



**SOUTHWESTERN BELL TELEPHONE COMPANY  
COMMENTS ON NARUC UNIVERSAL SERVICE PROJECT  
DRAFT POSITION STATEMENT**

Southwestern Bell Telephone (SWBT) Company applauds NARUC's efforts to fashion forward-looking national universal service policy which recognizes today's competitive marketplace and the urgent need for new telecommunications regulatory policies.

While universal service is not a set of services or technologies, but rather, the basic infrastructure with which network access is provided and services are offered, NARUC's categorization of services and technologies provides an effective means for delineating those basic telephone services for which universal service principles may apply.

NARUC has recognized that significant implicit support flows currently exist which cannot be sustained in a competitive environment. LEC's must be accorded the flexibility to rebalance rates in order to engage in effective competition and to recover the costs to provide universal service, thereby minimizing support flows. Following rate rebalancing, financial assistance should be targeted to those end users who cannot afford telephone service, based on a financial needs test. If rate rebalancing is limited, then an expansion of existing explicit support mechanisms will likely be necessary to allow the present universal service provider to recover its costs incurred to meet existing universal service obligations.

NARUC has recognized that information provided by OPASTCO and the Western Alliance shows that the impact of Universal Service Funds on rural, high cost areas can be significant. It is SWBT's view that rural areas served by larger LECs can also have similar high cost characteristics. These characteristics are often masked in the data provided by the larger LECs, since costs are normally reported at a study area level. In CC Docket No. 91-213, SWBT provided information indicating that there were cost differences between high volume and low volume offices for transport facilities. Based on preliminary information being developed by SWBT, it is likely that the cost characteristics reflected by the small, predominantly rural LECs included in the OPASTCO and Western Alliance studies will be similar for rural areas served by SWBT. In the past environment of minimal competition, the implicit support created by rate averaging created sufficient contribution for the high cost areas to be supported by the lower cost areas. As competition enters the lower cost areas, this contribution is likely to be eroded. In order to maintain/enhance universal service in all areas, it may be necessary to address the requirements of larger LECs serving both rural and urban (high cost and low cost) areas on a basis that makes some distinction of cost at a lower level than total study area.

SWBT agrees with NARUC's recommendation to allow the states, as part of their regulatory oversight functions, to individually address unique market demands in their respective states in determining the need for technical standards or minimum service capabilities, and to address the associated cost recovery issues. With respect to a DS0 minimum technical standard, SWBT believes that customers, via market demand for services, should define technical requirements.

SWBT continues to support the USTA position with regard to the modified building block (MBB) approach. The MBB approach does not effectively promote meaningful, economically efficient competition, but instead confuses pricing, unbundling, and imputation policies with the examination of proper costing methods. This serves to unduly handicap LECs.

Several MBB characteristics warrant mention. First, that portion of the MBB approach which is supported by sound economic principles is already included in the LECs' incremental cost study methodologies. Second, MBB unnecessarily restricts LEC pricing methods. Third, SWBT firmly believes that the majority of loop costs are not shared/common costs of the LEC. Loop costs are directly attributable to, and arise from, access to the network. MCI and many in the economic community support SWBT's argument. Finally, Shapley value calculation is not a cost analysis issue, but is instead a pricing issue which has little support from mainstream economists. Cost allocation via Shapley values is technically very difficult and, we believe, probably impossible from a practical view.

Regardless of whether or not a building blocks approach is ultimately used, regulators must address depreciation reserve deficiencies and define a mechanism for recovery of past franchise and carrier of last resort obligations, without relying on contribution from competitive services.

Regulators must carefully evaluate whether or not allowing multiple service providers to compete for support payments in high cost areas serves the public interest. Critical issues include: terms and conditions of universal service obligations, assignment of carrier of last resort obligations, network interconnectivity between competitors, compensation arrangements, and full recovery of LEC stranded investment placed under universal service obligations. LECs must be allowed to rebalance rates before any competition for support payments can occur.

Once rate rebalancing is in place, SWBT is prepared to further explore the merits of a virtual voucher system for the provision of end user support. Careful consideration must be given to each of the critical issues identified by NARUC which impact universal service objectives. SWBT agrees that, where competing providers do not exist, the incumbent universal service provider should continue to receive necessary support; however, that same provider should not also be required to contribute to the funding of universal service support.

