The current system simply provides little or no incentive for incumbent LECs to control or reduce their expenses. Thus, an incumbent LEC's reported cost studies would most likely be overstated and not representative of an economically efficient cost of providing the core services.

In addition, it is very difficult to verify the results of a LEC cost study. Basing determinations of the cost of providing core services on loop costs would reflect the inefficiencies and unnecessary expenditures that exist in monopoly markets. Therefore, making determinations on whether loop costs fully represent the costs associated with including a service in the definition of core services based on LECs' actual reported costs will perpetuate the existing inefficiencies and unnecessary expenditures in monopoly markets. In contrast, relying on the economic cost of providing local exchange service through the use of cost proxies rather than on LECs' embedded costs creates the proper incentives for efficient investment and operation.

Schools, Libraries, Health Care Providers

6. Should the services or functionalities eligible for discounts be specifically limited and identified, or should the discount apply to all available services?

As a general principle, TW Comm recommends that the scope of universal service should be narrowly defined to maximize competition and minimize the extent of required financial support. Accordingly, TW Comm suggests that discounts offered to schools, libraries, and health care providers should not apply to all available telecommunications services and technologies. Rather, consistent with other provisions of the 1996 Act, discounts to schools, libraries, and health care providers should be limited to those services that are "technically and economically reasonable". Discounts for all available technologies would result in misallocation of universal service support and inefficient pricing of telecommunications services.

The Commission should establish a separate program designed to provide support for schools, libraries and rural health care providers. The separate fund would be applied to those services eligible for the discount and only to end users pursuant to the 1996 Act. Section 254(h)(1)(B) provides that schools and libraries are entitled to a discount on telecommunications services only if the requested services will be used for educational purposes. Because the capacity of schools and libraries to use advanced services effectively varies widely, the Commission should consider the particular needs of these entities when determining which services should be provided at a discount. Additionally, it is important to ensure that the requested service will be used only for its intended purpose. For example, TW Comm fully supports the Commission's proposed requirement that schools certify that the requested services will be used only for "educational purposes," and will not be transferred in exchange for value. If the requesting school breaches the terms of the certification, the Commission should allow the service provider to terminate either the service or discount.

To evaluate whether certain services and technologies should be offered at a discount, the Commission must consider the ability of the telecommunications industry to provide the subsidy, which, of course, is ultimately borne by the ratepayers. Requiring a discount for schools and libraries on all available services and technologies will unavoidably drive the amount of support cost up. The level of cost support associated with such a program could impair the ability of the market to use pricing as an efficient means of allocating resources. Put simply, the rates paid by the recipients of the support in such a program would not reflect the actual costs associated with the service and the rates of all other services would be higher than their actual costs to provide contribution for the financial support.

9. How can universal service support for schools, libraries, and health care providers be structured to promote competition?

As a new entrant in the market for local telephone service, TW Comm is committed to promoting the development of full and fair competition in the local exchange marketplace. Indeed, TW Comm is fully prepared to participate in the funding of universal service programs that support schools, libraries, and health care providers if such programs are configured in a competitively neutral manner and do not impose substantial burdens on new entrants.

There is a danger that programs designed to provide universal support for schools, libraries and health care providers can impede the development of competition. This can occur if incumbent LECs are permitted to perpetuate, with subsidies already built into their rates, programs that offer discounts or special services to select groups of consumers that may include schools, libraries and/or health care providers. These programs, which by and large predate the 1996 Act, often contain multi-year commitments on behalf of the LECs and the designated customer groups. Incumbent LECs undoubtedly would prefer to continue these existing programs, and seek the assistance of their emerging competitors in paying for them into the future. This obviously would be contrary to the interests of the emerging competitors, who would not be afforded the opportunity to participate in providing the service in question. Beyond this anti-competitive effect, perpetuation of these existing programs would also be contrary to the public interest because, the emerging competitors being denied the opportunity to bid on the services, the cost of the overall subsidies undoubtedly would be higher than they would need to be. At a minimum, these existing subsidy programs must be identified in each state, halted on a go-forward basis, and then opened up to competition.

A bidding process in which no support is earmarked for use by incumbent LECs is the best method to provide universal support service to schools, libraries, and health care providers in a competitively neutral manner. Under such an approach, in response to requests for proposals, service providers would submit bids to furnish the requested services. The lowest bidder would be selected to provide the requested services. This method is both pro-competitive and easy to administer.

