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CPI Competition Policy Institute

October 4, 1996

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Federal Communications Commission
Office of Secretary

Mr. William F. Caton
Secretary
Federal Communications Commission
1919 M Street, N.W. Room 222
Washington, D.C. 20554

Re: CC Docket 96-45 Ex Parte Filing

Dear Mr. Caton:

The Competition Policy Institute (CPI) today submitted the enclosed paper, on an *ex parte* basis, to the members of the Universal Service Federal-State Joint Board. The paper presents CPI's proposal for an integrated universal service plan.

Pursuant to the Commission's Rules, two copies of this paper are being submitted. Please contact the undersigned should you have any questions.

Sincerely,

Debra Berlyn

Debra Berlyn
Executive Director

No. of Copies rec'd 0+2
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CPI Competition Policy Institute

Memorandum

TO: Members of the Federal State Joint Board on Universal Service:

Chairman Reed E. Hundt
Commissioner Rachelle Chong
Commissioner Susan Ness
Commissioner Julia L. Johnson
Commissioner Kenneth McClure
Commissioner Sharon L. Nelson
Commissioner Laska Schoenfelder
Public Counsel Martha S. Hogerty

FROM: Ron Binz, Debra Berlyn and John Windhausen
Competition Policy Institute

RE: Universal Service Proposal

DATE: October 4, 1996

The Competition Policy Institute (CPI) hereby presents to the Federal-State Joint Board, on an *ex parte* basis, the outline of a proposed plan to preserve and advance universal telephone service. CPI submits this proposal to assist the Joint Board in reaching its decisions on the implementation of new Section 254 of the Communications Act of 1934, as added by the Telecommunications Act of 1996.

CPI presented its initial thoughts to the Joint Board in its Reply Comments in response to the Notice of Proposed Rulemaking and Order Establishing Joint Board in CC Docket No. 96-45, released on March 8, 1996. After further discussions with representatives of the industry and consumers, CPI has prepared this more detailed federal Universal Service Plan to address many of the questions raised in that Notice.

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An Integrated Universal Service Plan

proposed by the Competition Policy Institute

The Competition Policy Institute (CPI) offers the following proposal for the support of universal service. We think this proposal is a comprehensive approach to universal service which is workable, consistent with the intent of Congress, and beneficial to consumers.

CPI's plan is *integrated* in three ways: first, it does not rely on distinctions between state and federal "costs;" second, the plan allocates responsibility for universal service support to providers based on total telecommunications revenues, interstate and intrastate; third, the plan will accommodate future changes that policy makers may make to access charges.

CPI's plan also shares universal service responsibilities between federal and state jurisdictions: the federal Universal Service Plan supplies a baseline funding level; the final responsibility for determining whether rates are just, reasonable and affordable rests with the States.

Main Features of CPI's Integrated Universal Service Plan

- The federal Universal Service Fund (USF) would provide subsidies in two areas: I) telephony and ii) services for schools, libraries and health care providers. Telephony subsidies would be targeted to high-cost areas and to low-income consumers.

- States may adopt USF plans expanding the scope of services defined by the federal USF or modifying the affordability of rates produced by the federal USF program.

- For large LECs, the federal USF computes subsidies based on model TSLRIC costs.

- For small LECs, the federal USF computes subsidies based on embedded costs initially, with a transition to model TSLRIC costs.

- Responsibility for the federal USF is apportioned to providers based on total *net* telecommunications revenues, *both interstate and intrastate.*

- States may use the comparable allocation factors, including revenues from interstate services, to apportion responsibility for state USF plans. The FCC will require carriers to report their interstate and intrastate revenues by state, so state factors can be calculated.

- The federal Lifeline Program is expanded and made non-optional. The Link-Up program is retained and restructured to be competitively neutral.

- The list of basic telephony services supported by the USF is the consensus list mentioned by most commenters at the Joint Board. States may expand on the list of services.

- The required telephony subsidy would be calculated based on appropriate costs over a suitable geographic area, such as a census block group. The subsidy would be averaged over such geographic area and would be available to customers of any LEC certified as an eligible provider under §214(e) of the Telecommunications Act of 1996.