SWBT's Response to

# Teleport

# Teleport's Universal Service Assurance Plan

## Summary of Paper

Teleport's paper entitled "Universal Service Assurance (USA)" proposes what Teleport refers to as "equal access to the local exchange subsidies". (p. 2) Teleport reasons that under its plan a competitor in the local exchange market would willingly serve high-cost or low-income consumers, "so long as it could receive for each such customer the same subsidy that the incumbent provider receives." Teleport explains that if the competitors cannot have access to such subsidies "regulators and telephone companies can hardly fault competitors for not serving such customers." (p. 3)

Teleport proposes to establish an independent subsidy fund from which all local telephone carriers including competitors could "draw" the subsidy required to serve particular customers. Carriers would contribute to the fund based on their share of the market. (p. 3) Any carrier may elect "to-serve" or "not-to-serve" certain customers or markets. (p. 4) The proposal states that "if the subsidy is properly calculated, few if any individual customers or geographic areas would be 'undesirable'." (p. 4) If no carrier wishes to serve a customer or a market, then the regulators must conduct an auction to determine the carrier of last resort. (p. 11)

HOW USA WOULD WORK -- Teleport's USA plan requires that:

1. regulators/legislators must establish equitable rules for quickly certificating new facilities-based local exchange carriers to compete with incumbent LECs; (p. 7)
2. regulators/legislators must establish the USA Fund administrator, to be independent of all carriers; (p. 7)
3. regulators/legislators must provide for full interconnection of local carriers' networks, so that competitive services are technically, operationally, and economically feasible; (p. 8)
4. incumbent LECs identify the amount of the subsidy required to maintain service to each of the claimed subsidized customers; (p. 8)
5. all intrastate common carriers of two-way public telecommunications services contribute to the USA Fund based on their market share; (p. 8)
6. any carrier wishing to serve a subsidized customer can register as Universal Service Carrier (USC); (p. 8)
7. "free entry and free exit will allow equal access to subsidies." Furthermore, if an existing company "cannot afford to serve a particular market without a particular subsidy,...it should be permitted to turn over its facilities (at net book value or through an auction) to another carrier willing to serve." (p. 10) Through this method, "the result would be the replacement of an inefficient incumbent monopolist with a more efficient monopolist." (p. 13)
8. consumers will have the ability to shop for total service. (p. 11)

## **Discussion - Opportunities and Concerns**

Teleport's proposal underscores the general industry consensus that a comprehensive review of universal service issues is critical to facilitate faster growth of competition while assuring continuance of universal service.

### **1. EQUAL ACCESS TO SUBSIDIES AND INDEPENDENT SUBSIDY FUND**

The proposal establishes an independent subsidy fund from which all local telephone carriers including competitors could "draw" the subsidy required to serve particular customers or markets. Carriers would contribute to the fund based on their share of the market. This approach suggests that universal service subsidies could pay for ubiquitous deployment for universal access by customers (high and low cost, urban and rural, wealthy and poor, etc.) of new networks to parallel existing LEC networks into America's heartland, hence, bringing choice to customers. A problem is that the existing subsidies are designed to recover the costs of the existing ubiquitously deployed infrastructure. Additionally, Teleport appears to suggest that the new subsidies it is proposing would be funded primarily by the very LECs that have built the current ubiquitous infrastructure which provides universal access to customers. This part of the proposal, while may be well intended in that it seeks to bring carrier choice to all customers, is not practical since it requires the LECs to pay for the costs they already incurred for providing universal service. Additionally, receipt of undeserved subsidies could be a windfall to competitors.

### **2. CUSTOMERS WILL HAVE A CHOICE OF CARRIERS AND CARRIERS WILL HAVE A CHOICE TO-SERVE OR NOT-TO-SERVE PARTICULAR MARKETS OR CUSTOMERS**

The proposal takes a new way of looking at universal service. It suggests that not only will customers have choices, the carriers will also have a choice to-serve or not-to-serve a customer or market based on the desirability of that customer or market. To determine desirability, the plan calls for calculation of subsidies on a customer-by-customer basis. If, based on this information, no carrier seeks to serve a customer or market, the plan calls for regulators to auction that customer's service or the market. A problem with this approach is that carriers' refusal to serve a customer or market could mean that universal service may not exist for that customer or market. Teleport's solution of auctioning off these areas and customers to the lowest bidder does not address the possibility that for some areas there may be no bidders or the low bid may be "higher" than socially desirable.

The plan also proposes the notion of "free entry and free exit" which suggests that if an existing company cannot afford to serve a particular market without a particular subsidy,...it should turn over its facilities to another carrier at net book value or through an auction. This portion of the plan is confusing as it makes a number of assumptions regarding the LECs' efficiency and the regulators' desire to replace the LECs' monopolies with more efficient monopolies by giving away LECs' networks to the new entrants. Other than exchanging one monopoly for another no other benefits are cited.

