

whole."⁶⁸ This constitutional issue can be avoided by establishing universal service regulations that provide for recovery of costs prudently incurred, by permitting carriers an explicit surcharge mechanism for recovery of their fund contributions, and by not lowering the cap on the Subscriber Line Charge.

In the past, the partly public, partly private nature of public utilities has created its own particularized set of issues in Fifth Amendment jurisprudence. "The guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public which is so unjust as to be confiscatory."⁶⁹ The law requires that the public utility's rates should enable the company to operate successfully, maintain financial integrity, attract capital and compensate investors for risks assumed.⁷⁰ Thus, whether a taking has occurred depended on whether the utility has the opportunity to earn a fair rate of return.⁷¹ More specifically, under this analysis if the Joint Board's recommendations did "not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments."⁷²

⁶⁸ *Dolan v. City of Tigard*, 114 S. Ct. 2309, 2316 (1994) (citation omitted).

⁶⁹ *Duquesne Power, supra*, 488 U.S. at 307 (1989); see also *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585 (1942) (the lowest reasonable rate is one which is not confiscatory in the constitutional sense).

⁷⁰ *Duquesne*, 488 U.S. at 310.

⁷¹ See *Federal Power Commission v. Hope Natural Gas*, 320 U.S. 591, 602 (1944).

⁷² *Duquesne*, 488 U.S. at 308.

In this public utility model, government largely defined the rate and risks because utilities were public monopolies that provided an essential service and enjoyed relative immunity from market risks. This classical, regulated monopoly model represents the so-called regulatory compact, under which "[t]he utilities incur fewer risks, but are limited to a standard rate of return. . . ."⁷³ Even under this traditional model, the Joint Board's recommendations will result in a taking without just compensation because (i) the cost methodology and benchmark, by design, will not give GTE the opportunity to recover the actual costs of its prudent investments in providing universal service and (ii) it fails to provide an alternative mechanism to recover these regulation-imposed costs. What is more, the traditional regulations of the monopoly environment can no longer be sustained. To the extent that it was ever permissible to force a telephone company to incur a loss on one part of its business in return for compensatory profitability in another part of its business, such an approach is no longer tenable under the 1996 Act's competitive framework.

More than 75 years ago, the Supreme Court squarely resolved this particular takings issue, holding that it was impermissible, in a competitive context, to aggregate loss-inducing business lines with profitable, competitive ones for purposes of the takings analysis. In attempting to deny a company permission to abandon a railroad line operated at a loss, a Railroad Commission had argued that, because the company made a profit on its related timber business, the test of the company's property rights

⁷³ *Id.* at 309.

"was the net result of the whole enterprise -- the entire business of the corporation."⁷⁴

In words with great import for the *Recommended Decision's* support scheme at issue in this proceeding, Justice Oliver Wendell Holmes firmly rejected this "entire business" theory:

A carrier cannot be compelled to carry on even a branch of business at a loss, much less the whole business of carriage. . . . The plaintiff may be making money from its sawmill and lumber business but it no more can be compelled to spend that than it can be compelled to spend any other money to maintain a railroad for the benefit of others who do not care to pay for it.⁷⁵

The era when ILECs would even be able to subsidize losses on service to high-cost areas with profits generated elsewhere has ended. The Commission must look at the totality of the costs and benefits imposed by the Joint Board's scheme, and must not include any potential profits that may flow from the now-competitive business lines⁷⁶ that are no longer part of the public franchise and cannot be considered in evaluating the confiscatory nature of any proposed universal service support scheme.⁷⁷

The *Recommended Decision's* methodology, by counting revenues from other services and failing to account for the actual costs of providing universal service, would

⁷⁴ *Brooks-Scanlon Co. v. Railroad Commissioner*, 251 U.S. 396, 399 (1920).

⁷⁵ *Id.*; see also, e.g., *Chicago, Milwaukee & St. Paul Railway Co. v. Public Utilities Commission*, 274 U.S. 344, 351 (1927) (state has no power to require intrastate hauling of logs at a loss, even if regulated entity receives adequate revenues from intrastate log hauling and interstate lumber businesses together); *Calfarm Ins. Co. v. Deukmejian*, 771 P.2d 1247 (Cal. 1989) (striking down law mandating insurance rate rollback because the regulation relied on the financial position of the company as a whole, including unregulated lines of business).

⁷⁶ See *Hope Natural Gas*, 320 U.S. at 591.

