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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

November 1, 1993

VIA COURIER

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Mail Stop 1170
Washington, D.C. 20554

RM-8388

Dear Mr. Caton:

Enclosed for filing with the Commission are an original and five (5) copies of the Petition of MFS Communications, Inc. for a Notice of Inquiry and En Banc Hearing in the Matter of Policies and Programs To Assure Universal Telephone Service in a Competitive Market Environment.

An extra copy to be date-stamped and returned to our messenger is also enclosed.

Respectfully submitted,

Andrew D. Lipman

cc (w/encl.):
Chairman James H. Quello
Commissioner Andrew C. Barrett
Commissioner Ervin S. Duggan
Kathleen Levitz, Acting Chief, Common Carrier Bureau
Jill Ross-Meltzer, Associate Chief, Common Carrier Bureau
James D. Schlichting, Chief, Policy Division

120286.1

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

In the Matter of	)
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Inquiry into Policies and Programs to	)
Assure Universal Telephone Service in a	)
Competitive Market Environment	)

PETITION OF MFS COMMUNICATIONS COMPANY, INC.
FOR A NOTICE OF INQUIRY AND *EN BANC* HEARING

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Attorneys for MFS Communications Company, Inc.

Dated: November 1, 1993

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Summary

MFS, the Nation's largest provider of local competitive access telecommunications services, petitions the Commission to issue a Notice of Inquiry and convene an *en banc* hearing on an accelerated basis to determine future policies for continuing to promote universal telephone service in a competitive market. Although local telephone service today is a nearly pure monopoly, competition is on the horizon and it can reasonably be foreseen that legal and regulatory developments in coming years will remove existing barriers to entry. As this transition occurs, it is the Commission's responsibility to assure both that the public interest in a universally available telephone network continues to be protected, *and* that entrenched monopolists cannot use universal service as a shield against more efficient competitors.

The "big myth" propagated by some local exchange carriers is that universal service inherently requires that local service be provided by subsidized and protected monopolies. MFS submits both that the supposed "subsidy" requirements of local carriers are grossly overstated and that, regardless of what amount of subsidy is actually required, these policy goals can be achieved without restricting competitive entry.

MFS recognizes its responsibility, shared with all other telecommunications providers, to contribute to the funding of universal service. One objective of this Petition to assist the Commission in determining an equitable, non-discriminatory, and competitively neutral funding mechanism that will permit MFS to fulfill that responsibility; as opposed to "contribution charges" and other mechanisms proposed in

the past that would place an unreasonable and disproportionate burden on competitive entrants.

An *en banc* hearing is appropriate in this instance given both the overarching significance of the issue and the wide range of parties potentially interested in the inquiry. The Commission should act expeditiously in this matter in order to establish a road map for future proceedings, such as separations and access charge reforms, that will have collateral impacts on universal service policies. Moreover, as other policymakers, both state and federal, begin considering these issues, it is important that the Commission maintain its leadership role in the ensuing dialogue.

Among the issues that the Commission should investigate, which are described in more detail in the body of the Petition and Attachment 1 thereto, are the following:

1. Which services or users require subsidization? Should the Commission continue to subsidize "high-cost" rural exchanges without regard to other factors, or should it target subsidies more narrowly to areas that have a demonstrated need due to a combination of geographic and income factors?

2. How much subsidy is actually required? Are existing subsidy levels necessary, or do LEC "subsidy" estimates actually reflect inefficient cost structures, excess profits, and/or a mismatch of costs and revenues due to arbitrary allocations?

3. Who should administer subsidy programs? The danger in allowing the fox to guard the chicken coop is obvious. The Commission should solicit bids from disinterested parties, such as financial services and/or information management firms, to administer

all universal service subsidy programs including the "implicit" subsidies supposedly contained in local exchange carrier rates today

4. How should subsidy funds be raised? A new mechanism needs to be developed that does not discriminate against providers or users of specific types of service, or for or against particular geographic areas. MFS urges the Commission to study a proposal being circulated by Professor Eli Noam of Columbia University, which appears to offer a method by which funding responsibility could be allocated equitably among all telecommunications service providers without competitive distortions.