### 3. UNIVERSAL SERVICE AND NATIONAL INFRASTRUCTURE GOALS

Teleport's proposal assumes that the only issue that must be addressed is basic residential service provided at a "subsidized" price. A major concern regarding this portion of the proposal is that it does not address a number of other issues. One example is whether customers in high-cost areas should pay more for toll calls than customers in low-cost areas--an issue that has been key to past universal service decisions.

Another concern is that the paper does not address the goals of advancing the national infrastructure: access to advanced services; classrooms; health-care facilities; etc.

#### **Issues For Further Discussion**

##### **-- Hard Questions That Will Have To Be Answered**

- (1) Would competitive entry based on receipt of subsidy promote efficiency? Would the proposal motivate multiple suppliers to make substantial investments in high-cost areas which, without support, would not sustain a single supplier? Would this compound rather than reduce the subsidy problem?
- (2) How to balance the task of recovery of costs of existing universal service infrastructure with the recovery of the costs of future competitor networks?
- (3) Would high-cost areas pay more since they would have to possibly support the high-cost of two service providers? Will having "choice" justify the higher prices?
- (4) How should subsidies be defined and quantified?
- (5) Who are "all intrastate common carriers" that would be required to pay into the USA Fund?
- (6) Assuming full competition, would a Net Trans Account system be necessary?
- (7) Would granting LECs pricing flexibility be a much simpler approach to resolving universal service problem? Would LECs be able to minimize subsidy amounts by rebalancing rates?
- (8) Would consumers benefit more by having market driven prices or by having multiple subsidized providers?
- (9) Should "carrier of last resort (COLR)" responsibility require a firm commitment to-serve, without the ability to refuse-to-serve a particular customer or market?
- (10) How should COLR responsibility be assigned to various carriers? Is there an equitable way to share this responsibility?
- (11) How should various providers including LECs interface for a ubiquitous seamless nationwide network to exist?

- (12) **Should universal service be provided on a customer-by-customer basis? Would this be a more costly method?**
  
- (13) **Who is the true beneficiary of this proposal? Should it be the customer or should it be the alternate provider?**

SWBT's Response to

**Eli Noam**

## Eli Noam "NetTrans Accounts" Proposal

### SUMMARY

#### FINANCING THE UNIVERSAL SERVICE SYSTEM OF TOMORROW

Eli Noam's paper establishes certain principles for a reformed universal service. These principles suggest that the new system of universal service should: (1) not skew the relative market strength of any carrier; (2) not favor or disfavor integrated or unbundled provision of a service; (3) not favor any type of transmission technology over others; (4) not favor any particular use of telecommunications, or type of message; (5) not burden any parts of the country disproportionately; (6) not result in a shock or windfall to any participants; (7) be integratable into the federal-state regulatory system. (p. 15)

Noam also suggests that successful revenue raising systems should meet the following criteria: (1) there should be no rate shocks, windfalls, or unilateral advantages to some competitors; (2) should have stability in generating the targeted revenues; (3) must be simple; (4) may not require overturning existing universal service system; (5) should provide incentives to production efficiencies. (p. 16)

#### NOAM'S OPTIONS FOR REFORM -- Pros and Cons

The paper identifies the following options and describes the major problem with each option:

1. Set regulated rates on franchised LECs and support low prices for universal service customers -- In a competitive environment, this exposes the LECs' subsidizing customers to "cream-skimming" entry by new entrants. (p. 17)
2. Impose access charges on carriers as they interconnect into the LEC local network at a contributory level -- This approach does not work in a multi-carrier local environment. (p. 17)
3. Institute income tax, or general sales tax to fund universal service -- This is not realistic in the current political and budget environment. (p. 17)
4. Levy a telecommunications sales tax on customers bills of LECs and other Carriers -- This would suffer from the political difficulty of raising a new tax. (p. 17)
5. Apply a tax on telecommunications equipment -- This is also not very workable for the same reasons noted above. (p. 18)
6. Apply property tax on carriers -- This system would be a disincentive to investment and quality. (p. 18)
7. Levy a comprehensive telecommunications value-added tax on all carriers, services, etc. -- This would also suffer the same political problems as any other tax. (p. 18)
8. Implement an accounting mechanism to assure fairness of burden via the NET TRANS ACCOUNT (NetTrans) -- The system keeps score that all carriers pay a proportionately similar share to the maintenance of universal service. Noam proposes that this system would be implemented at the same time that full local competition is permitted. (pp. 18, 22)

b. HOW DOES NetTrans WORK?

NetTrans essentially works as follows:

1. NetTrans would apply primarily to two-way telecommunications providers subject to Title II Regulations such as LECs, CAPs, IXCs, Cellular carriers, etc. Resellers, enhanced and information service providers, cable TV providers (if one-way transmission), one way paging service providers, and private networks are excluded.
2. NetTrans would be administered by an independent third party.
3. A flat percentage is calculated pursuant to the following formula:

$$\text{Subsidy Revenue Requirement} / (\text{Total Industry Transmission Path Revenue} - \text{Subsidy Revenue Requirements})$$

Accepting Monson Ponifs \$18B subsidy amount and an industry transmission path revenue estimate of \$150B, Mr. Noam estimates this charge percentage to be approximately 12%.