⁷⁷ *Broad River Power Company v. South Carolina*, 281 U.S. 537 (1930).

place ILECs in the position of bearing mandatory costs on a massive scale -- costs that government does not allow them to collect from customers and for which government will not compensate them. This would violate the Constitution. Moreover, the Joint Board actually recommends further reducing the opportunities for ILECs to recover these costs.

The Supreme Court has observed that the government's decision to switch back and forth arbitrarily between methodologies in a way which requires investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others may also raise serious constitutional questions.⁷⁸ The Joint Board's proposals fall into this constitutional trap. By locking ILECs into below-actual-cost proxies while eliminating other opportunities for cost recovery, the Commission would place ILECs in just such regulatory shackles.⁷⁹

III. TO MEET THE REQUIREMENTS OF THE 1996 ACT, THE COMMISSION MUST ADOPT AN INTEGRATED PLAN THAT DIFFERS IN IMPORTANT RESPECTS FROM THE *RECOMMENDED DECISION*.

For the reasons set forth *supra*, the universal service support plan put forth by the *Recommended Decision*, if adopted by the Commission, would not satisfy the requirements established by the 1996 Act. To ensure that the federal plan is sufficient,

⁷⁸ *Duquesne*, 488 U.S. at 315.

⁷⁹ At the very least, the Joint Board's proposals raise serious constitutional concerns under the Takings Clause. Wherever fairly possible, an agency is required to adopt a statutory interpretation that avoids difficult constitutional issues. See *Ashwander v. Tennessee Valley Authority*, 297 U.S. 288, 347 (1936) (Brandeis, J., concurring); *Bell Atlantic v. FCC*, 24 F.3d 1441, 1445 (D.C. Cir. 1994) ("Within the bounds of fair interpretation, statutes will be construed to defeat administrative order that raises substantial constitutional questions." (citations omitted))

explicit, and competitively neutral, the Commission must modify the *Recommended Decision* in a number of important areas. The support mechanism that is adopted must confront the essential problems of universal service, rather than turn away from them, as the *Recommended Decision* does. The federal fund itself need not (and should not) seek to provide all universal service support or to dictate matters that are best left to the states. The FCC must, however, establish an effective, integrated framework that will ensure that the combined effects of the support mechanism and of measures adopted by the states will preserve universal service in the manner mandated by the 1996 Act. To do this, the plan must incorporate the following key elements.

A. The Receipt Of High Cost Funding Must Be Linked To An Obligation To Serve.

The federal plan should require that any eligible telecommunications carrier, in order to receive high cost funding, must undertake an adequately specified obligation to provide the designated universal service. The terms of this obligation should be set by each state, subject to broad federal guidelines.

As explained *supra*, this linkage between funding and obligation is necessary for several reasons. First, the plan cannot accomplish Congress' goals, or the plan's own objectives, if the plan does not specify what it wants carriers to do. Providing the defined universal service under designated terms and conditions -- including an affordable price -- is the task that a state commission wants the carrier to perform in return for high cost funding. Second, tying availability of support to achieving a specific goal is the only way to distribute funds efficiently where customers are heterogeneous and information is not perfect. The only way to ensure that all customers are served voluntarily would be to offer enough support to elicit supply to the least desirable

customer, which would involve paying too much for all of the other customers in the area.⁸⁰ Third, in order for the plan to be competitively neutral, each carrier should receive the same level of support in return for performing the same function. If the things the carrier is expected to do are not specified, the plan cannot assure this neutrality. Fourth, an obligation to serve under pre-determined criteria is necessary to ensure that the plan is sufficient. If some carriers can serve selectively and be paid to serve customers they would have served voluntarily, then the incumbent will not be able to sustain its obligation to serve all other customers in the face of this selective entry. This will be true even if the support is set at a level that is sufficient for an average of all the customers in the area.⁸¹

GTE does not suggest that the Commission should attempt to specify in the federal plan each of the terms and conditions related to the obligation to serve. Each state should determine the requirements necessary to ensure affordable basic service in its area. This is consistent with the states' continuing role as the entities responsible for regulation of local service, and with their charge under Section 214(e)(2) to designate eligible telecommunications carriers. It is also consistent with the *Recommended Decision's* preference (at ¶ 131) for leaving the determination of affordability with the states. Further, it is not necessary for the terms of the obligation to be the same across different areas in order to satisfy the requirements of the 1996 Act;

⁸⁰ Note that this would be true even if there were not an incumbent with service obligations today. This is not just an issue of fairness with respect to ILECs; it is a necessary element in the design of an effective plan.

