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October 7, 1996

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

Re: <u>Ex Parte Presentation - CC Docket 96-45</u>
<u>Federal - State Joint Board on Universal Service</u>

Dear Mr. Caton:

On Monday, October 7, 1996, Mr. Gerry Salemme, Mr. Joel Lubin and I met with Mr. Daniel Gonzalez, Legal Advisor to Commissioner Rachelle B. Chong, to discuss the above captioned docket. The attachments were used as the basis of the discussion.

In accordance with Section 1.1206(a)(1) of the Commission's Rules, two (2) copies of this Notice are being filed with the Secretary of the FCC.

Sincerely,

Bruce K. Cox

Attachments

cc: Mr. Gonzalez

UNIVERSAL SERVICE

Universal Service Principles *(Section 254)*

- Universal service subsidies should be based on same TELRIC standard as unbundled network elements
- All telecommunications service providers contribute to universal service support in an equitable and nondiscriminatory manner
- Universal service support should be explicit and sufficient for intended purpose
- Any carrier designated as eligible would be entitled to universal service support
  - Competitive LECs (CLECs) who buy/lease unbundled network elements from Incumbent LECs (ILECs) should be eligible

ELEMENTS OF THE NEW UNIVERSAL SERVICE FUND

- Large Local Exchange Companies:
  - National Universal Service Fund (NUSF)
  - State Universal Service Fund (SUSF)

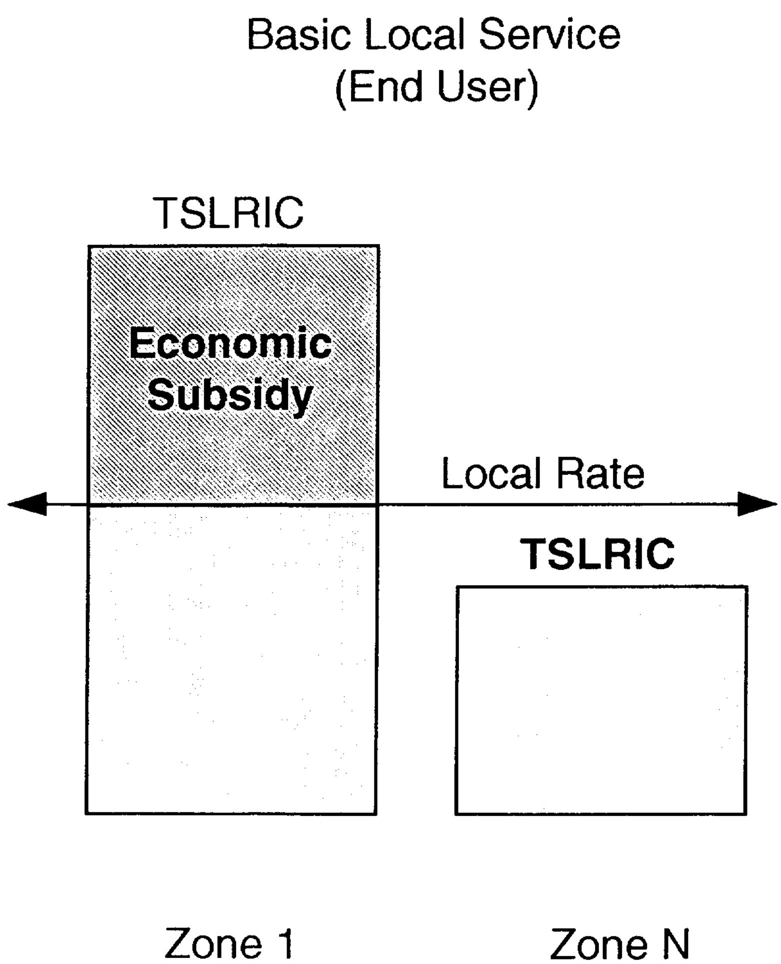
- Small Rural Local Exchange Companies:
  - NUSF