10. Should the resale prohibition in Section 254(h)(3) be construed to prohibit only the resale of services to the public for profit, and should it be construed so as to permit end user cost based fees for services? Would construction in this manner facilitate community networks and/or aggregation of purchasing power?

The Commission should broadly construe Section 254(h)(3)'s prohibition on schools and libraries from selling, reselling, or transferring for money or any other thing of value, any telecommunications service and/or network capacity obtained through universal support mechanisms. Schools, libraries, and health care providers should not be authorized to share discounts with entities that are ineligible for discounts. For example, if a town's public library receives discounts for certain telecommunication services, it should not be permitted to share those discounts with the town hall. Put simply, municipalities should not profit from sharing services with schools, libraries or health care providers and entities not eligible for the discounted services at issue.[18]

Sharing services should only occur between entities eligible for the discount. If the Commission decides not to impose an absolute prohibition on such sharing, the Commission could require that, to the extent a network is shared with parties not eligible for support, those parties should be responsible for the pro rata share of network costs based on the non-discounted prices of those network costs.

---

[18] Moreover, the final rule should take into account the enormous pressure that municipal budgeteers will be under to take advantage of subsidized rates for service.

12. Should discounts be directed to the states in the form of block grants?

Relying on discounts in the form of block grants to states makes it impossible to target subsidies to schools, libraries and health care providers with the necessary accuracy. Targeting assistance to eligible customers is far more efficient than general support programs. Thus, when considering whether discounts should be directed to the states in the form of block grants, the focus of universal service funding should be on the user. The statutory goal of assistance to schools, libraries and health care providers is straightforward: to ensure the discounts necessary to achieve affordability of telecommunications services for educational institutions and health care providers. Transmogrification of that goal into block grants would wasteful and counterproductive.

19. **<u>Should an additional discount be given to schools and libraries located in rural, insular, high-cost and economically disadvantaged areas? What percentage of telecommunications services (e.g., Internet services) used by schools and libraries in such areas are or require toll calls</u>?**

As a general matter, TW Comm recommends that universal service should be defined in a manner that would tend to minimize the need for subsidies. The broader the scope of universal service and hence the more financial support earmarked for it, the less affordable all other services necessarily become. Currently, many states have begun regulatory initiatives that benefit schools, libraries, and health care providers. For example, in 1995, the Florida legislature established the Florida Distance Learning Network in order to encourage telecommunications services providers to furnish connectivity to public schools, colleges, universities, libraries and rural and teaching hospitals in the state. In Missouri, the Missouri Public Service Commission has taken steps to support the Missouri Interactive Telecommunications Education network, a two-way interactive television network involving five rural school districts and a private, liberal arts college in central Missouri. In Oklahoma, a grant from the Oklahoma Department of Commerce provides funds for the Oklahoma Telemedicine Network, a network designed to provide data, video and Internet connectivity to hospitals. Any federal support to schools and libraries should complement, rather than duplicate, state initiatives, but should be structured in a competitively neutral manner.

Based upon those general propositions, it would appear unnecessary to create a special discount for schools and libraries located in rural, insular, high cost and economically disadvantaged areas. Universal service support for high-cost areas - that available to all consumers in high-cost areas - would be available to schools and libraries located in these areas, as would the normal discount for these institutions; i.e. that available generally to schools and libraries regardless of location. Creation of yet another applicable support mechanism specially tailored to schools and libraries in these areas would be excessive.

In addition, the Commission should consider the factors that may limit the costs associated with toll calls related to providing telecommunications services to schools and libraries located in rural or insular areas. For example, schools located in rural or insular areas will not necessarily incur more toll call costs when using Internet services than other schools simply because of their location. Schools and libraries located in rural areas near large universities, for example, may not require a toll call for Internet connectivity. In addition, the cost of the necessary telecommunications services could decrease if communities in rural or insular areas banded together to obtain volume discounts from telecommunications service providers for the schools and libraries in those communities. Further, the Commission should also consider that if the subsidy issues before the Commission are resolved satisfactorily, toll rates will decrease. As a result, the toll call costs related to telecommunications services incurred by schools and libraries in rural areas will similarly decrease.

Finally, the Commission should consider alternatives that will decrease, or in some instances eliminate, the need for schools and libraries in rural or insular areas to rely on toll calls to provide the relevant telecommunications services. For example, in areas with higher than average cable penetration rates, cable operators possess the potential to offer modem services to subscribers at a lower cost than the incumbent local exchange company. This, and other similar alternatives, could decrease the need to rely on toll calls to provide services such as Internet services

High Cost Fund

General Questions

26. If the existing high-cost support mechanism remains in place (on either a permanent or temporary basis), what modifications, if any, are required to comply with the Telecommunications Act of 1996?