⁸¹ In fact, if the *Recommended Decision* were to be adopted without modification, the average level of support would not be sufficient.

hence there is no need for the federal plan to impose uniform requirements on the states.

What the Commission must do is to establish minimum guidelines in the federal plan for the state-established service obligations. These guidelines need only make certain that the obligations are adequate to ensure that the combined effect of the state and federal plans will satisfy the requirements of the 1996 Act. GTE proposes the following federal guidelines:

- 1) As the *Recommended Decision* proposes (at ¶ 156), in order to receive high cost funds, a carrier should satisfy the requirements for certification as an *Eitel* specified in Section 214(e)(1) and (2) of the 1996 Act. These include offering the defined service throughout a service area and advertising the carrier's prices.
- 2) As the *Recommended Decision* proposes (at ¶ 131), the state commission should determine the price level it finds to be affordable for each serving area in the state.⁸² This affordable price would serve as a ceiling for the price charged by all supported carriers in that area. Each

⁸² This affordable price could be the same statewide or could vary by area within the state on whatever basis the state commission may choose.

supported carrier would be required to offer a service package that met the basic service definition at a price that did not exceed this ceiling.⁸³

- 3) These conditions for the receipt of funds, and any others the state may choose to impose, such as providing the defined universal service under specified installation intervals with required repair procedures,⁸⁴ should be the same for all carriers in a given area. This does not mean that they must be the same as those currently applied to the ILEC.⁸⁵

While the Commission does not have the authority to require the states to establish obligations to serve, it can adopt the proposed guidelines as conditions for receipt of support from the federal fund.

B. The Benchmark Should Be Chosen To Yield A federal Fund Of The Desired Size, And The federal Fund, Together with State Funds, Must Be Sufficient to Assure Universal Service.

As shown *supra*, the level of funding determined using the benchmark proposed in the *Recommended Decision* will not be competitively neutral, nor will it be sufficient, as required by the 1996 Act. It is therefore necessary for the Commission to adopt a

⁸³ The carrier would be free to charge less than the ceiling, or to include features in this basic offering that were not in the definition. Carriers would also be free to offer packages at higher prices; these could be expressed as adders to the basic service price. The proposed guidelines would thus not inhibit carriers from combining services or packaging them in creative ways. It would simply limit carriers' ability to use packaging or price differentials to avoid customers they did not wish to serve.

⁸⁴ California, for example, requires all new entrants that offer local exchange service to meet the same quality standards it has established for ILECs.

⁸⁵ The obligations imposed on all supported carriers should ideally be limited to the minimum set necessary to ensure provision of universal service. Certainly not all of the current constraints on ILECs are necessary for this purpose.

different approach for developing a benchmark in the federal plan. It is important in this context to distinguish between the total amount of funding that is required to meet the requirements of the 1996 Act, and the portion of that funding that should be provided by the federal plan. GTE proposes that the federal plan should depart from the *Recommended Decision* in each of these aspects.

First, the federal plan should be based on a framework that correctly identifies the total need for high cost support, even if the federal plan itself will not provide 100 per cent of that support. This need should be estimated by comparing the rate ceiling the state imposes on eligible carriers who undertake the obligation to serve with the cost of the basic service.⁸⁶ For purposes of this calculation, the rates considered should be those that are caused by the customer's decision to subscribe to the defined basic service.⁸⁷

The *Recommended Decision* errs by including in its benchmark calculation revenues from other services, such as access and vertical services, which are not caused by the customer's decision to subscribe. While the *Recommended Decision* uses this calculation not to determine the total of state and federal support, but only to

⁸⁶ Any comparison of revenue and cost can only approximate the actual support needed, because a carrier's willingness to serve may depend on other factors. As the *Recommended Decision* recognizes (at ¶ 342) the only way to capture all relevant factors is through a competitive bidding process.

⁸⁷ In addition to the monthly recurring charge itself, this should include any additional charges which are triggered by the decision to subscribe, such as the Federal end user charge, and any similar state charges. In Texas, for example, some Extended Area Service charges are non-optional; they are applied automatically when the customer orders basic service.

establish a federal benchmark, it does not clearly distinguish between these two purposes.