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In the Matter of	)
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Inquiry into Policies and Programs to	)
Assure Universal Telephone Service in a	)
Competitive Market Environment	)

PETITION OF MFS COMMUNICATIONS COMPANY, INC.
FOR A NOTICE OF INQUIRY AND *EN BANC* HEARING

MFS Communications Company, Inc. ("MFS"), by its undersigned counsel, hereby petitions the Federal Communications Commission to issue, on an accelerated basis, a notice of inquiry pursuant to 47 CFR §§ 1.1 and 1.430 to determine future policies assuring the continued availability of universal telephone service as certain aspects of the local telephone market become increasingly competitive; and in connection with this inquiry to convene an *en banc* hearing to obtain proposals and factual information from a wide range of interested parties.

MFS respectfully submits that the assurance of universal service is undoubtedly the single most significant public policy issue that the FCC will have to address as the market for local telephone service becomes increasingly competitive, as it inevitably will.[1] The very first stated purpose of the Communications Act of 1934 (the "Act") is

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[1] Today, local exchange service is almost exclusively monopolized by local exchange carriers ("LECs") serving mutually exclusive exchange territories. In most states, there are significant legal and practical barriers to the entry of competitors into any of these territories. However, the economic barriers to local exchange competition have been steadily eroding in recent years due to technical changes, and, as a result, the legal barriers are also being re-examined in certain States and in the U.S. Congress. Although it undoubtedly will take a number of years for effective competition to develop within the local exchange, MFS believes that this will inevitably occur.

to regulate communications "so as to make available, so far as possible, to all the people of the United States a rapid, efficient, Nation-wide, and world-wide wire and radio communication service with adequate facilities at reasonable charges . . . ." Act § 1, 47 USC § 151. The assurance of universal service is, therefore, one of the Commission's most significant public service responsibilities. At the same time, as accelerating economic and technological developments make local telephone competition increasingly feasible, it is also the Commission's bedrock responsibility to assure that the protection of universal service is not used by entrenched monopolists as a shield against competition, which would be contrary to the statutory goals of assuring "efficient" service at "reasonable charges."

MFS believes that Universal service and local competition are highly compatible and not inherently inconsistent. Some incumbent local exchange carriers ("LECs"), however, foreseeing the emergence of competition into their lucrative, sheltered local markets within the next few years, have attempted to raise "fear, uncertainty and doubt" by claiming that local telephone competition would inevitably undermine the existing system of alleged "implicit" or "hidden" subsidies that supposedly make possible universal, affordable local exchange service. These LECs reflexively invoke the phrase "universal service" to discourage regulators from introducing increased local service competition. It is essential that the Commission lay these fears to rest by determining what form and amount of subsidy is really necessary to preserve universal service, and then establishing a secure, competitively neutral and equitable source of funding for that subsidy. By addressing these significant issues, the Commission will be simultaneously ensuring both universal service and competitive choices for all Americans.

MFS also suggests that an *en banc* hearing is appropriate in this instance given the overarching significance of the issue and the wide range of interested parties potentially affected by the inquiry. An *en banc* hearing would also help the Commission to develop an overall universal service policy that could provide guidance to the staff in other, related proceedings (such as the several pending proceedings regarding access charge reform,[2] and the proposed revision of the rules governing the Universal Service Fund[3]). For this reason, it would be desirable to conduct the hearing and inquiry promptly, before actions are taken in other dockets that may have major substantive impacts on universal service.