4. This percentage is applied to a carrier's Net Transmission Path Revenues (NTPR). NetTrans revenues would include, but not be limited to, revenues generated from long distance services, switched access, local usage, local access lines (including business, residence, and PBX trunks), private lines and special access, and collocation and interconnection charges. This revenue total would be reduced by the amount of payments to other carriers for transmission and basic switching services (e.g., CAPs would deduct collocation and interconnection charges paid to LECs, IXCs would deduct all access charges paid to LECs, etc.) and credits for universal service contributions made and for amounts associated with subsidized users choosing a local provider's service.
5. The Carrier would pay or receive an amount depending on whether its net amount is a debit or credit.

## **Discussion - Opportunities and Concerns:**

### **Assumptions Underlying the Paper May not be Realistic**

The paper only addresses universal service from the aspect of providing explicit subsidies to end users. Ensuring users connection to the network at reasonable rates is just one aspect of universal service. The existence of a reliable ubiquitous network which serves all areas regardless of levels of efficiency is another. For universal service to be a reality, recovery of the costs of this network, which have been incurred by LECs, is necessary.

Assuming full competition, would a NetTrans Account System really be necessary? If full competition would exist and LECs have been granted pricing flexibility by regulators, LEC rates will most likely be rebalanced and/or set at competitive/market based levels. This would minimize subsidy amounts.

### **LECs May Incur and Pay a Substantial Portion of Existing Subsidies/Universal Service Costs**

Under the proposal, LECs would fund a portion of the lost subsidy while still having the costs already incurred to ensure ubiquitously available universal service. Noam's proposal essentially requires all telecommunications providers to contribute, including the LECs. This proposal will impose a double burden on the LECs: first, LECs will incur costs for facilities and employees necessary for meeting universal service requirements; and second, they will have to pay for a portion of their own and other local exchange providers' universal service costs. This is unfair in that LEC competitors are not required to incur facility or operational costs to provide universal service. They are more likely to rely on the existing LEC networks for ubiquitous transmission capability and for provision of telecommunications services to less efficient areas. The total bill to LECs could be as high as \$10.6 B.

### **The Proposal Would Place LECs at a Substantial Competitive Disadvantage**

Another downside of this proposal is that it would impose an extreme competitive disadvantage on the LECs, since, they would incur facility and operational costs that their competitor does not incur, and would have to raise rates substantially to fund the added costs associated with their universal service payment amount. This, in the end, would likely jeopardize not enhance universal service.

## **Additional Administration and Accounting Requirements and Other Drawbacks**

NetTrans proposal will presumably require quantification of the aggregate subsidy amount required to maintain universal service in the U.S. This will certainly be a monumental and costly task. Subsidies are not routinely calculated as part of the regulatory process. Additionally, it will be difficult to get acceptance of subsidy calculations and amounts from industry participants and regulators.

In addition to changing the LECs' accounting systems; increasing accounting, reporting, and other administrative expenses; the NetTrans proposal also includes several other drawbacks to LECs' participation in this process. For example, the contribution generated from sales of LEC access and toll services (i.e., the excess of revenues over costs for these service categories) would be subject to a "productivity adjustment" in calculating LECs' NetTrans balances. The presumed reason for this adjustment is to "force efficiency" on the LECs by reducing the amount of "current subsidy" that can be credited against LECs' NetTrans accounts. LEC NetTrans credits would be further reduced by also subjecting the residence access line subsidy to a productivity factor. This calculation would progressively reduce the portion of the residence subsidy that LECs will be allowed to claim credit for over time. The rationale behind this "financial penalty" on the LECs is not at all clear. However, it is as likely that this aspect of the NetTrans proposal would pressure LECs into seeking basic local service rate increases.

The proposals require LECs and others to calculate net transmission path revenues. A problem is that while these are available for LECs interstate access services (transport and local switching revenues), they are not available for toll services, CAP services, and other services.

## **Inconsistencies in the Proposal**

A threshold question that exists is: should competitors be entitled to subsidies that would be calculated initially based on LEC cost structures which reflect costs of providing universal service? Inconsistent with the goals of the proposal, this could be a windfall to LECs' competitors.

Noam states that contributions for access charges above cost should be credited against the universal service fund debit. It is not clear exactly what this means. This may imply that if access customers can prove that subsidies exist in non-transmission path related revenues, any related payments could be credited.