There is no reason why the nationwide level of other service revenue should be relevant to the determination of the proportion of total support the federal plan should supply; hence it is not a sound basis for choosing a federal benchmark. Including these revenues in the calculation will bias downward the amount of support provided by the federal fund.

More importantly, if the states were to base their own assessment of state funding needs on the incorrect reasoning in the *Recommended Decision*, then the need for state funding, given this federal benchmark, would be severely underestimated. As a result, the total amount of funding -- both state and federal -- would be insufficient.⁸⁸ For reasons explained *supra*, considering other service revenues in the determination of support would result in building implicit support into the new universal service policy - which is forbidden by subsection 214(e). Further, such a plan would not be competitively neutral because it would set the price of local service, from the carriers'

⁸⁸ The *Recommended Decision* expresses concern (at ¶ 316) that the universal service fund might "overcompensate" the provider of service. This would result in a "large" universal service fund that would ultimately be paid for through higher rates, which might "result in some customers having to drop off the network." This ignores the fact that any new support provided to ILECs will be exactly offset by rate reductions, so that the overall effect on the level of rates will be zero. In fact, the true cost of universal service is determined by the magnitude of the intervention in local rates and terms it must support; the only way to reduce this cost is to reduce the intervention itself.

perspective, artificially low, thereby deterring competitive entry and unfairly burdening ILECs, who bear the responsibility for universal service today.⁸⁹

It is therefore imperative to the development of an effective overall universal service policy that the federal plan should recognize the correct basis for estimating total support by comparing the rate ceiling for the basic local service with the cost of that service.

Second, the federal funding mechanism should incorporate a benchmark (or benchmarks) that will divide funding responsibility between the federal and the state plans. This benchmark should not be determined on the basis of average service revenue, as the *Recommended Decision* proposes. Instead, it should be based on considerations that relate to the desirability of funding a particular proportion of the needed support from federal, as opposed to state, sources.

GTE has proposed that the benchmark should be based on a national assessment of the level of local rates that would be considered affordable. Under this approach, the federal plan would seek to ensure that rates did not exceed this level; states would be free to fund lower rates if they choose.⁹⁰ GTE continues to believe that an affordability standard is a reasonable way to judge the need for federal funding,

⁸⁹ The ILECs meet this responsibility today by relying on implicit support.

⁹⁰ The *Recommended Decision* expresses concern (at ¶ 131) that an affordability benchmark would fail to take into account local conditions, and that it would in some way interfere with ratemaking at the state level. However, since the setting of local rates (and the funding needed to maintain them below the level supported by the Federal plan) would remain the responsibility of the states, this concern appears to be misplaced.

because it ties the calculation of federal support directly to the congressional intent to ensure that rates are affordable.

The *Recommended Decision* (at ¶ 131) expresses a preference of leaving judgments concerning affordability to the states. GTE believes that an effective national policy can be crafted which accommodates the Joint Board's preference. If the federal benchmark is not to have any significance as a determination of affordability, then its only significance is its function of dividing the plan's assignment of support responsibility between state and federal mechanisms. Neither average costs, nor average revenues, has anything to do with answering this question.

GTE proposes that the federal benchmark should be set at the level which would cause the federal plan to assume a reasonable proportion of the total funding needed, provided that the total amount of state and federal funding is "sufficient." The determination of the reasonable level of federal funding, in turn, should depend on several factors. First, the Commission should consider the relative ease of gathering funds through a national mechanism, as compared with state mechanisms. Second, the federal fund should be at least sufficient to pay for offsetting reductions in federal access charges that provide implicit support for universal service today that would eliminate universal service subsidies.⁹¹ Third, the Commission should consider the extent to which the federal mechanism is to be used to fund offsetting reductions in state rates that are providing implicit support today. The larger the federal fund, the

⁹¹ As discussed *infra*, if the Federal plan is used only for the purpose of funding offsetting reductions in interstate rates, then the funding base for the Federal plan should be limited to interstate revenues.

greater these offsetting reductions will be, and the greater will be the transfers of funds across states through the federal mechanism. In its earlier comments in this proceeding, GTE demonstrated that there is a wide variation across states, both in their need for universal service funding and in the revenues they have available as a base for funding their state plans.⁹² In setting the size of the federal fund, the Commission should strike a reasonable balance between the need to even out these differences and the need to limit transfers from states with greater resources and/or lower funding needs.