- This Universal Service proposal does not require an increase in the residential Subscriber Line Charge.

Details of CPI's Integrated Universal Service Proposal

Issue #1: *Which Services Should be Subsidized?*

In crafting a definition of "universal service," the Act requires the FCC to consider those services that (1) are "essential," (2) have been subscribed to by a substantial majority of residential customers, (3) are being deployed in the network, and (4) are in the public interest. CPI believes the following services should be included in the definition of universal service:

Single line, single party, residential service[1]
Dial tone plus local usage[2] within a local calling area[3]
Touchtone
The highest level of emergency service offered
Directory Assistance
White pages listing
Operator Services
Access to advanced services[4]
Special or advanced services for schools, libraries, and health care providers[5]

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[1] While second lines are increasingly demanded, they are not now essential, nor are they subscribed to by a substantial majority of consumers. However, subsidizing only the first line in each location could lead to inequities in certain circumstances. Two low-income families might share the same residence in a high cost area and be required to pay a much higher rate for the second line into the home. One way to address this inequity is to permit an exception for additional residential lines into the same residence in such cases.

[2] In most areas, flat-rated service is the preponderant local service. In areas where measured service is mandatory, the amount of local usage included in the definition of universal service should be a multiple of the average amount of local residential usage--150% of average, for example.

[3] A reasonable zone of local calling should include extended area service extensions where appropriate.

[4] Although Section 254 contains the principle that universal service should include access to advanced services, CPI believes that, today, this principle is generally satisfied by the features listed above, assuming the transmission quality is sufficient. Data uses are not "essential" and are not subscribed to by a substantial majority of residential customers at this time. However, the Commission should consider including a standard for certain data rates in the future as such data uses become more important and popular.

[5] CPI does not offer a position at this time on the specific eligible services for schools, libraries, and health care providers.

Issue #2: *What is the relationship between the federal USF and state USFs?*

CPI proposes a universal service plan which closely integrates federal and state efforts to support universal service. In short, the federal USF provides a baseline funding level for support of high-cost areas, low-income customers and schools, libraries and health care. States would then exercise their prerogative to adopt additional universal service mechanisms that build on the baseline support provided in the federal USF.

The Telecommunications Act of 1996 provides that States may adopt universal service plans which are not inconsistent with the federal USF. It is reasonable to assume that some States may differ with the FCC's determination of an implied affordable rate or the scope of services supported by the federal USF. For example, a state fund could expand the federal USF's scope (e.g., add services) modify the support structure (e.g., fund a deeper Lifeline discount or additional educational discounts), modify the cost basis (e.g., use historic costs instead of forward-looking costs) or lower the target rate (e.g., adopt a lower affordable rate standard). These differences would be permitted in this plan and would be consistent with the federal USF.

CPI proposes that the FCC establish a federal USF on the presumption that today's rates for universal service are just, reasonable and affordable. Although prices for service may vary somewhat among States, the FCC should adopt a benchmark rate (which includes the Subscriber Line Charge) as the basis for distributing the federal USF to the serving LECs. In those cases where the federal USF subsidy is not sufficient to support today's rates, state regulators will determine whether to permit rate changes or adopt a state USF to increase the subsidy, among other options.

A very important feature of this proposal is that the States and the FCC may use the same broad allocator (net interstate <u>and</u> intrastate revenues) to allocate universal service support. This factor would be used by the FCC and would be available, optionally, for States to use. The FCC would require interstate carriers to report interstate revenues consistently on a state-by-state basis in order to facilitate the development of these factors which the States may then use.

Issue #3: ***How should the federal Universal Service Fund be computed?***

The 1996 Act requires that the federal USF be "explicit and sufficient to achieve the purposes of this section." There are potentially four types of costs that the federal Universal Service Fund should support:

1) support for universal service in high-cost areas;
2) support for universal service, including special services, made available at discounted rates to eligible schools, libraries and rural health care providers;
3) support for universal services for low-income subscribers;
4) the costs of administering the federal Universal Service Fund.

