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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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In the Matter of)
)
Federal-State Joint Board on)
Universal Service)
)
)

CC Docket No. 96-45

REPLY COMMENTS

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SUMMARY

“Competitive neutrality” should be added as a universal service principle because the application of universal service in a manner which favors certain competitors or technologies would hurt the development of competition. Accordingly, the Commission should urge the states to designate service areas for non-rural telephone company areas that are of sufficiently small geographic scope to permit efficient targeting of high cost support and to facilitate entry by competing carriers.

The Commission should adopt forward-looking economic cost, as determined by the Hatfield model, as the basis for determining universal service support and reject LEC claims that support must be based on their embedded costs. The use of forward-looking economic cost will preserve and advance universal service, promote efficiency, and provide the correct signals for entry, investment, and innovation.

Contributions to universal service must be assessed on all revenues, both interstate and intrastate, to effectively meet the goal of universal service. However, if the contribution to federal support, ultimately, is based on interstate revenues only, then the federal fund must be limited to support for costs in the interstate jurisdiction.

Finally, the Commission must preclude the double recovery of universal service support by removing universal service costs from interstate access charges before or simultaneously with the implementation of the explicit federal universal service fund.

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REPLY COMMENTS

MCI Telecommunications Corporation (MCI) hereby replies to certain comments filed in this proceeding, as specified herein, on the Joint Board's Recommended Decision concerning the implementation of the universal service provisions in the Telecommunications Act of 1996.

I. COMPETITIVE NEUTRALITY

The majority of commenters who address the issue support the Joint Board's recommendation that universal service support should be competitively neutral. As demonstrated by the comments, competitive neutrality should be added as a universal service principle because the application of support in a manner that favors certain competitors or technologies would hurt the development of competition, which is needed to ensure that the goals of universal service are met. Accordingly, the Commission should adopt the Joint Board's recommendation and urge the states to designate service areas for non-rural telephone company areas that are of sufficiently small geographic scope to permit efficient targeting of high cost

support and to facilitate entry by competing carriers. In addition, the Commission should ensure that all telecommunications carriers that provide interstate telecommunications services contribute to federal universal service support and that support is available to all carriers providing supported services.

II. FORWARD-LOOKING ECONOMIC COST

Many commenters support, and none effectively refute, the Joint Board's recommendation that forward-looking economic cost should be the basis for determining universal service support for non-rural carriers initially and, after a transition period, for rural carriers, as well. The use of forward-looking economic cost will preserve and advance universal service, promote efficiency, and provide the correct signals for entry, investment, and innovation in the long-run. Thus, the Commission should adopt the use of forward-looking economic cost as the basis for determining universal service support.

Local exchange carrier (LEC) claims that universal service support must be based on their embedded costs must be rejected.¹ The only subsidy necessary is the difference between the rate established by universal-service mechanisms and the economic cost of supported services. In a truly competitive market, the LEC would be able to charge only its economic cost for providing universal service; its embedded costs would be irrelevant. Basing universal service support on a LEC's own costs would ensure that the LEC faced less incentive to control its costs. This would lead to a higher subsidy than is necessary to ensure that service is available at affordable rates.

¹ See, e.g., Comments of Pacific Telesis Group (Pacific) at 12; and GTE at 28.

The universal service subsidy should support only the LECs' economic cost. It should not be a vehicle for ensuring the LECs' current revenue stream.

USTA's claim that there is currently \$21 billion of implicit and explicit universal service support which is comprised of about \$1 billion of explicit support in the high cost, Lifeline, and Link-up programs, and \$20 billion of implicit support embedded in incumbent LECs other services, such as toll and access services, also must be rejected.² USTA bases this \$20 billion claim on the Monson and Rohlf's study, which greatly overstates the amount of support. The correct basis on which to compute the necessary universal service support, as the Joint Board determined, is the difference between the economic cost of providing the services to be universally available and the acceptable benchmark level. USTA arrives at its estimate exactly backwards; it computes the long run marginal cost of services other than the universal services -- i.e., access and toll services -- and then computes the difference between the revenue from those services and that cost as the implicit universal service support. That difference is not the amount of support needed for universal service; it includes shared economic costs, economic overhead expenses, overearnings, monopoly inefficiencies, and overvalued plant, as well. The LECs should not be permitted to recover such costs in the subsidy for universal service because universal service exists to support individuals, not monopolies.