I. INTRODUCTION AND STATEMENT OF INTEREST

MFS is the largest provider of local competitive access telecommunications services in the United States. Its subsidiary, MFS Telecom, Inc., has installed and operates fiber optic communications networks in 14 major metropolitan business centers across the Nation, and offers a wide range of high quality digital local access and private

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[2] For example, and without limitation, issues relating to funding of universal service have been raised recently in the FCC staff working paper entitled *Federal Perspectives on Access Charge Reform*; in the petition of NARUC for a Notice of Inquiry Concerning Access Issues; in Ameritech's Petition for Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region; and in the United States Telephone Association's Petition for Rulemaking regarding "Reform of the Interstate Access Charge Rules" (filed Sept. 17, 1993).

[3] *Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board*, CC Docket No. 80-286, Notice of Proposed Rulemaking, FCC 93-435 (released Sept. 14, 1993).

line services to communications-intensive business and government end users. Another subsidiary, MFS Intelenet, Inc., provides a complete package of telecommunications and information management services to small businesses, including (where authorized) both local and long distance calling services. MFS Intelenet has recently been recognized by the New York Public Service Commission as a "local exchange carrier" entitled to the same form of interconnection within the public switched network as incumbent LECs.[4]

In 1989, MFS Telecom (then known as Metropolitan Fiber Systems, Inc.) filed a Petition for Rulemaking with the Commission seeking expanded interconnection to local telephone company facilities. As a result of this Petition, the Commission proposed and later adopted rules requiring the major LECs to offer third parties expanded interconnection to interstate special and switched access services, and in most instances to offer the option of physical collocation for this purpose.[5] In the course of that proceeding, many LECs argued that MFS and other interconnectors should be required to pay a "contribution charge" as a condition of interconnection, ostensibly to support public policy objectives such as universal service—although the LEC proposals did not draw any quantitative link between the proposed charges and the supposed policy goals. The

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[4] New York PSC, Case 92-C-0665, *Proceeding on Motion of the Commission to Investigate Performance-Based Incentive Plans for New York Telephone*, Staff Memorandum, Sept. 20, 1993, "Adopted as Recommended and so Ordered By the Commission," Oct. 4, 1993.

[5] *Expanded Interconnection with Local Telephone Company Facilities*, CC Docket No. 91-141, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd. 7369, *modified on recon.*, 8 FCC Rcd. 127 (1992), *further modified on recon.*, FCC 93-378 (released Sept. 2, 1993), *petitions for recon. pending, appeals pending, Bell Atlantic v. FCC*, No. 92-1619 *et al.* (D.C. Cir. filed Nov. 25, 1992) (special access); Second Report and Order and Third Notice of Proposed Rulemaking, FCC 93-379 (released Sept. 2, 1993), *petitions for recon. pending* (switched access).

Commission properly rejected these contentions after finding that there is no identifiable support flow from LEC special access services to universal service or any other public policy goal.[6] This finding is supported by independent analyses demonstrating that LEC dedicated transmission services provide little or no contribution to LEC overhead expenses, and in some cases even require subsidization by other services.[7] Indeed, even USTA's recent white paper on the supposed $20 billion "Potential Impact of Competition on Residential and Rural Telephone Service" confirms that special access and private line services, as a class, are priced at or below their costs, and do not make a net "contribution" regardless of how the term "contribution" is defined.[8]

Some LECs have sought to argue that MFS' opposition to special access contribution charges is inconsistent with its acknowledged obligation to participate with the rest of the industry in supporting universal service goals. However, MFS opposed special access contribution charges because it is not appropriate to single out interconnectors for a "contribution" when the LEC services against which they would directly compete do not make any contribution to universal service. MFS is willing to provide direct financial support for universal service programs as long as this support is assessed against all participants in a relevant market on an equitable, non-discriminatory and competitively neutral basis. In particular, as MFS Intelenet obtains full co-carrier interconnection to the local network, initially in New York and eventually in other

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[6] *Id.*, 7 FCC Rcd. 7369 at paras. 144-147

[7] Probe Research, Inc., *Private Line Economics and Implications for Competition* (1993).

[8] *See* note 15, *infra*.

jurisdictions, it is prepared and intends to take on additional responsibility for universal service. A major objective of this Petition is to allow the Commission to develop an appropriate funding mechanism so that all competitors can bear a fair share of the burden of supporting universal service.