It is with this last concern in mind that GTE has proposed the use of two federal benchmarks, rather than one. Under this approach, states would be responsible for all funding between the rate ceiling and a lower benchmark. The federal plan would fund all support above a higher benchmark. The need for funding between the two benchmarks would be shared between the federal plan and the state plans.⁹³ This structure would provide the Commission with two additional degrees of freedom in shaping the federal plan (the second benchmark, and the proportion of the amount between the two benchmarks covered by the federal plan). With a single benchmark, a given size for the federal fund will also imply a unique pattern of support flows across states through the federal mechanism. With the two benchmarks suggested by GTE,

⁹² See *GTE's D.96-45 Comments*, filed April 12, 1996, at Appendix B.

⁹³ See *GTE's D.96-45 Comments In Response To Questions*, filed August 2, 1996, at 6.

the Commission would have greater opportunity to arrive at a suitable overall fund size, while striking a reasonable balance with respect to transfers across states.⁹⁴

Regardless of whether one benchmark or two is used, GTE strongly urges the Commission in setting the benchmark(s) to focus solely on the role of the benchmark in dividing funding responsibility between state and federal plans. By considering average service revenues in setting the benchmark, the *Recommended Decision* confounds this issue with that of determining the total amount of support needed, and creates the risk that this total amount will not be sufficient.

C. The Federal Plan Should Rely On Proxy Costs Only To Geographically Disaggregate Actual Costs

1. The Output of A Proxy Cost Model Should Only Be Used To Apportion Actual Costs To Geographic Areas Smaller Than The Current Study Area.

Many parties, including the Joint Board, have expressed concern over the accuracy of a cost proxy model. Some predict that a model will systematically underestimate costs; others fear overestimates. GTE has long supported the development of a proxy model. While it is certainly preferable to expend the energy to make a proxy model as accurate as possible to reduce the inevitable areas of disagreement between parties. The proxy model, by its nature, will never be a precise estimator of cost levels. However, this weakness can be sidestepped if the model is

⁹⁴ Regardless of how the benchmark or benchmarks are chosen to meet the criteria suggested here, it must be emphasized that the choice of the benchmark in no way limits the overall responsibility of the FCC to assure that universal service support is "sufficient."

used in a way that plays to its strength, which is to generate information about relative costs across small geographic areas.

If the relative levels of costs produced by a reasonable, forward-looking cost model are used only to apportion actual costs to geographic areas smaller than the current study areas, the need for accuracy from the proxy model, with respect to cost levels, is eliminated. Instead, the relative cost relationships can be used, even if the total cost estimate is either too high or too low. This solution satisfies the need to provide sufficient universal service support while targeting that support to high cost areas that cannot be identified through examination of ILEC records that are kept at the study area level.

When combined with a bidding process, use of these geographically specific cost estimates would serve only as the starting point for a transition to a market-based mechanism, and any significant errors would quickly be corrected by market forces through the auction.

2. The Commission should analyze costs at the Census Block Group Level.

In calculating the cost of universal service, GTE believes it is particularly important that the Commission use Census Block Groups in establishing proxies. It is very difficult to define service areas that are homogenous in terms of the costs of serving subscribers. However, smaller areas are more homogenous, and basing costs on small areas will reduce the ability of carriers to avoid serving higher cost subscribers yet still obtain an average amount of support for lower-cost customers. Service providers may still assemble groups of small areas that fit their technological capabilities. Smaller areas will also provide a more accurate prediction of actual costs

and will send more accurate price signals to potential new entrants. Hidden subsidies between high and lost cost areas would also be reduced by smaller areas that more accurately reflect the cost of each customer in the area.

3. With further improvements, the CPM and BCM2 models or a combination of the two could provide estimates usable as a starting point.

Although in GTE's view none of the models put forward thus far is sufficiently developed to provide estimates suitable for use in the federal plan, two models, CPM and BCM2, show promise.⁹⁵ Both of these models can be further improved and may be combined to gain the benefits of each. The models share a number of common strengths. First, both are based on engineering simulations and therefore reflect the current engineering practices used by incumbent LECs in placing new equipment. Second, neither is based on a theoretical deployment of least-cost technologies, rather both are tied insofar as possible to "real world" conditions. Third, both will be sensitive to the values of the input prices and engineering assumptions used and therefore capable of case-specific modification. CPM and BCM2 are markedly more effective than the other models submitted to the Joint Board and should therefore form the basis of any future Commission action.⁹⁶

⁹⁵ For a full discussion of GTE's views of the Cost Models before the Joint Board, see GTE's Comments on Cost Models, D.96-45 (filed Aug. 9, 1996).