Other LEC arguments also must be rejected. Thus, Pacific claims that if support is based on forward-looking costs, forward-looking demand should also be used. Pacific claims that this forward-looking demand will be lower than current levels, because the incumbent LEC will lose

² Comments of the United States Telephone Association (USTA) at 4.

customers, and that, therefore, the forward-looking unit cost will be higher.³ As an initial matter, it is not clear that the incumbent LECs will lose customers as new entrants come into the market, because competition may stimulate demand such that no loss of demand occurs (e.g., the "losses" to new entrants may be offset by sales of second lines as prices come down). In addition, new entrants will provide service either over their own facilities or through unbundled elements purchased from the incumbents. A new entrant will build its own facilities only if the cost of doing so is less than the Total Element Long Run Incremental Cost (TELRIC)-based price of the unbundled elements. This can be the case only if there are not economies of scale to serving those customers. If the new entrant provides service using the incumbent LEC's unbundled elements, the incumbent LEC will receive the TELRIC of its loop, and no loss of economies of scale will occur. Thus, no explicit adjustment needs to be made.

Some LECs claim that they will need rate re-balancing among services when universal service support is reformed.⁴ While MCI agrees that current LEC prices do not reflect their economic costs and, therefore, need to be changed, we do not agree that the appropriate solution is to allow the LECs to change their prices in a revenue neutral manner. LEC current prices, in part, reflect their monopoly inefficiencies; the answer to the call for reform should not be merely that LECs change the customers from whom they recover these inefficiencies. As long as the rates for basic residential service plus universal service support generate revenues sufficient to recover all costs attributable to providing basic service including a reasonable portion of

³ Comments of Pacific at 14.

⁴ See, e.g., Comments of USTA at 10.

common costs, as included in the Hatfield cost estimates, there is no public policy rationale for raising other rates. Indeed, to do so would be harmful, because improperly high support would harm efficiency in the markets that are "taxed" to provide these support funds and would encourage inefficient entry. Instead, all LEC prices should be set at economic cost. Allowing the LECs to rebalance their rates at their current levels would simply be another revenue insurance mechanism for the LECs.

Finally, some commenters challenge whether forward-looking economic cost should be the basis for determining universal service support for rural carriers and whether the interim support mechanism for rural carriers, the continuation of per-line support based on embedded cost frozen at 1995 and 1996 levels, is appropriate. These commenters argue that support based on frozen cost is not sufficient and will cause local exchange carriers to refuse to make necessary network upgrades⁵ and that a reduced subsidy for rural businesses, and higher rates, would discourage economic development in rural areas.⁶

The Commission must reject these arguments. In essence, such comments amount to an argument that forward-looking economic cost is not an appropriate support basis for rural carriers. However, the reasons for adopting forward-looking cost apply equally to rural areas. Thus, even in rural areas, forward-looking cost is sufficient to preserve and advance universal service and it is necessary to promote efficiency, and provide the correct signals for entry, investment, and innovation in the long-run. Moreover, the Joint Board's recommended transition

⁵ Comments of the Wyoming Commission at 2 and 5 ; and the Rural Alliance at 5-8.

⁶ Comments of the United States Small Business Administration at 22.

period is more than sufficient to ensure that there is no harmful effect to universal service as a result to the transition to the use of forward-looking cost as the basis for support.