Policies expressed in the 1996 Act strongly support the adoption of a competitively neutral universal service funding mechanism, based on forward-looking, economic cost, to replace the existing high-cost fund. Retaining the existing high-cost fund for any incumbent LECs ("ILECs") on other than an expressly transitional basis is inconsistent with the 1996 Act.

If the high-cost funding mechanism is retained for a limited time during the transition to a cost-proxy model approach, steps must be taken to make it competitively neutral. Today, an ILEC's entitlement to draw on the high-cost fund is triggered when the carrier reports embedded loop costs (by study area) that exceed 115% of the national average. In order for the high-cost fund to be competitively neutral, the Commission must adapt the existing mechanism to permit competitive LECs ("CLECs") to get equivalent universal service support when they serve high-cost exchanges. However, CLECs do not have "reported" costs, and the Commission has long recognized that there is no need to extend the accounting requirements in place for ILECs to such non-dominant carriers. If the high-cost fund is maintained temporarily, TW Comm recommends that during that time CLECs be entitled to obtain the same level of support, per customer served, as the ILEC with respect to any high-cost exchange, without any independent cost showing by the CLEC.

If the existing high-cost fund is retained for a limited period, TW Comm recommends that several additional, straightforward steps be taken to make the mechanism more targeted (specific) and focused on affordability. First, as detailed further in TW Comm's response to Question 33, there is no demonstrated need to preserve dial equipment minute ("DEM") weighting, and its elimination is long overdue. Second, it would make sense to increase the threshold from the current 115% threshold to one standard deviation above the national average. Third, in order to better "target" universal service assistance, the Commission should cut off support to study areas with minimal needs. Thus, TW Comm recommends that the Commission eliminate high-cost assistance to any study area that would receive less than $1.00 per line per month. Finally, the affordability of telephone service must be considered before universal service support levels are determined, since the existence of high costs to serve an area does not establish that basic exchange service is not affordable. Inasmuch as the existing high-cost fund does not consider income or any other relevant criteria for determining affordability, the Commission should modify the high-cost rules to correct this deficiency.

27. <u>If the high-cost support system is kept in place for rural areas, how should it be modified to target the fund better and consistently with the Telecommunications Act of 1996</u>?

Rural locations comprise a large portion of the areas eligible for high-cost universal service support under the provisions of the Act. Carving out a broad exception for "rural areas" would seriously undermine the objective of crafting a new, more targeted high-cost mechanism. Establishing a new high-cost mechanism for non-rural areas makes very little sense, as the vast majority of these areas should not be receiving any high-cost support at all. On the other hand, adopting a cost proxy approach and exempting rural areas also makes little sense. LECs serving rural areas should be provided with the same incentives as in non-rural areas to provide exchange service efficiently, and should not be rewarded indefinitely, through bloated universal service support, for preserving higher-cost, outdated technologies.

TW Comm is sensitive to the fact that some smaller ILECs serving predominately rural areas have expressed concerns of "support shock" if the Commission makes too abrupt a change away from the funding mechanisms presently in place. TW Comm urges the Commission and Joint Board to verify whether such concerns are well-founded, before relying on them as the basis for any comprehensive policy decisions. If the Commission determines that the existing high-cost funding mechanism should be retained temporarily for "rural areas," it should limit this treatment to smaller LECs, not the Tier 1 and/or price cap LECs. In addition, the Commission should superimpose an affordability component, so that support does not flow to preserve artificially low rates in rural communities whose customers could afford to pay a higher, cost-based rate.

The Commission should also recognize that the 1996 Act already affords rural carriers with special treatment that mitigates the alleged (although not well-substantiated) impact of competition on an ILEC's ability to serve higher-cost areas. Under the Act, rural carriers (those with fewer than 2% of subscriber lines nationwide)[19] may be exempted from complying all of the interconnection requirements imposed on LECs and ILECs under Section 251, subsections (b) and (c). Through this mechanism, a rural carrier can ensure that competition is kept out of the more attractive portions of its service territory. A rural carrier that has invoked this special protection against competition should not then be allowed to receive universal service support on a highly disaggregated basis, based on claims of vulnerability to "cream-skimming." In fact, it would make sense to continue to determine high-cost support, even under a cost proxy model, at the study area level for rural carriers who have invoked Section 251(f) and insulated themselves from competition by maintaining significant entry barriers.