⁹⁶ See Attachment 2 for a discussion of the many critical shortcomings of the Hatfield Associates Model.

D. The Commission Should Incorporate A Competitive Bidding Mechanism In The Federal Plan.

The *Recommended Decision* acknowledges (at ¶ 341) that "a properly structured competitive bidding system could have significant advantages over other mechanisms used to determine the level of universal service support." Among these advantages, the *Recommended Decision* notes that auctions holds the promise of using a market-based approach to set support levels, that would allow the role of regulators in determining costs to be reduced. It would reflect "bidding carriers' assessments of the costs of serving the market as well as their assessment of revenues, including current and future follow-on revenues."⁹⁷ These assessments would capture many more factors, including changes in technology, regulatory burdens, and market opportunities, "than can be incorporated into a cost model." *Recommended Decision* at ¶ 342. Bidding would also offer the opportunity to reduce support over time by creating incentives for efficiency and by converting gains from new technology into cost savings for universal service. *Id.* at ¶ 343. Perhaps most importantly, "competitive bidding would put all prospective eligible carriers on an equal footing." *Id.* at ¶ 342. For this reason, it is the only method for determining support that is inherently competitively neutral.

⁹⁷ *Recommended Decision* at ¶ 342. As the *Recommended Decision* acknowledges, demand complementarities, which the *Recommended Decision* refers to as "follow-on net revenues," are even more difficult to assess than costs. GTE submits that the Commission cannot presume any level of such follow-on revenues without violating the 1996 Act's requirement that the plan be "sufficient." Bidding is the only mechanism that can capture the value of any complementarities that may exist. If a carrier voluntarily bases its bid in part on the expectation of follow-on revenues, then the level of support thus determined is presumably sufficient.

GTE submits that the Commission should seek to gain these advantages by incorporating competitive bidding into the framework of the federal plan. The *Recommended Decision* (at ¶ 349) suggests that the Commission "continue to investigate how to structure a fair and effective competitive bidding system." GTE believes that the Commission should call upon its staff's extensive experience in auction design to craft a system that will be successful in the universal service application.⁹⁸

There are very good reasons for incorporating an auction mechanism into the federal plan from the outset. As GTE has shown *supra*, the funding mechanism proposed in the *Recommended Decision*, if not corrected, will seriously misspecify the level of universal service support. Even if the faults in the *Recommended Decision* are corrected, a well-designed universal service plan based on cost estimates will still set support incorrectly because errors in the cost estimates are inevitable and because such a plan cannot consider all of the factors other than cost that are relevant. These errors will in turn cause significant distortions in the development of the competitive market and could jeopardize the maintenance of universal service. It is very important, therefore, that the plan should incorporate, from the beginning, a mechanism that allows market information to be used to correct the errors that are certain to arise in a proxy cost-based system.

⁹⁸ As a basis for this effort, GTE has provided an outline for the design of a universal service auction. This proposal was described in *GTE's D.96-45 Comments In Response To Questions*, filed August 2, 1996, at Attachment 1, Statement of Paul R. Milgrom.

Further, the levels of support established on a cost basis will create winners and losers among industry participants. Once parties become entrenched in these positions, it may be more difficult for the Commission to alter the pattern of benefits at some later date. By incorporating a bidding process into its framework at the outset, the Commission will send an important message to all participants: that in future they will have to participate in bidding to receive support and will have to accept the level of support determined through a market process.

Because the plan proposed by GTE will be triggered flexibly over time as carriers enter different markets, it is not necessary for the Commission to be prepared to auction all markets on the first day of implementation in order to incorporate auctions into its framework for the federal plan. GTE envisions that the auctions would be conducted by or on behalf of the states.⁹⁹ From the outset, the federal plan must contain a set of guidelines which, if satisfied by the state-sponsored auction, would allow the Commission to accept the auction results for purposes of the federal plan.¹⁰⁰

The *Recommended Decision* finds (at ¶ 348) that GTE's auction proposal raises a number of questions that warrant further inquiry. GTE submits that these questions

⁹⁹ There are several ways in which the Commission could work with the states to implement a competitive bidding process. One approach would be for each state to develop its own auction design, subject to Federal guidelines. For this purpose, the states could designate a third party, if desired, to conduct the auctions; several consulting firms do this kind of work today. Or the Commission itself could manage the auctions on behalf of states. The Commission has already offered to act as a consultant and auction administrator to several foreign governments.