II. The Need for an Inquiry

Although, as noted in the introductory section of this Petition, the subject of universal service is of undoubted importance and has been identified as such in a number of recent proceedings before the Commission, none of these pending proceedings (at least as currently structured) would provide a comprehensive review of Commission policies and programs relating to universal service. The only docketed proceeding in which the Commission is now considering any aspect of these issues is CC Docket No. 80-286, in which the Commission has referred the issue of interim changes to the Universal Service Fund to the Federal-State Joint Board, and has announced its intent to propose long-term changes to the Fund in the next several months.[9] MFS understands, however, that the USF rulemaking will consider only restructuring of the existing Fund, which provides support to "high-cost" LECs, and will not consider the broader issue of whether and to what extent "high-cost" support remains appropriate as part of an overall universal service policy and whether those subsidies should be targeted to individual subscribers, rather than operating companies.

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[9] *See* note 3, *supra*.

Similarly, although other parties have proposed Commission actions from time to time that would affect some aspects of universal service, none of these proposals address the overall question of universal service policy in a comprehensive or holistic manner. In particular, universal service policy involves two fundamental aspects—what financial subsidy/support mechanisms are appropriate to achieve the universal service goal, and how should the funds needed for these programs be raised? Most LEC-sponsored proposals, including Ameritech's "Customers First" plan and USTA's access charge reform petition, only skirt the latter issue, and assume that whatever funds are raised will continue to be distributed to their current recipients (not coincidentally, the LECs). The report of NARUC's Access Issues Working Group, on the other hand, does recognize that existing subsidy mechanisms should be re-examined but offers no specific proposal.

Universal service issues will undoubtedly play a central role in any future reform of access charges, regardless of whether the Commission considers the proposals of the NARUC Working Group, the Staff task force, USTA, MFS, or other parties. Universal service has been and remains an essential aspect of the Commission's pricing policies.[10] MFS respectfully suggests, however, that universal service issues should be considered separately from, and in the early stages of, any overall review of access charges, since the Commission's policy determinations on universal service questions will

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[10] *See generally*, *MTS and WATS Market Structure*, Third Report and Order, CC Docket No. 78-72, Phase I, 93 FCC 2d 241 (1983); *MTS and WATS Market Structure*, Report and Order, CC Dockets 78-72 and 80-286, 2 FCC Rcd. 2953 (1987); and *Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board*, CC Docket No. 80-286, Notice of Proposed Rulemaking, FCC 93-435 (released Sept. 14, 1993).

be a necessary input into the resolution of other access charge issues. For instance, many of the access charge issues raised in the recent Staff working paper[11] cannot be resolved until the Commission determines, first, what level of continuing financial support for universal service is actually required, and second, how that support should be collected and targeted. Furthermore, although MFS supports a comprehensive review of access charges and does not seek to delay that process, it is concerned that resolution of critical policy issues concerning universal service should not await the outcome of a lengthy access charge reform docket. As earlier noted, MFS firmly believes that future universal service can best be structured to encourage simultaneously optimal telephone penetration as well as enhanced consumer choice among services and service providers.

For these reasons, MFS urges the Commission to initiate a separate inquiry into universal service issues, the results of which can be used in other proceedings to help develop more specific rules regarding access charges and related matters. Moreover, as other policymakers, on both a federal and state level, begin considering these issues, it is important that the Commission maintain its leadership role in the ensuing dialogue.

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[11] *See* note 2, *supra*.

III. Specific Issues for Investigation

MFS suggests that a Notice of Inquiry (and *en banc* hearing) into universal service policies solicit comments on a number of specific issues relating both to the definition of the Commission's universal service goals, and particular means of achieving those goals. To begin the process of formulating these issues, MFS is providing as Attachment 1 to this Petition a statement articulating its views as to how universal service should be defined, what specific types of subsidy mechanisms should be adopted to promote those goals, and how the subsidy programs should be funded. MFS' position statement is intended as a framework to begin the discussion of these issues, not to dictate their outcome, and it is fully anticipated that other parties will offer divergent views on some issues or identify other issues not addressed in MFS' statement. In the following section, MFS will briefly describe the issues that are raised in its position statement and that it urges the Commission to consider in this inquiry and related en banc hearing.