In the Commission's implementation of the 1996 Act, Section 251(f) should be treated as a transitional mechanism, not a permanent barrier to competitive entry. Consistent with the

---

[19] The manner in which this exemption is drawn – based exclusively on the size of the LEC (in terms of lines served) – clearly does not restrict it to carriers whose service is rural or even substantially rural in nature, and even if the area served is rural, it may not exhibit high costs.

overriding policies of the 1996 Act favoring competition, the Commission should implement universal service policies that encourage rural companies to come out from under the shelter of Section 251(f) sooner, rather than later. Allowing rural companies to retain universal service support based on embedded costs, rather than economic, forward-looking costs, particularly in combination with the Section 251(f) exceptions, creates a protected environment that will operate to the long-term detriment of consumers, by insulating these companies from the pressure to lower costs in response to competition.

28. What are the potential advantages and disadvantages of basing the payments to competitive carriers on the book costs of the incumbent local exchange carrier operating in the same service area?

The only advantages to allowing CLECs to receive universal service support based on the embedded costs of ILECs serving the same area are (1) that it roughly achieves competitive neutrality under circumstances where the ILECs continue to receive payments based on reported costs, and (2) that it does not require CLECs to produce independent cost support as a basis for receiving universal service payments, which would be burdensome and would unreasonably deter entry, with no compensating benefits.

Allowing CLECs to receive universal service support based on the embedded costs of ILECs serving the same area does nothing, however, to cure the fundamental problems with the use of the ILECs' reported costs as the basis for universal service support. The reported, embedded costs presently used as the basis for high-cost fund assistance are simply the wrong costs to measure for purposes of providing universal service support in a competitive environment. There are verification problems with using reported costs. In addition, the ILECs' reported, book costs – based on embedded cost methodology – reflect past engineering practices and acquisition decisions. These past engineering practices and investment decisions have, in large part, become obsolete due to fundamental changes in telecommunications technology. Moreover, many of the ILECs' past investment initiatives should not be recoverable through any universal service funding mechanism, since they were not undertaken to serve any legitimate universal service objective, but rather were driven by incentives existing under rate-of-return regulation (the "Averch-Johnson" effect) and to achieve business goals with little direct bearing on the universal service objective of assuring the widespread availability of (a single) basic exchange line to residential households. Further, relying on book costs provides LECs with little or no incentive to control or reduce their expenses, nor does it (unlike a cost proxy approach) provide any objective information on the costs of serving an area in the future, in a competitive environment.

29. <u>Should price cap companies be eligible for high-cost support, and if not, how would the exclusion of price cap carriers be consistent with the provisions of section 214(e) of the Communications Act? In the alternative, should high-cost support be structured differently for price cap carriers than for other carriers</u>?

ILECs fall within Section 214(e)'s definition of eligible carriers. However, before the ILECs receive any universal service support, there needs to be a determination of whether funding is actually required and, if so, the extent of the necessary funding. Price cap ILECs, for example, should be ineligible for high-cost support. Incentive regulation provides price cap ILECs with both earnings flexibility and pricing flexibility, which enables them to respond to and mitigate the financial impact of competition. Under the Commission's price cap plan (and the price cap plan in many states), the ILECs have significant earnings options and, in many cases, no earnings limit whatsoever.[20] Pricing flexibility for the range of service offerings and the ease of offering new services provide price cap ILECs tools to adjust to competition. Thus, price cap ILECs are subject to broad regulatory flexibility unavailable to rate-of-return-regulated companies. In exchange for this flexibility, price cap companies are expected to accept and anticipate certain risks and costs from which companies subject to rate of return regulation have been insulated. In light of

---

20 A significant majority of LECs who come under federal price cap regulation have selected the productivity offset level that frees them from any upper limit on earnings. According to a recent NYNEX filing, in the 1996 Annual Access Tariff Filings, LECs selecting the no-sharing option had approximately 80% of all interstate revenues. NYNEX Petition for Forbearance, filed May 2, 1996, AAD 96-66.

the _opportunity_ for increased earnings, price cap ILECs should not be doubly rewarded with a _guarantee_ of increased earnings through universal service support.[21]

[21] If an ILEC is able to demonstrate that its universal service obligations render it unable to earn a reasonable rate of return without universal service support, support could be made available.