¹⁰⁰ In its recent decision adopting a universal service plan, the California commission established a schedule for workshops to be held this winter to develop a record on the use of auctions for universal service.

can be answered, and in fact that they may prove to be more tractable than the problem of choosing a cost model. For example, the *Recommended Decision* (*id.*) asks whether "only those carriers willing to accept carrier of last resort obligation in addition to those obligations contained in section 214(e) be permitted to bid." As GTE has shown *supra*, in order to meet the other requirements of the 1996 Act, any funding mechanism must make the receipt of funds conditional on the assumption of a meaningful obligation to provide service in a specified manner. For this purpose, the obligation to serve must be defined beyond the minimal items specified in section 214(e). This is true regardless of whether the level of support is determined on a cost basis or through competitive bidding. The auction proposal therefore does not raise any additional issues with respect to the obligation to serve, as compared to a proxy cost-based plan.

The *Recommended Decision* also notes (*id.*) that some commenters have questioned whether any bidding plan that excludes carriers may be consistent with section 214(e). However, section 214(e) itself links eligibility for funding to the assumption of some obligation to serve and would exclude any carrier that does not assume this obligation. Further, section 254, particularly 254(f), requires the FCC to ensure that payment of support is linked to a real contribution to universal service. As with other aspects of the universal service provisions of the 1996 Act, the details of this obligation must be specified by the expert agency in order to make the plan effective, and to ensure that it is sufficient, predictable, and competitively neutral.

GTE's auction proposal calls for the state commissions, under broad federal guidelines, to specify the function they wish the universal service provider to perform and to allow firms to bid on this "contract. The "price" the firms bid in this case is the

compensation they will accept, in the form of support payments, for undertaking the required function that includes setting the price for the supported service at or below the maximum price allowed by regulators. In competitive markets, contracts are put up for bid all the time -- by government agencies as well as by individuals and private firms. Firms in these markets compete for government contracts, just as they compete for any other business. The bidding process GTE proposes is no more a barrier to entry than the bidding process that goes on in competitive markets every day. In fact, GTE's proposal is carefully designed to achieve the greatest possible benefits from competition among multiple carriers seeking to provide the designated service and obtain support payment, consistent with other objectives, such as minimizing both the cost of supply and the amount of support required.¹⁰¹ The proposed design would exclude a carrier only if its costs, as measured by its bid, were so much higher than those of other bidders that they exceeded a range set by the Commission. The FCC

¹⁰¹ GTE's plan is the only proposal in the record that actually considers the tradeoff among these objectives and explicitly solves the problem of maximizing the expected benefits. The proxy cost-based plan described in the *Recommended Decision* is actually not consistent in its treatment of this tradeoff, since it is designed to operate in a competitive market with multiple carriers, yet when estimating costs it assumes that a single firm will serve 100% of the demand in a given area.

can determine the tradeoff it wishes to make among the competing objectives by its choice of the parameters in GTE's proposed auction design.¹⁰²

The *Recommended Decision* also asks (at ¶ 348) whether bidders may designate areas for auction that differ from the service areas designated by the states. GTE's intent is that the bidding process should be based on the same units that are used in designating the service areas. As the *Recommended Decision* itself proposes (at ¶ 175), these geographic units should be small enough to minimize heterogeneity of costs within each area and also to make it easier for new entrants to serve the entire area. These considerations must be balanced against the need to keep the administration of the plan reasonable. Similar considerations apply to the choice of geographic areas for bidding. GTE believes that the CBG represents a reasonable balance of these considerations. However, as the *Recommended Decision* (at ¶ 175) points out, the 1996 Act assigns responsibility for designating service areas to the states. GTE suggests that the Commission should design its guidelines with respect to bidding around the geographic units the states may select. If, as the *Recommended Decision* proposes, a state selects small geographic areas, then the notice process

¹⁰² Suppose that the FCC determines the level of support for a given area on a cost basis. Suppose also that, by accident, this support level exactly equals the level that would have been set by the auction. This would indeed happen only by accident, since, as the *Recommended Decision* acknowledges, the proxy cost-based approach cannot generate the same information the auction does. In this case, a firm whose costs were significantly higher would also be excluded, since the support provided would be insufficient for that firm. The difference is not that the auction excludes some firms -- both approaches would do that -- but rather that the auction will more accurately find the right level of support. The auction therefore involves less risk of excluding an efficient firm from the market, just as it involves less risk of providing too much support to an inefficient firm.