A. Which Services or Users Require Subsidization?

A threshold issue in formulating universal service policies is to determine what services are "basic" enough to justify subsidization. Historically, subsidies have applied only to "Plain Old Telephone Service" access lines and, in some cases, to calling within a limited local area. Recently, some parties have suggested many other services that should be classified as "basic" and offered at subsidized rates, such as access to a wide variety of digital information services, databases, and other enhanced services. Although

MFS vigorously supports widespread access to these enhanced services, MFS believes that subsidy programs should initially be limited to POTS access, including Touch-Tone (or DTMF) signalling. The universal service goal should be designed to allow all Americans to be *connected* to the ubiquitous public switched network; it should not subsidize particular services offered over that network. MFS strongly believes that, if the basic infrastructure needed to connect customers to the network exists, competing service providers will have ample incentives to make available a wide variety of communications and information services over that network at reasonable prices.

A related issue is the extent to which subsidies should be targeted to particular end users. Today, some subsidies are targeted to particular users based on need, as determined by either income (Lifeline and Link-Up) or disability (Telecommunications Relay Service). On the other hand, a far larger number of dollars is distributed to small or "high-cost" LECs, either directly through the USF or indirectly through the NECA Common Line Pool and such cost-shifting mechanisms as triple DEM weighting. This approach has been used to suppress rates for telephone service in rural areas, at the expense of urban consumers. In fact, thanks in part to these programs, telephone service often costs *less* in rural areas and the territories of small LECs than it does in urban areas, leading to the extraordinary result that the service that costs more to provide is offered at a lower price.[12] It is at the very least open to question whether such a blanket subsidy of "high-cost" LECs, regardless of the average income level of their

[12] In New York State, for example, nearly all of the state's independent telephone companies charge lower rates for basic local service than does New York Telephone.

subscribers, is warranted any longer, as opposed to more targeted subsidies based on income, disability, and other customer characteristics that would assure the continued availability of basic service to all individuals. No other commodity or service offered in the marketplace is sold at subsidized prices based solely on geography, even those that are most essential to human life and to society (such as food, healthcare, electricity, or gasoline). Housing, which is undoubtedly an essential service, is far more expensive in major cities such as New York, Los Angeles, Chicago, and Washington than it is in most rural areas, yet farmers are not required to pay a real estate surcharge to subsidize urban rents.

MFS suggests that rural areas should, as a general proposition, be expected to pay their own way for telephone service just as urban areas pay their own way for housing. Certainly, there are many areas of low population density whose residents have ample income to pay cost-based charges for telephone service (such as Southampton, New York; Palm Springs, California; Jackson Hole, Wyoming; or Middleburg, Virginia). Targeted subsidies could be used to keep rates affordable in areas with low income levels, regardless of whether they are rural or urban.[13]

Targeting of subsidies would also eliminate the perverse incentives in the existing system, which rewards LECs for having high costs. Although high costs *may*, in many instances, be the result of low subscriber line densities and similar factors, there may also be instances in which they are simply the result of inefficiency. Under the existing

[13] Of course, any transition from "high-cost" to targeted subsidies would probably have to be phased in over some period of time, to avoid subjecting rural customers to rate shock.

system, if two LECs serve areas of similar size and with similar line density characteristics, the one with the higher costs is rewarded with a higher subsidy. The existing USF system clearly provides no incentive for the higher-cost company to improve its efficiency and reduce its costs; to the contrary, that company would be penalized for doing so.