Each of these four components is discussed more fully below:

1. High-cost areas

The Universal Service Fund should provide support for universal services in areas where the costs of providing service exceeds an affordable rate for universal service. As explained above, CPI envisions a system of universal service support where the responsibility for ensuring that rates remain affordable is shared by the FCC and the States. The combination of state and federal USF support and state ratemaking practices should result in a price for universal service which is affordable. This sharing is necessary since the ultimate responsibility of setting rates for local service resides with state commissions.

We focus on the federal USF contribution first, although we suggest that much of this discussion should also apply to the development of state USFs.

Costs. To determine the costs, CPI recommends using a benchmark model to determine the Total Service Long Run Incremental Costs (TSLRIC) of providing service in each area of the country. Embedded, or historic costs, that the ILECs have invested or incurred in the past, could include unnecessary or inefficient costs which should not be subsidized, especially not by other providers that may soon be in competition with these incumbent LECs. Using a TSLRIC model will help to ensure that the costs that are subsidized are the "efficient" costs of providing service.

Using a TSLRIC model to determine the costs of small, rural LECs may impose an undue hardship on these carriers in the short run. We recommend that the smallest ILECs be permitted to use their embedded costs for the first year, with a transition to the use of TSLRIC over 7 years. Mid-sized ILECs, such as those with less than 2 percent of the nation's access lines, should be

required to make the transition to a TSLRIC basis over 4 years. The ILECs with over 2 percent of the nation's access lines would use TSLRIC immediately. This three-tiered approach is consistent with Section 251 of the Telecommunications Act of 1996, which recognizes the same three tiers in determining the unbundling obligations of ILECs.

The costs of each ILEC should be determined on the basis of Census Block Groups (CBGs) or some other suitable compact geographic area. Since the costs of providing service can vary widely across a state or a county, reviewing the costs on the basis of CBGs can present policy-makers with a realistic estimate of the costs of providing service without being so specific as to be unworkable. For purposes of the federal USF, it is important that the cost methodology be consistent across the country so that the fund is allocated equitably among customers of various competing LECs.

Affordable Price. In theory, the federal USF could be designed to subsidize the difference between the TSLRIC cost of universal service and all net revenues available to the serving LEC which can be attributed to the customer being considered for a subsidy. In this case, the FCC would determine, for each CBG, the TSLRIC-based cost and then subtract the available revenue sources within the LEC which support the facilities used to provide universal service.

While this approach has some merit, there are also several concerns with this approach. First, it produces the largest subsidies where rates are the lowest, for a given level of cost. If a carrier reduces its price for voice messaging, for example, the subsidy for the CBG would increase. Second, there will be significant controversy about the net contribution made to each customer's universal cost from these services. This debate properly takes place at the state commission where rates are determined and should not become part of the FCC's process for establishing the federal USF. Third, this system would produce a subsidy which is based on the financial circumstances of an incumbent LEC, yet it should be applicable to any new entrant that seeks to become an eligible provider in the geographic zone. It is preferable to derive a subsidy calculation that is independent of specific carriers. Finally, it would be relatively difficult to gather the data necessary, on a CBG basis, to track this method accurately.

In practice, the federal USF can be fairly apportioned across regions and across carriers if it is computed as the difference between the TSLRIC-based cost in each CBG and a nationwide benchmark rate which the FCC would choose. This benchmark could be chosen to approximate the net total revenues related to all services provided to customers in high-cost areas, including the basic service rate, access, interexchange service and "vertical" services.

Caveat: This does not mean that average rates for residential service would move to the federal benchmark cost. First, the estimate assumed revenues from additional services which the serving LEC would provide in addition to the services included in universal service, including the current Subscriber Line Charge. Second, States would have complete freedom to determine the rate for universal service, subject to the requirement in the Telecommunications Act of 1996 that rates be just, reasonable and affordable. Third, States may establish universal service plans which provide additional subsidies. This option was discussed above. Finally, we expect competitors, to whom the subsidy will also be available, will begin to compete within high-cost CBGs, either through new facilities, the purchase of network elements, resale, or a combination of all these methods of entry. Their presence will put downward pressure on prices for universal service.