GTE suggests would allow carriers the ability to aggregate these areas to assemble the service area they wish to enter.

To gain the many advantages of competitive bidding, which the *Recommended Decision* acknowledges, GTE urges the Commission to move forward with the design of an auction mechanism to be included in the federal plan. The inclusion of competitive bidding in the Commission's framework is particularly important because it provides the only available means for correcting misspecification which will inevitably result from a proxy cost-based approach.

E. Contributions To Universal Service Support For New High Cost Fund And Low Income Programs Should Be Based Upon Both Intrastate And Interstate Revenues.

Under Section 254(d), "[e]very telecommunications carrier that provides interstate telecommunications service shall contribute, on an equitable and nondiscriminatory basis, to the specific, predictable, and sufficient mechanisms established by the Commission to preserve and advance universal service." As the *Recommended Decision* (at ¶ 820) recognized, "the statute does not expressly identify the assessment base for the calculation of the contribution," but only the characteristic of the provider. Nonetheless, the Joint Board (at ¶ 817) concluded that contributions to support public institutions should be based on intrastate and interstate revenues but reached no decision on the appropriate revenue base for the high cost fund and low income programs.

GTE supports the *Recommended Decision's* conclusion that schools, libraries, and rural health care providers should be supported based on an interstate carrier's total revenue (both interstate and intrastate). There are good reasons for basing the

support for rural, insular, and high cost areas on all revenues as well if the plan adopted by the Commission is properly structured and sized to address the entire universal service problem. However, if the Commission adopts a measure of federal support which is limited in nature, it may be more reasonable to base the plan on interstate revenues only.

GTE believes that the statute would permit the Commission to choose either revenue base. The choice should therefore be determined by two criteria. First, which approach is easier to administer and less distorting? For reasons discussed *infra*, a fund based on total revenues would best satisfy this criterion. Second, for what purpose are these funds being raised, and does this have a jurisdictional nature? GTE submits that if the fund addresses the universal service issue as it should, the support should be used to offset existing rates in both jurisdictions; hence it is reasonable to use total revenue as a base.

- 1. The 1996 Act permits the Commission to base the federal universal service support mechanism on both state and interstate revenues.**

There is no basis in the statute for using different funding bases for different subsets of universal service. The federal universal service funding mechanism for services to all end users is based on the same statutory provision, subsection 254(d). Congress, in constructing the universal service support system, defined the category of carriers that would contribute to the universal service fund, not the measure of revenue upon which they would be assessed. The 1996 Act states that "[e]very telecommunications carrier that provides interstate telecommunications services shall

contribute" to the Commission's federal universal service fund. § 254(d).¹⁰³ If Congress had intended to restrict the revenue pool from which federal universal service funding could be drawn, it would have done so explicitly. Absent that, the Commission may require contribution to the universal service fund to be based on both the intra- and interstate revenue of interstate telecommunications providers.¹⁰⁴

2. Use of total revenues as a base would be more efficient, easier to administer, and more equitable.

The use of total revenues would be more efficient because it would provide a broader base for funding. An effective universal service plan should base its assessments on the largest possible base of contributors to distribute costs more evenly throughout the system, reduce the burden on each subscriber, and permit a sufficient level of universal service support. Only by applying a uniform lower rate against all revenues can the goal of advancing universal service be achieved. By minimizing the rate, a broader base will minimize any resulting distortions of customers' or firms' decisions.

¹⁰³ See § 152(b); Section 254 creates none of the jurisdictional issues raised by the Commission's interpretation of Section 251. See GTE's Motion for Stay Pending Judicial Review and For Expedited Judicial Review (filed Sept. 16, 1996) in *GTE Service Corp. v. Federal Communications Commission*, No. 96-3321 (8th Cir. 1996). Section 254 is being administered by the Joint Board pursuant to a decades-old shared jurisdictional regime for universal service obligations established pursuant to § 410. The federal universal service program has long supplied federal support for state-regulated local services. In contrast, the Commission's interpretation of Section 251 attempts to impose anew the federal will on the statutorily and constitutionally protected pricing jurisdiction of the states.

¹⁰⁴ This conclusion does not, however, permit states to assess universal service fees against revenues generated by out-of-state consumers, or the Commission to assess these fees against purely intrastate carriers.