A further reason for eliminating "high-cost" subsidies is that such programs are plainly incompatible with increasingly competitive markets. As long as rural LECs are dependent on subsidies, the Commission may feel compelled to protect these entities against competition to prevent further increases in the amount of the subsidy. Indeed, it is hard to imagine why any competitor would want to serve a rural area if the incumbent LEC is subsidized and the new entrant has to compete based on its own costs.[14] Elimination of direct subsidies to LECs would mean that competitors and incumbents would each compete based on their own costs, creating a market incentive for competitors to seek to serve rural areas if they can do so efficiently.

B. How Much Subsidy Is Actually Required?

The Commission has recently expressed concern about the rate of increase in the size of the existing USF, recognizing that every dollar of subsidy is a dollar that has to be collected, directly or indirectly, from some user of telecommunications services.

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[14] For example, it is very likely that telephone subscribers in some of the very low-density areas of the country could be served today by cellular radio systems, BETRS, or other radio services at lower economic cost than by conventional telephone service. Because the conventional service is subsidized, however, customers have no incentive to use the more efficient radio alternative.

Excessive subsidies are harmful in two ways—first, they create economic inefficiencies by stimulating usage of some services (those that receive subsidies) and discouraging usage of other services (those that provide the subsidies); and second, they create uneconomic incentives for users to avoid those services whose prices are inflated by subsidy funding requirements. These harms, of course, must be balanced against the social benefits of subsidy programs. Some level of "inefficiency" must be tolerated, and indeed may even be desirable, to assure that the telephone network remains a ubiquitous national asset; but the Commission must constantly remain vigilant to assure that the benefits and costs of subsidy programs remain in balance.

Currently, explicit "subsidy" or "assistance" mechanisms under FCC jurisdiction collect and distribute something in excess of one billion dollars per year. The USF and Lifeline funds administered by NECA currently account for approximately $800 million; additional indirect assistance is provided through the Common Line Pool and other mechanisms. Some states have additional Lifeline assistance programs, "high cost" pools and the like. Yet all of these explicit subsidy programs are, according to LEC accounts, dwarfed by "implicit" or "hidden" cross-subsidies embedded in existing rate structures. Some LEC-sponsored analyses claim that subsidies of up to $20 billion per year (out of total regulated LEC revenues estimated at $92 billion) flow to basic local exchange service.[15] If subsidies of such magnitude really existed, preserving them in a competitive marketplace would be a daunting challenge and would result in a permanent and

[15] USTA, *Potential Impact of Competition on Residential and Rural Telephone Service*, July 21, 1993 (citing Monson and Rohlfs, *The $20 Billion Impact of Local Competition in Telecommunications*, for subsidy flows and F. W. Nolte, Bellcore, for revenues).

massive drain on the resources of new entrants in order to assure the continued prosperity of incumbents.

LEC subsidy claims should, however, be subjected to the most careful and skeptical analysis. The LECs obviously have every incentive to inflate the apparent amount of subsidy to delay and frustrate the evolution of a competitive market. Indeed, the LECs' claims have at least two readily apparent and fundamental flaws. First, the major purported "subsidy" identified by the LECs is based on a comparison of subscriber loop costs and monthly local exchange service rates. This ignores the fact that subscriber loops provide access to *all* current and future telecommunications services, not just to local exchange service, and therefore are the archetypical joint and common cost of the network. When a LEC incurs costs to construct subscriber loops (say, to a new housing development or office building), it generates new revenues not only from local exchange service but also from intraLATA toll services and switched access usage generated by these new loops. As long as the aggregated total of these revenues exceeds the cost of the loops, it is wrong and misleading to say that the loops are subsidized.[16] Several recent state regulatory proceedings have correctly debunked the LEC "subsidy" argument on this basis.[17] Whether the LEC recovers its loop costs through monthly access line

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[16] Since LECs are uniformly profitable, revenues obviously do exceed costs on average. Although this does not mean that revenues from every individual customer necessarily cover the costs of serving that customer, it is reasonable to assume that *most* customers generate total revenues (including indirect revenues such as terminating access charges for calls received by the customer) that exceed the cost of serving them.