Further, the statement that under the present system LECs have no incentive to reduce cost of operations is inaccurate and not consistent with the efficiency incentives inherent in price cap regulation.

The paper is also inconsistent with its goal of being "competitively neutral". For example, an area of concern for LECs is the NetTrans proposal's treatment of LEC competitors. The proposal recommends that "new entrants" be granted a **three year** exemption from participating in the NetTrans universal service funding scheme. This exemption period is explicitly included as a form of "infant industry" protection. The concern is how, and by whom, "new entrants" would be defined. If CAPs such as MFS and Teleport were somehow designated "new entrants", yet another **competitive advantage** would be granted these firms by regulatory practices and policies.

### **NetTrans Might Not Reduce Actual Subsidy Requirements**

The NetTrans plan dictates that all payments received by LECs from the fund be flowed through to end users in the form of rate decreases for services (such as carrier access and long distance) that are priced to yield substantial contribution toward recovering the costs of local service. A problem is that this requirement, over time, tends to depress LEC revenue growth unless other service prices and/or sales growth rates can be adjusted. As LEC revenues decline due to both increasingly intense competition and the NetTrans rules, the potential for calculating increased subsidy amounts arises. To avoid this, NetTrans developers have included a productivity adjustment to LEC local service costs. So long as the productivity factor is sufficiently large, LEC calculated costs (net of productivity) will decline more quickly than LEC transmission path revenues, thereby guaranteeing a shrinking subsidy over time. This could result in a situation where calculated subsidies are eliminated, but technological changes, LEC cost structures, market demand characteristics, and political decisions to support targeted consumer groups still combine to create a situation in which true (as opposed to NetTrans calculated) costs remain above the price of local service. If this occurs, LECs and their shareholders lose.

SWBT's Response to

**M C I**

**MCI's Paper**  
**From a Single Lane to the Superhighway:**  
**Rethinking Universal Service Policy for the 21st Century Consumer**

SUMMARY

MCI's paper is based on the premise that introduction of competition in the local market will bring choice and lower prices to the local telephone subscribers. Consequently, MCI suggests that a revised universal service policy will be needed to facilitate the transition to local competition. (p. 1)

MCI recommends that LECs' revenue requirements should be "de-linked" from the LECs' funding of the universal service subsidy. MCI alleges that because LECs currently operate as a monopoly, their revenue requirement includes excessive profits, inefficient operations, and overvalued plant. (p. 2)

MCI suggests that true subsidy to basic local exchange service is the difference between the costs of basic local exchange service and the revenues generated by the service. (p. 2)

MCI proposes a two-tiered plan which provides for (I) Basic and (II) Advanced universal service. The Basic universal service proposes access by residential customers to existing telephone network. Among the issues to be addressed are defining the service and determining the amount of the required subsidy. (p. 4)

According to the paper the Advanced universal service proposal promotes digital connectivity and affordability for all consumers. For example, the plan states that it encourages private sector development through tax credits. (p. 5)

BASIC UNIVERSAL SERVICE

MCI's basic universal service would provide residential local exchange service at rates no higher than the existing nationwide average of \$18 per month. Such basic service would include access to the first point of switching (dial tone); local usage; touch tone service; 911 service; white pages listing; access to directory and operator assistance; and single-party service. (p. 6)

MCI wants to identify and quantify the cost of performing specific network functions using an economic model that accounts for each function and recognizes the variables that affect cost. MCI states that similar cost analysis is done today by LECs without undue hardship. (p. 7)

Under MCI's basic universal service plan the following telecommunications providers would contribute to universal service: current and future local exchange

carriers; long distance carriers; Competitive Access Providers; cellular telephone companies; pay phone providers

Each carrier would pay a percentage of its total telecommunications transmission and switching revenue, minus any payments to other carriers. (p. 7)

A Universal Service Association run by a third-party will be formed to **administer** the funding pool from which any carrier can withdraw to reduce local exchange service billing. (p. 7)

MCI asserts that subsidies are "benefits" that LECs will have to share with competitors. MCI proposes the use of "virtual vouchers" to apply toward customers' telephone bill. (p. 8)

MCI tells the regulators that they must continue regulatory oversight of **existing** LECs for a number of years. (p. 8)

If no carrier is willing to serve an area, MCI's plan suggests auctioning that **area** and carriers would bid the level of per-line subsidy at which they are willing to **serve** the entire customer base within the local exchange. (p. 9)

#### II. ADVANCED UNIVERSAL SERVICE

MCI states that it would be "imprudent" to impose a large subsidy burden to ensure widespread delivery of, for example digital services, which would **increase** rates for all customers. (p. 10) MCI's Advanced universal service proposes investment tax credits for LECs and other providers in the business of digital end-to-end capabilities.