CPI also notes that disbursements from the federal Universal Service Fund will, in some cases, provide an ILEC with earnings in excess of those required to earn a reasonable return on investment. We assume that state commissions are postured to require LECs to reduce rates appropriately. In the case of a LEC that receives federal USF support, yet maintains rates for universal service at high levels, the FCC should consider requiring such LEC to file a "show cause" petition with a state commission, showing why rates should not be reduced.

Finally, using a benchmark rate to compute the USF subsidy also makes the universal service system competitively neutral. The subsidy is not designed to keep an incumbent LEC "whole," nor does it confer on competitors the ability to receive a larger subsidy merely by lowering prices for competitive services or demonstrating "losses" to competition.

2. Schools, Libraries and Health Care Providers

CPI does not make a specific recommendation on the size or form of discounts that should be provided to qualified schools, libraries and rural health care providers at this time. However, for consistency, such discounts should be reported to the federal USF by the carriers and be collected from the federal USF in the same manner as subsidies for high cost areas are collected.

3. Services for Low-Income Consumers

The FCC currently maintains two mechanisms to support low-income consumers -- the Lifeline and Link-Up programs. CPI recommends that the Lifeline program be expanded and the Link-Up program be preserved.[6]

Lifeline. The FCC currently provides two forms of Lifeline support for low-income persons. The more generous plan allows low-income persons to be exempted from the $3.50 subscriber line charge if the State provides a matching program that allows the customer to obtain a further $3.50 discount from state funds. CPI believes this program needs to be expanded in three ways. First, low-income persons should receive a larger discount: CPI suggests that the Lifeline rate should be one-half the prevailing rate or one-half the average rate in the country, whichever is lower. Second, the FCC should require carriers to offer this discounted rate to consumers whether or not a State matches the program. States could provide additional discounts using their own intrastate mechanisms if they so desire. Third, the FCC should simplify the process by which low-income subscribers can take advantage of the Lifeline discount. The FCC should allow consumers who qualify for certain other federal assistance programs, such as Food Stamp Assistance, to qualify automatically for the Lifeline program, a practice that is used in some states already.

Link-Up America. The Link-Up America program, which provides assistance for installation charges for low-income persons, should be retained. In order to make the Link-Up subsidy competitively neutral, the program should be restructured to provide the same subsidy to any eligible LEC on behalf of any qualified low-income consumer. Subsidies for Link-Up should be funded through the federal Universal Service Fund in the same fashion as other subsidies.

4. Administrative Costs

Some small amount must be included in the federal universal service plan to cover administrative expenses. CPI supports the idea of allowing independent entities to bid for the right to manage the universal service fund.

The size of the Universal Service Fund will be the sum of the amounts needed to support all four of these categories of costs. Once this sum is determined, it will be necessary to determine who will contribute to the fund and in what amounts.

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[6] In addition, termination of universal service for non-payment of telecommunications services (other than universal service) should be prohibited for Lifeline participants.

Issue #4: ***How should the USF contributions be apportioned among providers?***

CPI believes that all carriers that provide interstate service must contribute to the federal Universal Service Fund, including ILECs, CLECs, interexchange carriers, resellers, wireless carriers, satellite carriers, etc. The next question is how to apportion each carrier's responsibility to contribute to the fund. CPI believes that the responsibility to contribute to the fund should be based on the carrier's net revenues from providing interstate and intrastate service.[7]

Net Revenues. The carrier's net revenues are derived by deducting the carrier's transfer payments to other carriers from its total revenues from its telecommunications services.

Interstate and Intrastate Revenues. The federal legislation identifies who must contribute to the federal USF as those that provide interstate telecommunications services, but it does not specify the basis on which contributions should be made. CPI believes that contributions should be made based upon these carriers' net intrastate and interstate revenues. The Universal Service Fund will be providing subsidies to cover total costs of the local exchange network, without regard to "separations," so it is consistent that carriers should contribute based upon their interstate and intrastate revenues. In this way the allocation will reflect the relative "size" of each carrier as a telecommunications provider. Further, it will be difficult (if not impossible) to separate the interstate and intrastate revenues of unregulated carriers. Finally, to exclude the intrastate revenues of carriers would exclude revenues from the very sources that are often viewed as the reason for creating the Universal Service Fund.[8]

Caveat: The FCC should consider intrastate and interstate revenues only if a State is also permitted to consider the intrastate and interstate revenues attributable to that State when funding its own universal service plan. The Joint Board and the FCC should explicitly require carriers to

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[7]Carriers that receive subsidies because costs exceed affordable levels in a given CBG would also contribute to the federal fund based, in part, on their revenues generated in that CBG, leading to some circularity. The carrier's responsibility could be reduced slightly by excluding the revenues in that CBG when calculating that carrier's responsibility for the fund.