[17] For instance, the New Hampshire Public Service Commission rejected New England Telephone's contention that basic local exchange service required a "subsidy" from intrastate toll,
(continued...)

charges to the end user, through usage (local message and toll) charges to the end user, or through per-minute access charges for originating and terminating usage is a matter of rate design that is separate from universal service policy concerns.[18]

Second, the LEC studies assume that a "contribution" to local service is provided whenever the price of a service exceeds its "economic cost."[19] As noted above, the Commission has already rejected this approach in its *Expanded Interconnection* decision,

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[17](...continued)
finding that "basic exchange services are not only covering their incremental costs but are also contributing towards common overhead costs." *New England Tel. & Tel. Co.*, DR 89-010, Order No. 20,082, 76 NH PUC 150, 167 (1991). A witness for the Maine Public Utilities Commission staff similarly testified that NET's basic exchange service revenues exceeded the stand-alone costs of the service; he found that the revenue in excess of stand-alone costs generated by NET's larger exchanges (over $26 million) was more than sufficient to offset the shortfall in revenues from smaller exchanges (about $4.5 million). Testimony of David Gabel at 34-35, *Investigation into New England Tel. Company's Cost of Service and Rate Design*, Docket No. 92-130 (Maine PUC 1992). A report of the Illinois Commerce Commission staff reaches similar conclusions, finding that total revenues from local residential service in that State, including local usage and features charges in addition to access line rates, were more than sufficient to cover the cost of service in each of Illinois' three pricing zones. *Local Competition and Interconnection* at 30-32 (July 1, 1992).

[18] Indeed, it is far from certain that there is any economically "correct" way of designing prices to recover these costs. In a fully competitive market, carriers would design prices based on consumer demand and in response to the pricing of rivals. Carriers might well choose to keep monthly access fees low in order to encourage subscription to their services, and to recover more of their common costs through usage-sensitive charges (*i.e.*, giving away the razor in order to sell more blades). *See* Comments of National Telephone Cooperative Ass'n (at 7-8) on the Staff working paper, Federal Perspectives on Access Charge Reform, submitted to Common Carrier Bureau on Sept. 23, 1993. If such pricing patterns prevail in a competitive market, then it would be absurd to think that monopolies would be unable to sustain similar rate structures without being subsidized. Of course, until a fully competitive market for local service exists, it is impossible to determine what form of pricing is most efficient.

[19] The concept of "economic cost" is itself particularly slippery when applied to services that have never been provided in a competitive market. In a market economy, the cost of producing goods and services is affected by the demand for those services and by the prices charged by competitors. In the local telephone sector, by contrast, the "cost" of service is often an artificial regulatory construct that may have little relationship to the costs that a new entrant would incur, or even to the costs that the incumbent would actually incur if faced with competition.

in which it refused to permit LECs to impose "contribution charges" on interconnectors to recover the difference between special access rates and their supposed costs. Rather, the Commission determined that contribution charges would be authorized only if a LEC could demonstrate an explicit non-cost-based subsidy to some other service.[20] Prices that exceed the apparent cost of a service may be the result of misleading or incorrect computations of "cost"; of arbitrary allocations of joint and common (overhead) costs; of inefficiencies that cause the LEC's actual cost to exceed the "economic" costs that would be incurred by a more efficient firm; or of above-market returns on capital (which may account for the fact that LEC stockholders have historically received above-average returns on their investments). None of these factors provides any readily apparent justification for subsidizing the company in question.

Apart from these obvious problems with the LEC arguments, there may well be further flaws and new insights that can only be identified through a detailed analysis of the LECs' supporting cost studies and arguments. Because of the economic inefficiencies created by subsidies, the Commission needs to be sure that it maintains only those subsidies that actually produce significant public benefits, and that it does not fall sway to LEC efforts to maintain their monopolies and profit levels through inflated and unnecessary "subsidies."