MCI proposes the creation of a "separate virtual voucher system" to provide government with a mechanism for encouraging consumer demand. This would **protect** the "basic service" consumer from subsidizing high-tech services and benefits for those "digital" consumers more likely to use and afford them. (p. 11)

MCI's advanced universal service plan provides funding through a **broad-based** subsidy pool involving all industries that stand to benefit. For example, if any public opinion survey predicts that movies on demand will top the list of what consumers demand from the "information superhighway", then the entertainment industry would represent a natural contributor to a separate funding pool. (p. 11)

The plan suggests funding digital connection to libraries, schools and **hospitals** to the information superhighway through competitive bidding. MCI asks the **regulators** to "refrain from making deals with monopolies for these services." (p. 12)

## SWBT's DISCUSSION OF MCI's PAPER

MCI's proposal emphasizes that it is now time for a comprehensive review of **universal service issues**. MCI points out that "while everyone agrees **universal service should remain a vital component of future telecommunications policy, the combination of new technologies and a changing marketplace have rendered the current system obsolete.**"

As might be expected, because it is a purchaser of access, MCI is quick to **criticize** the level of LEC costs incurred to provide universal service even-though its **paper** does not contain any support that shows how MCI's proposal will maintain or **improve** universal service. Similarly, MCI's voucher proposal is a thinly veiled attempt to benefit MCI financially, **likely** at the expense of a ubiquitously available network constructed by the LECs which provides universal service.

Irrespective of MCI's unfounded allegations about the impropriety of LEC costs to provide universal service, SWBT strongly believes that it should have the ability to recover the costs it has and continues to incur to build and maintain a **network that provides ubiquitously available universal service**. SWBT supports the following **basic** approach for recovery of universal service costs in the competitive marketplace:

- o LECs should be allowed rate rebalancing and pricing flexibility;
- o If pricing flexibility is limited, other means should be allowed for LECs to recover costs associated with universal service (e.g. **Universal Service Rate Elements**).
- o Subsequent to rate rebalancing, additional explicit mechanisms **should** be targeted to end users who cannot afford basic telephone service;
- o Existing explicit mechanisms (USF, LTS, Lifeline, Linkup, etc.) **should** continue to be maintained.

### **De-linking LEC Revenue from Universal Service.**

MCI claims that the support for universal service should be "de-linked" from LEC revenue requirements and replaced with a system that would ensure **equal access to the universal service subsidy**. MCI alleges that the \$20B estimate of support for universal service is vastly overstated by LECs. Apparently, MCI does not **understand** that the \$20B represents implicit subsidies in LEC rates designed to:

- o provide support for a universal service network to low volume, high cost (largely rural) areas; and
- o provide support to keep basic local service rates low.

MCI's proposal is based on the premise that competitor providers should have **access** to LECs' universal service subsidies to help pay for deployment of their new **networks** even-though MCI has made no commitment to provide service to all customers, particularly those in high cost areas. Presumably, MCI's network would parallel

existing LEC networks across U.S.A., in order to bring choice to customers. While giving customers a choice is a noble notion, supported by all, facilitating this choice through duplicate networks paid for with LEC subsidies creates a number of problems. First, the existing implicit subsidies were designed to recover the costs of the ubiquitously deployed infrastructure. Therefore, MCI appears to suggest that either the existing network would have to be abandoned or two parallel networks would have to be subsidized. Neither one of these choices results in specific customer benefits.

Second, MCI's paper is silent regarding commitments to provide universal service. Competitors are strangely quiet about making a firm commitment to provide a universally available ubiquitous network themselves. There is no evidence that MCI, MFS, or other potential local service providers intend to make the commitments necessary to satisfy universal service objectives. Consequently, voucher systems such as those proposed in MCI's paper make no sense and will only serve to further the real objective of MCI or MFS which is to financially benefit by forcing LEC access rates down and/or by receiving vouchers for subsidies they don't need. Based on their actions so far and announced future actions, it is apparent that MCI, MFS and others intend to serve businesses located in metro areas. It is quite likely that funds to place investments to provide service to residential customers and rural areas will not be forthcoming in the near future. Additionally, there is no indication they will commit the capital resources necessary to provide a ubiquitous public network. For example, the \$2 billion recently committed by MCI to enter the local exchange business is a "drop in the bucket" compared to what capital has been expended by the LECs and is necessary to build a network capable of serving all subscribers in the nation. Thus far, the new local service providers are short on commitments to help maintain universal service, but are very focused on trying to get favorable regulatory treatment that will allow them to grab "subsidies" on a selective basis to help finance their entry into the local exchange business. In sum, MCI and others are focused solely on reducing their cost of access and/or gaining a financial or competitive advantages, not the provision or maintenance of universal service.

