such as net revenues.

Finally, we disagree with two other proposals made by some commentors. Several advocate the use of retail revenues to allocate the costs of universal service and then describe cost in terms of a surcharge on customers’ bills.²⁷ Further, some commentors argue that the requirement that the subsidy be “explicit” requires that the subsidy amount (paid or received) be posted on consumers’

²⁶AT&T Comments, p. 8.

²⁷E.g., Comments of Southwestern Bell Telephone Company, p. 19.

bills.²⁸

When discussing the USF funding mechanism, the Act states that “all providers of telecommunications services should make an equitable and non-discriminatory contribution to the preservation and advancement of universal service.” If Congress had intended that all *consumers* make an equitable and non-discriminatory contribution, we assume the Act would have said so. Instead of a customer surcharge, the USF contribution should be treated as a cost of doing business, which telecommunications providers may collect from customers, depending upon their form of regulation or what the competitive market permits. Some providers may indeed “surcharge” their customers; others may find that it is not possible to recover the costs uniformly, or will act to reduce other costs to offset the USF assessment.

Proposals to require that the subsidy amount be printed on the customers’ bills should also be rejected by the Joint Board and Commission. The requirement that the subsidies be explicit is certainly fulfilled by identifying universal service costs, by removing them from the prices of other services, and by creating and administering state and federal USF funds.

USF and Competitive Neutrality

A most critical feature of the Commission’s duty is to create a system of subsidies which do not hinder the development of a competitive telecommunications industry. Based on the comments of many parties on the subject, we suggest at least the following features be included in the USF plan:

1. The subsidy should follow the customer, not the carrier.

²⁸E.g., Comments of Citizens for a Sound Economy Foundation, p. 19.

2. The subsidy should be available for the customer of any carrier in a suitably defined region (e.g., a Census Block Group) which advertises its services to all customers.
3. For Tier 1 LECs, the subsidy should be based on the difference between a benchmark cost and the affordable rate as determined jointly by the FCC and the States.
4. The federal USF should be administered by a neutral third party determined as the winner of a bid process conducted by the Commission ²⁹. Several commentors recommended that the Commission select NECA as the fund administrator.³⁰ Although it is qualified by experience (and should be permitted to bid) NECA should not be assumed to be sufficiently independent.

Conclusion

We have woven a tangled web of support mechanisms, subsidies and systems of non-economic prices among telecommunications providers and consumers. While the Telecommunications Act of 1996 captures the requirements of a new universal service funding system in just a few pages of law, the practical reality is that it will take some time and a lot of effort to reform the system. CPI suggests that the Joint Board and Commission view their responsibilities as a series which should be accomplished in approximately the following order:

²⁹We agree with the comments of Teleport Communications Group, p. 16, concerning the need for independence of the Administrator and the benefits of using a bidding procedure for selection.

³⁰See, for example, the Comments of the Rural Telephone Coalition and the letter from Commissioner Edward Salmon.

- Adopt a definition of supported services.
- Restructure existing universal service mechanism to collect costs from all providers of telecommunications services on the basis of net telecommunications revenues.
- Begin a phased transition of subsidies paid to small LECs; rationalize DEM weighting to more nearly relate subsidies to actual high costs for switching. Use reported costs initially, but construct a transition to forward-looking costs for small LECs.
- [In the parallel §251 proceeding] Adopt rules for interconnection, resale and unbundling which provide a realistic opportunity for new entrants to become local exchange competitors with prices for inter-carrier transactions set at economic costs.
- Conduct a review and restructuring of access rates.
- Simultaneously review Commission's obligations under Section 254(k), including the applicability to the CCLC.
- Use the Benchmark Cost Model and a nationwide target rate to compute the federal universal service subsidy required for customers of Tier 1 LECs. This should be conducted in concert with the States, which will likely establish state universal service funds at the same time.
- Move CCLC and SLC to economic costs
- Depending on i) the status of State universal service plans, and ii) the status of support for

small LECs, re-examine the potential for unifying the universal service subsidy system.

- Periodically review definition of universal service.

Respectfully Submitted,

Ronald J. Binz
President

Debra Berlyn
Executive Director

Competition Policy Institute
1156 15th Street, N.W. Suite 310
Washington, D.C. 20005
202-835-0202 202-835-1132 (fax)