[20] *See* note 6, *supra*.

C. Who Should Administer Subsidy Programs?

Existing subsidy programs are largely administered by the LECs, primarily either through their collective organization, NECA, or through charges (such as the transport "interconnection charge" element) collected and retained directly by the LECs themselves. Given the clearly selfish economic incentives of the LECs, as outlined in the preceding section, it would be highly inappropriate to permit them to continue to oversee subsidy collection and distribution in a competitive market. Although NECA operates subject to Commission jurisdiction and oversight, experience has shown that it is difficult for the Commission, with its limited staff resources, to detect and correct possible abuses in a timely manner.[21]

MFS proposes that the Commission provide for designation of a disinterested third-party administrator for all subsidy programs. The Commission has previously recognized the potential for bias in administering support mechanisms when it established the National Exchange Carrier Association to oversee the access charge pooling mechanism, and more recently, as noted above, has recognized the need for increased oversight in its proposal to require the addition of outside directors to NECA's board.[22] The problems that have arisen with NECA could be avoided by contracting with a neutral party to administer universal service programs on a day-to-day basis. The administrator's

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[21] *See* News Release, "Methods to Strengthen NECA's Administrative Procedures Proposed; Related Items Address Independent Audits of NECA (CC Docket 93-6)," Report No. DC-2314 (released Jan. 14, 1993).

[22] NECA was a sufficiently neutral administrator for access charge pooling purposes since its primary function was to collect money from low-cost LECs and distribute it to high-cost LECs, and its membership represented both groups.

operating expenses could be recovered from the subsidy funds. This administrator should account for all subsidy collections and payments by telecommunications carriers, including both explicit subsidy programs and (unless and until they are phased out) indirect subsidy payments such as the transport interconnection charge, state "contribution" charges for expanded interconnection, and other concealed subsidies.

Although some parties may suggest that an industry forum or committee (similar to an expanded NECA) should be placed in the administrative role, MFS sees no need for this. Any industry-wide organization would necessarily be very costly, since dozens or hundreds of participants would have to devote personnel and other resources to the organization; also, it is very likely that the organization would get bogged down in recurring and acrimonious disputes among different industry factions. The administration of the subsidy program should instead be entrusted to a disinterested party such as an accounting, financial services or information management firm that has no direct stake in the structuring of subsidy programs.[23] The administrator will be able to hire whatever expert personnel, including experts in telecommunications costing and pricing disciplines, it needs to fulfill its responsibilities.

D. How Should Subsidy Funds Be Raised?

One point on which the telecommunications industry appears to be virtually unanimous is that, in a competitive market, it is crucial that the financial responsibility

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[23] MFS suggests that the administrator be selected through a competitive bidding arrangement to give candidates an incentive to keep administrative costs at reasonable levels.

for subsidies be spread as broadly and as equitably as possible. Today, interexchange carriers bear the lion's share of the responsibility for explicit subsidies, through USF and Lifeline assessments and through other subsidies embedded in carrier common line charges. The LECs claim that they are responsible for even larger amounts of "implicit" subsidies, although as discussed above these claims are highly suspect.

MFS recognizes its obligation, as a provider of telecommunications services, to participate in the funding of universal service goals. Any new funding mechanism should be designed so that all users of telecommunications services (other than subsidy recipients) contribute equitably to the subsidy burden, regardless of what form of telecommunications they use or which carrier they obtain service from. In this process, all services (including, without limitation, local exchange, competitive access, interexchange, cellular, PCS, and satellite) should be expected to contribute on a non-discriminatory, competitively-neutral basis.

Attachment 1 hereto provides an outline of a "play or pay" system under which all carriers would be assessed a Universal Service Assurance obligation each year based on an appropriate competitively neutral criterion. Significant features of the system would be as follows:

1) *All* telecommunications service providers would be required to participate; no carrier would be excluded from supporting universal service based on the market it serves, the type of service it provides, its size, or other features that characterize existing subsidy mechanisms.