In its paper, MCI makes several false and unsupported allegations regarding LEC operations and costs. MCI suggests that LEC cost recovery used to provide for universal service is an over-inflated number and really reflects the cost of their inefficient monopoly operations. It should be noted that LECs are to a great extent driven by the carrier of last resort obligations (COLR) they have committed to in each and every state in which they operate. For example in Missouri, SWBT is a carrier of last resort by statute, in its territory. This means that SWBT has to have networks deployed and be ready to serve all customers in all locations, at all times, regardless of current demand. Further, the "ready-to-serve" requirement extends far beyond the physical network and reaches to a number of operations such as availability of operator services, time limits on new installations, repairs, etc. Therefore, although transparent to observers such as MCI, these COLR requirements create costs for the LECs.

Further, MCI's allegations about inefficiencies of LECs' operations merely rely on a worn-out argument that LEC costs exceed "economic costs". While economic cost studies are useful for making certain business decisions, they will fall short of being able to identify all LEC costs that are pertinent to providing a ubiquitous telephone network. Again the majority of the LECs' costs are fixed costs that are common to most services provided on the public network. Therefore, an economic cost analysis is not any more accurate for analyzing such costs than any other costing method. In fact, an economic cost study intentionally ignores the majority of the joint and common costs (because these are indivisible costs that cannot be unambiguously assigned to any particular service) which is precisely why MCI is so focused on its use to analyze the problem. By equating the price for LEC services to economic cost, MCI could conveniently avoid paying for the costs necessary for providing the network.

MCI states that "today, by virtue of their internal subsidy, the individual LEC possesses a huge advantage over any potential competitor vying for the same customers." One of these internal subsidies is rate averaging and contrary to MCI's assertion quite the opposite is true. The current regulatory structure has handicapped LECs by strictly controlling LEC prices. Price averaging has caused LEC prices to be artificially high in higher volume low cost areas. A competitor is not constrained to average pricing and can often easily charge a price lower than the LECs. Further, competitors can pick and choose which customers they want to serve. This enables them to serve customers and areas that will provide the highest profit margins.

MCI unfairly assesses that LECs have profited the most from universal service funding and would like to see the system continue. Everyone, including MCI has profited from universal service. For instance, were it not for the ubiquitous network, Interexchange Carriers and others could not efficiently provide their services to all customers. Further, it is the LECs' profit levels that have and are currently restricted by regulation, not competitors' profit levels.

## I. Basic Universal Service

### A. Defining the Service

MCI proposes that Basic Universal Service would provide residential local exchange service at rates no higher than the existing nationwide average of approximately \$18 per month. MCI's definition of services to be included in basic universal service appears reasonable. However, there does not appear to be a compelling reason why rates for the basic service should be no greater than the nationwide average. Local service rates should reflect levels that are commensurate with the level of cost to serve the customer. It is not necessary that everyone, nationwide, pay no more than \$18 per month. Those who can afford to pay for higher local service costs should pay those costs. If these higher rates are unaffordable for low income consumers, targeted subsidies (lifeline) can be provided.

## B. Determining the Amount of the Required Subsidy

MCI states that under their proposal, the cost of performing specific network functions would be identified and quantified using an economic model that accounts for **each** function and recognizes the variables that affect cost, like population density. MCI further states, local phone companies already conduct similar cost analysis **without** undue hardship.

With this proposal, MCI makes yet another attempt to "sell" its building-block cost approach. Contrary to its statement this method is not similar to any type of cost analysis done today by the LECs.

Further, MCI's definition of subsidy is narrow. Confining the universal service funding to local service is insufficient. Universal service not only requires that households and businesses be equipped with facilities to provide access to the local network, but also a network that provides ubiquitous connectivity between all subscribers. Providing this connectivity requires substantial investments in facilities necessary to transmit **calls** beyond local calling areas. Any universal service subsidy calculation must take these costs into account.

## C. Generating Funding in a "Competitively Neutral" Way

SWBT agrees with MCI that universal service should be funded on an "equitable and competitively neutral" basis. The proposal made by MCI is, however, a far cry from being equitable and competitively neutral.