[8] As competition enters the local market, some competitors are likely to target business customers before entering the residential market, reducing contributions available for high cost areas. It is only fair for the competitor's share of universal service funding to grow as its local market share grows. Further, since existing subsidies are provided by intrastate as well as interstate services, it is logical to apportion contributions to the Universal Service Fund based on intrastate and interstate revenues at both the state and federal level. Finally, if intrastate revenues were excluded, competitors that provide primarily intrastate service would avoid making a significant contribution to universal service unless a State also adopted a universal service plan.

report their total interstate and intrastate revenues that are attributable to each State in order to assist the State in gathering the information concerning the revenues attributable to each State.

The total industry revenues are derived by adding together the net revenues of all the carriers nationwide. Once the total is derived, each carrier contributes to the federal USF in the same proportion as its total net intrastate and interstate revenues relate to the net total revenues. In other words, if a carrier's intrastate and interstate revenues account for 2% of the total industry net revenues, the carrier contributes 2% of the funds required for universal service support.

Thus, for a carrier, the federal USF factor is equal to a carrier's net telecommunications revenues, interstate and intrastate, divided by the sum of all such revenues from all carriers. This means that sum of all federal USF factors is 100%. For carriers that provide intrastate services, the optional state USF factor is equal to the carrier's net interstate and intrastate telecommunications revenues attributed to that State, divided by the sum of all such revenues from all carriers. For each State, the sum of all such state USF factors is 100%.

In summary, the following ratios describe the relationship between a carrier's revenues and its share of the federal Universal Service fund. A corresponding set of ratios would apply in the case of a State that elected to use the comparable state USF factors.

$$\frac{\text{Carrier's Total Net Intrastate and Interstate Revenues}}{\text{Total Industry Intrastate and Interstate Revenues}} \quad \text{Equals} \quad \frac{\text{A Carrier's Contribution to the USF}}{\text{Total Amount in the USF}}$$

Issue #5: *Who is eligible for the subsidies?*

The Act requires that only eligible carriers that meet the requirements of Section 214(e) may withdraw from the federal Universal Service Fund. To become an eligible carrier, a carrier must offer and advertise the availability of the universal service throughout the "service area" for which the designation is sought. In areas served by rural telephone companies, the service area is the company's study area unless and until the Commission and the States alter the definition of the "service area" for that company.

CPI recommends that, except in areas served by a rural telephone company, a service area should be defined as the CBG. This would be consistent with the cost model which determines costs on a CBG basis. The "study area" of many companies today encompasses an entire State. It is unreasonable to require a competitor to a large LEC to serve the entire State before being allowed to become an eligible carrier capable of receiving subsidies from the federal USF. Without a doubt, this would severely limit competition in high cost areas served by large LECs.

For rural telephone companies, CPI recommends that the FCC and States change the existing "study area" definition to CBGs at the same time the use of embedded costs for these companies is phased out.

The Act allows the States to designate more than one carrier as an eligible telecommunications carrier. CPI believes that the FCC should permit any carrier to draw from the Universal Service Fund as long as it satisfies the eligibility requirements set forth in the Act. In other words, the FCC should not set any additional hurdles for competitive carriers to qualify to receive universal service support.

Further, carriers should be permitted to draw from the fund based on the number of customers served in a CBG. Although only carriers may draw from the fund, basing a carrier's subsidy on the number of customers has the effect of making the subsidy "portable" -- the subsidy follows the customer and is available to any carrier that provides service.

Issue #6: ***How should the federal USF be administered?***

The federal USF should be administered by a neutral third party determined as the winner of a bid process conducted by the Commission. Reasonable costs of administering the fund should be included in the total fund requirements as described above.