- Low Income/LifeLine Assistance Subsidy:
  - NUSF

- Schools, Libraries and Rural Healthcare:
  - NUSF

- Competitively Neutral Collection and Distribution of the Fund

Paradigm Change



There is a direct linkage between the TELRIC prices of the unbundled network elements and the subsidy per line which determines the size of the fund. (Illustrative)

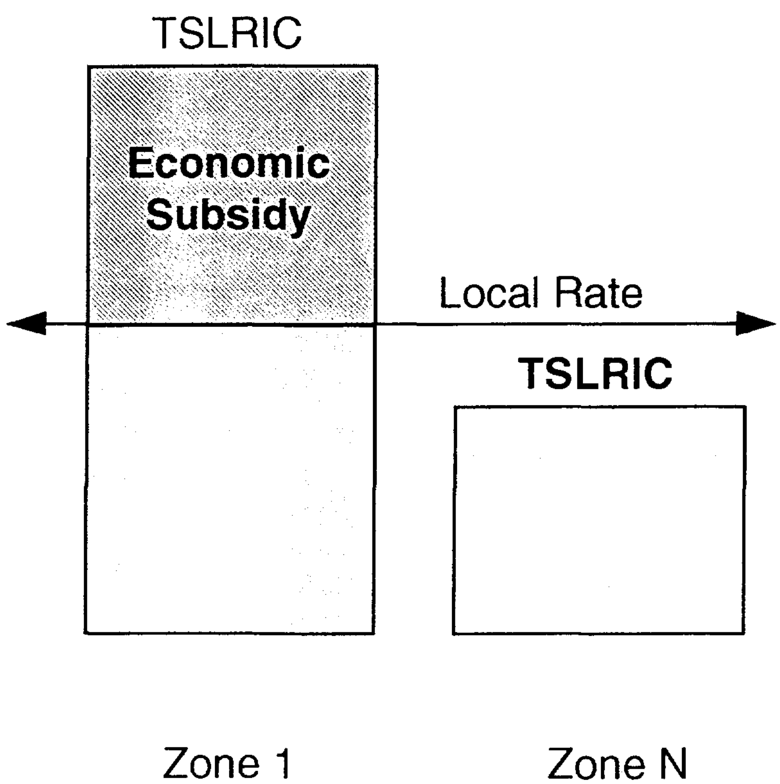
UNE*:	LOOP	SWITCH	TRANSMISSION	SWITCH
	(Zones) 1 to N	End Office		Tandem
TELRIC	$75....$9	.2 ¢ - .4 ¢	.25 ¢	.15 ¢

TSLRIC of Local Service =	zone 1...	zone N
Line:	$75.	$ 9.
Port:		
Switch Usage:	$ 3.	$ 3.
Transmission:		
Signaling:		
SUBTOTAL	$78.	$ 12.
Retail End User Cost	2.	2.
TOTAL	$80.	$14.

* UNE: Unbundled Network Element

Paradigm Change

Basic Local Service
(End User)



USE LARGE LEC ACCESS RATES AS BENCHMARKS FOR SETTING RATES FOR SMALL RURAL CARRIERS

When calculating the new universal service fund for small rural LECs...

- Access rates should be based on the rates of the large company in the state or region
- Any incremental subsidy required to meet the rural carrier's revenue needs should be provided through the new NUSF mechanism
- Subsidy need not be portable in small rural company territory initially

ALTERNATIVE USF SURCHARGE METHODOLOGIES

Universal service subsidies should be funded by a surcharge on all retail telecommunications revenue, both interstate and intrastate.[1] This surcharge would appear as a separate line on the retail customer's bill, and be denoted as support for universal service. The benefits of this approach are two-fold. By placing the surcharge on all retail revenues, it ensures that all telecommunications end-users make an equitable contribution to universal service support; and because the surcharge is paid directly by end-users rather than carriers, carriers cannot allocate strategically the cost of this subsidy onto particular services for which there are fewer competitive alternatives[2].