MCI proposes that each carrier would contribute a percentage of its total telecommunications transmission and switching revenue, minus any payments to other carriers. MCI's plan essentially requires all telecommunications providers to contribute, including the LECs. This proposal will impose a double burden on the LECs: first, LECs will incur costs for facilities and employees necessary for **meeting** universal service (OLR) and readiness-to-serve requirements; and second, they **will** have to pay for a portion of their own and other local exchange providers' universal service costs. This is unfair in that LEC competitors are not required to incur **facility** or operational costs to provide universal service. They are more likely to rely on the existing LEC networks for ubiquitous transmission capability and for provision of telecommunications services to less efficient areas. Quite obviously, in the guise of a "reasonable proposal" MCI has advanced a proposal to benefit its bottom line and competitive position. The only downside of this trojan horse proposal is that it **would** impose an extreme competitive disadvantage on the LECs, since, they would incur facility and operational costs that their competitor does not incur, and would **have to** raise rates substantially to fund the added costs associated with their universal service payment amount. This, in the end, would likely jeopardize not enhance universal service.

A more equitable mechanism would allow local exchange providers credit for **switching** and transmission costs associated with providing ubiquitous telephone service or exempt ubiquitous network providers (LECs) from funding requirements.

#### D. Distributing Funding in a "Provider Neutral" Way

SWBT agrees with MCI that funding should be distributed in a "provider neutral" way. MCI claims that once effective local competition is achieved, current monopoly providers will have to share subsidy benefits with new competitors. MCI **proposes the use of virtual vouchers** supplied to end users for end users to select which local exchange provider should receive the subsidy.

SWBT believes that this is a self-serving and inappropriate mechanism to **selectively** siphon subsidy amounts to MCI's bottom line. In fact, this voucher system is a disguised means to do just that. SWBT's internal subsidies such as rate averaging, CCL, etc., are necessary to maintain the ubiquitously available network which is **used to provide universal service**. Replacing the implicit subsidies in SWBT's rates with vouchers which could flow to MCI and others will not allow SWBT to continue its carrier of last resort commitment to the ubiquitous network. Consequently, **universal service will be jeopardized** if this proposal was implemented.

#### E. Regulating the Transition to Effective Local Competition

MCI claims that it will take several years before the local exchange achieves **true viable competition**. However, continued strict regulatory oversight is not **necessary for effective competition to flourish**. In fact, continued regulation of LECs may **stifle effective competition**. For instance, MCI is concerned that it cannot compete assuming current LEC price levels that include subsidies. However, if **LEC prices are rebalanced to remove the impacts of subsidy amounts**, a much more competitive marketplace will develop. Also, for effective competition to exist, LECs should be allowed non-discriminatory access to competitive service providers' networks, which was not mentioned by MCI.

#### F. Fulfilling Carrier Responsibility: Consumer Safety Net

The fact that MCI finds a need for a consumer "safety net" in its proposed plan suggests that MCI's proposal contains frailties that do not currently exist. Simply, a consumer "safety net" is not needed to assure universal service today.

MCI suggests that under its proposal customers would be able to choose the **type of service and specific provider to receive their universal service subsidy**. Unfortunately, a problem with this approach is that it over-simplifies the situation and does not address the issue of varying costs between urban and rural areas. According to **MCI's example**, customer A could select MCI to provide its service. What MCI apparently

doesn't understand or chooses not to discuss is what would happen if the actual cost of providing service to customer A is \$1,000 instead of the averaged rate of \$25 estimated in the plan? Since the plan allows for the customer to be billed \$18, and the remainder of \$7 be recovered in subsidies, then apparently MCI would be willing to spend \$993 out of pocket to provide service to customer A. SWBT expects that this high cost, likely rural but possible interurban, customer is not the customer that MCI would want to serve and when they realize the cost involved they would call for a LEC to provide service to customer A.

Under MCI's plan carriers will have a choice to-serve or not-to-serve particular areas. MCI suggests an "auction feature" similar to the Teleport proposal. It would be used if a carrier refuses to serve an area with the subsidy provided under the Basic Universal Service plan. In this circumstance, "carriers would 'bid' the level of per-line subsidy at which they are willing to serve the entire customer base within the local exchange." However, this approach is also problematic. For example, a carriers' refusal to serve a market could mean that universal service may not exist for the customers in that market as it does today where service is provided by LECs. MCI's solution of auctioning off these areas does not address the possibility that for some areas there may be no bidders.

## II. Advanced Universal Service

MCI's Advanced Universal Service addresses the availability of the emerging technologies and the anticipated cost associated with technological development and delivery. MCI is correct in saying that "it would be imprudent to impose a large subsidy burden to ensure widespread delivery of such services in the immediate future which would increase rates for all customers." However, MCI's proposal for an investment tax credit has a narrow focus and does not address the fact that pricing flexibility is also needed. Additionally, the Advanced Universal Service requires further development to address key issues such as: (1) Which technologies will best suit customer needs; (2) Would consumers need or want digital technology; (3) Will there be sufficient demand to defray the cost of some technologies; (4) How would the cost of such advanced ubiquitous networks be recovered; and (5) Is the creation of yet another "voucher system" the answer?