III. CONTRIBUTIONS TO UNIVERSAL SERVICE MECHANISMS

Although a significant number of commenters support basing contributions to universal service on all revenues, both interstate and intrastate, a significant number of commenters argue that only interstate revenues can and should be assessed for the federal fund. As demonstrated in MCI's Comments, the Commission has the authority to base support for the federal universal service fund on both interstate and intrastate revenues of interstate carriers. Moreover, this is the correct way to assess support for the federal fund. However, if the contribution to federal support, ultimately, is based on interstate revenues only, then the federal fund must be limited to support for costs in the interstate jurisdiction. The Iowa Utilities Board suggests that the federal fund should support 50% of the costs of providing universal service and the Ohio Public Utilities Commission suggests that federal funding should be limited to 40% of the universal service revenue requirement as determined by the proxy model. Under a "separations" type approach to universal service funding, however, the size of the federal fund should be no more than 25 percent, which is the current allocation of loop costs to the interstate jurisdiction. In fact, a 25 percent allocation, arguably, is too high because interstate usage is only approximately 15 percent of total usage.

IV. REMOVAL OF IMPLICIT SUBSIDIES

Some parties have correctly argued that it is critical that the Commission preclude the double recovery of universal service support by removing universal service costs from interstate access charges before or simultaneously with the implementation of the explicit federal universal service fund. This should be accomplished by conditioning the cut-over to explicit universal service funding on completion of bringing all access charges to economic cost in the Commission's forthcoming access charge reform proceeding. However, if access charges are not reduced to economic cost or if the Commission is not able to complete the access proceeding simultaneously with the implementation of the explicit universal service fund, then, at a minimum, access charges must be reduced by an amount equal to the current universal service subsidies in access charges. This would include, at a minimum, the portion of the carrier common line charge that exceeds economic cost and the current Universal Service Fund (High Cost Fund), Long Term Support, and triple dial equipment minute weighting.

V. HATFIELD MODEL CRITICISMS ARE OVERSTATED

Some LECs claim that the Hatfield model understates the true economic cost of providing universal service. U S West, for example, claims that the Hatfield model "is a results-driven model which can be manipulated to produce whatever cost answer its sponsors desire."⁷ U S West then lists several inputs to the Hatfield model, such as depreciation rates, cost of money, and structure sharing percentages, whose default values it claims result in greatly understated

⁷ Response of U S West, Inc. at 33.

costs. For this reason, U S West claims, the Commission should not use the Hatfield model to determine universal service support.

U S West's criticisms of the Hatfield model are misplaced. The Hatfield model has evolved over time, with each revision reflecting legitimate comments made by other parties on the previous version. The changes made have also resulted in a higher cost. If the parties sponsoring Hatfield were attempting to produce whatever answer we desired, as U S West claims, it seems unlikely we would be constantly revising our cost estimate upward.

The inputs about which U S West complains are user-variable inputs. Support for the particular values used in the Hatfield model was provided in the January 7 filing in this docket, and will be discussed in the cost model workshops on January 14 and 15. While MCI believes that the input values used are correct, it is straight-forward to change them to compute the necessary support, if the Commission determines they should be changed. By allowing the user to vary these inputs directly and re-computing costs directly based on those inputs, the Hatfield model meets the requirement of the Joint Board.

The particular inputs used in the Hatfield model do not invalidate the model. In fact, USTA states that the Hatfield model can render reasonable results.⁸ MCI looks forward to the cost model workshops as the vehicle for discussing the values of the inputs to be used.

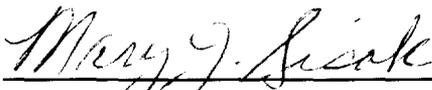
⁸ See, Comments of USTA at 14, n. 19. USTA also states that the input assumptions should be changed.

IV. CONCLUSION

Based on the foregoing, MCI respectfully requests that the Commission adopt the recommendations contained herein and in MCI's Comments.

Respectfully Submitted,

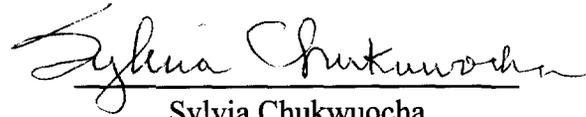
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