30. **If price cap companies are not eligible for support or receive high-cost support on a different basis than other carriers, what should be the definition of a "price cap" company? Would companies participating in a state, but not a federal, price cap plan be deemed price cap companies? Should there be a distinction between carriers operating under price caps and carriers that have agreed, for a specific period of time, to limit increases in some or all rates as part of a "social contract" regulatory approach?**

The Commission should decide this issue based on the opportunities present under the particular form of incentive regulation for the ILEC. If an incentive regulation plan that is not strictly denominated as a "price cap" offers the ILEC significant regulatory and pricing flexibility, and the ability to increase earnings significantly, then the ILEC has opportunities similar to those afforded under a price cap plan and should be expected to accept the risks of operating without guaranteed cost recovery provided by the "safety net" of universal service support. Certainly, all of the ILECs subject to the FCC's price cap regime would fit within this rule, with regard to any universal service support that falls within federal jurisdiction.

31. **<u>If a bifurcated plan that would allow the use of book costs (instead of proxy costs) were used for rural companies, how should rural companies be defined?</u>**

TW Comm notes that it is unclear from the Commission's questions whether the bifurcated approach would apply to rural "areas" (as in Question 27) or rural "companies" (as referenced in Question 31); these two concepts are not identical. With regard to the question at hand, because the use of embedded costs should be disfavored any "rural company exception" to the use of a proxy/bidding approach should be drawn narrowly. The focus should be on carriers whose service territories are very substantially rural, rather than hybrid rural-urban, in nature. Under no circumstances should any Tier 1 or price cap ILEC be eligible for this treatment.

32. <u>If such a bifurcated approach is used, should those carriers initially allowed to use book costs eventually transition to a proxy system or a system of competitive bidding? If these companies are transitioned from book costs, how long should the transition be? What would be the basis for high-cost assistance to competitors under a bifurcated approach, both initially and during a transition period</u>?

The Commission's objective should be to develop a proxy approach that can be applied to all locations. A bifurcated approach, even on a temporary basis, detracts from this objective. However, if proxy/bidding is not used initially, the basis for high-cost assistance to competitors should be structured to provide the same level of assistance as the ILEC receives. The time needed for the transition should not exceed three years, and the ILEC should be given the opportunity to switch to a proxy basis earlier if desired. Regardless of what form of "transition" is adopted, the Commission should be careful to ensure that the mechanism remains competitively neutral throughout each step in the transition.

33. **If a proxy model is used, should carriers serving areas with subscription below a certain level continue to receive assistance at levels currently produced under the HCF and DEM weighting subsidies?**

No. This question suggests that a low penetration level indicates something about the cost characteristics of the location, when, in fact, low penetration is more likely to correlate with income, rate levels, and possibly other factors (e.g., persons locating in isolated areas may simply exhibit a lower interest in maintaining social contact than the broader population).[22] Even if a correlation did exist between higher costs and low penetration levels in these communities, a mechanism would have to be created to assure that high-cost funding targeted to these areas was passed on to the consumers whose income constraints or high rates were interfering with a decision to obtain telephone service. Further, if a cost proxy approach properly models the costs for serving an exchange, then there is no reason to perpetuate the numerous, miscellaneous universal service funding mechanisms (including DEM weighting) that exist today. Instead, they should be subsumed by that broader model.

Whether a cost proxy model is used or there is some temporary perpetuation of the current high-cost system, DEM weighting is no longer useful and should be eliminated. The original period provided for phasing out DEM weighting has long since expired, and small companies have had ample time to make

---

[22] TW Comm understands the question to relate to penetration levels, not population density. Population density is a factor that can be addressed within the cost proxy model.

any modifications necessitated by jurisdictional cost shifts caused by changes to the DEM allocation methodology. There is also no evidence that companies subject to DEM weighting have above-average switching costs, and it is not clear that the average cost per access line varies significantly based on switch size. There is also no evidence that the elimination of the support provided through DEM weighting would make local service less affordable. In any event, the cost characteristics associated with serving a low-density exchange can be adequately captured within the cost proxy model.

Competitive Bidding

49. <u>How would high-cost payments be determined under a system of competitive bidding in areas with no competition</u>?

As the question clearly recognizes, a one-party auction cannot constrain price in any meaningful way. As a check on this process, absent an affirmative showing of extenuating circumstances, the proxy cost should serve as the *ceiling* for bidding. In a single-bidder situation, the cost proxy would serve as a substitute for the "competitive outcome." Over time, if the support level based on the cost proxy model is still too high by competitive standards, other providers are likely to consider entering the market, triggering a bidding requirement.