If direct collection of subsidies from end-users is deemed undesirable, a less efficient alternative is to collect these via a carrier-paid surcharge. To avoid the possibility that telecommunications carriers would be able to collect this support disproportionately from certain of their services, one of the two following competitively neutral implementation methods should be employed:

1. a surcharge applied only to the carrier's retail telecommunications revenues, or
2. a surcharge applied to the carrier's gross revenues net of its payments to its supplier carriers (also referred to as a surcharge on the carrier's "value-added").

Both of these alternatives are competitively neutral, and, indeed, mathematically identical if the surcharge paid by each carrier in a state is calculated as a uniform percentage applied to all of its "taxable" revenues (and subject to audit by a neutral administrator), and, in the case of the second alternative, identified separately on all carrier-to-carrier (wholesale) bills.[3] The equivalence of the above alternatives is demonstrated in the following example.

Suppose the USF requirement is $200, and the market is split between two carriers: Carrier A sells both retail services directly to end-users and wholesale services (e.g., access, unbundled network elements or other wholesale services) to Carrier B. Carrier B uses Carrier A's inputs to create retail services that it sells to end-users in competition with the end-user services sold directly by Carrier A. Thus,

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[1] The national portion of this subsidy (difference between the TSLRIC of basic service and the national affordable rate) would be recovered by a nationally uniform percentage surcharge on all interstate and intrastate retail services. The state portion of this subsidy (difference between the national affordable rate and current local rates) would be recovered by a state-specific percentage surcharge on all interstate and intrastate retail services provided in that state.

[2] An end-user retail surcharge, as implemented in Vermont and California, also can help to ensure maximal flow-through of any access reductions to retail toll reductions -- because the support for universal service will not be part of the service providers' cost structure. In addition, with an end-user surcharge, regulators are relieved of the burden of ensuring that updates to the surcharge are appropriately reflected in carriers' charges.

[3] This line item exposure of the charge on carrier-to-carrier bills will help the auditor ensure that wholesale/retail service providers do not strategically price their services by recovering their support obligations only from their wholesale customers. This is another form of price squeeze.

	Carrier A	Carrier B
Retail Revenue	2,000	2,000
Wholesale Revenue	1,000	—
Gross Revenue	3,000	2,000

Alternative 1: Surcharge on Retail Revenues

Total Retail Revenues = $4,000
Surcharge = $200 ÷ $4,000 = 5%

Carrier A pays $100 for USF and collects $2100 from its retail customers.

Carrier B pays $100 for USF and collects $2100 from its retail customers.

Subsidy is competitively neutral because each carrier must markup the services that it sells in competition with the other carrier (retail services) by an identical amount. Customers have no reason to prefer buying from one carrier over the other.

Alternative 2(a): Surcharge on Carrier's Retail Revenues

Under the first option of Alternative 2 (namely, a surcharge applied to the carrier's retail telecommunications revenues), the result would be identical to Alternative 1, except that end-users would not "see" the surcharge as a line item on the bill.

Alternative 2(b): Surcharge on Gross Revenues Net of Payments to Supplier Carriers

Gross Revenues = $5,000
Payments to Supplier Carriers = $ 1,000
Gross Revenues Net of Payments to Supplier Carriers = $4,000
Surcharge = $200 ÷ $4,000 = 5%

Carrier A pays $150 for USF and collects this by surcharging its sales to both end-users and Carrier B by 5%. Thus, it collects $2100 from its retail customers and $1050 from Carrier B (which passes on $50 of USF obligation to Carrier B).

Carrier B owes $50 directly for USF based on its $1000 of retail revenues less its payments to Carrier A. But because it must pay Carrier A $1050 rather than $1000 for its inputs, it has implicitly paid another $50 in USF support.

Thus, although this mechanism has Carrier A and B remitting different amounts to the USF administrator, because Carrier A has transferred the burden of paying for the USF assessment on its wholesale revenues to Carrier B, each carrier's retail customers bear equal $100 obligations to pay for USF support. Thus, the subsidy mechanism is competitively neutral.