

Further, because Congress intended that all customers should have access to the "core" basic service at an affordable price, it is reasonable that the Federal plan should require that customers be able to buy the defined service on a stand-alone basis -- without being forced to buy a bundled package, at a much higher price, that includes other services.<sup>29</sup>

The reasonableness of these symmetry requirements is made clear by considering the case of an *Eitel* that decides to relinquish its obligations pursuant to Section 214(e)(4). Consider again the example described *supra* wherein four universal service providers -- an ILEC and three new entrants -- serving a given area. If one of the four decides to relinquish its *Eitel* designation, it should be possible for customers in that area to obtain service at a price no higher, terms no less advantageous, and quality no worse than before, from the remaining three carriers. But if the departing carrier is the ILEC, and if no symmetric obligation has been imposed on the other three newer entrants, that will not be the case. If the terms offered by the other three carriers are not satisfactory -- if they do not meet the state commission's goals for universal service -- why were those carriers ever being compensated for offering service on those terms? Conversely, if the requirements placed on the ILEC were not those the state commission would consider necessary for universal service -- for any customer in the area -- why were those requirements ever imposed on the ILEC?

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<sup>29</sup> This would not preclude carriers from offering service at a lower price, or creating packages that would add functionality to the basic service for an additional separate charge. Nor would such a requirement serve as a barrier to entry, for it would merely obligate a firm to offer the defined, supported service at no more than an affordable price, in addition to other offerings the firm may choose to design.

The Commission should adopt the minimum guidelines for state-determined service obligations suggested by GTE. These include an obligation to provide the basic service to any customer at an affordable price, and to offer that service on a stand-alone basis. Most importantly, they would require these obligations to be the same for any *Eltel* that receives support in a given area.<sup>30</sup> The Commission has ample authority to adopt such guidelines, and the states have ample authority to adopt requirements which would comply with them. The suggested guidelines would not interfere with the states' prerogatives in regulating local service. However, they are essential to ensure that the Commission's universal service plan will meet the requirements established by Congress, and by the Joint Board -- that the plan be effective, sufficient, and competitively neutral.

#### **IV. FEDERAL HIGH-COST SUPPORT SHOULD BE BASED ON AN ESTIMATE OF THE MARKET PRICE OF BASIC LOCAL SERVICE.**

The intent of the 1996 Act is generally to introduce competition in telecommunications markets. If this intent is to be achieved, then prices for all telecommunications services must move toward the levels that would be set in competitive conditions. Recognizing this, the 1996 Act provides for the elimination of

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<sup>30</sup> GTE is not suggesting that the full panoply of detailed regulation that applies to ILECs must be applied to *Eltels* receiving universal service support. For example, there is no reason to apply the requirements at the state and federal level that are related to regulation of earnings (ARMIS reporting, depreciation prescriptions, and so forth). Indeed, far better than increasing the regulatory burdens of CLEC would be decreasing the regulatory burdens of ILECs. What commissions must do is to distinguish between requirements that are made necessary by universal service, and those that are necessary to control such market power as the ILEC may retain. Regulations intended to promote universal service must be symmetric. Clearly, holding rates below market level is not an action taken to control market power, but can be justified only on universal service grounds.

implicit support flows that cause rates to depart from competitive levels today.<sup>31</sup> The one exception is the price of basic or "core" local service. The 1996 Act provides for an intervention in the price of basic local service to assure that it is affordable.<sup>32</sup> Recognizing that this intervention must be supported in order to be sustained in a competitive market, the 1996 Act requires that explicit, sufficient support be provided to carriers to the extent they are subject to this market intervention.<sup>33</sup>

These facts govern the method Commission chooses for calculating high-cost support to meet its responsibilities under the 1996 Act. The support cannot be chosen arbitrarily, but must be sufficient to compensate the carrier for the market intervention. The compensation needed can best be measured through the competitive bidding process that GTE has suggested. In order to estimate this amount through the use of a cost estimate, the Commission must choose a cost estimate that will serve as a proxy for the rate a carrier would charge in the competitive market. This should then be compared with the rate the carrier is actually allowed to charge.<sup>34</sup> Since this difference is the rate intervention actually imposed on the carrier, any method that does not

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<sup>31</sup> 47 U.S.C. § 254(e).

<sup>32</sup> *Id.* at § 254(b)(5).

<sup>33</sup> *Id.* at § 254(e).

<sup>34</sup> This comparison cannot estimate the support amount as effectively as an auction can, even if the cost estimate is perfect (an unlikely circumstance), because it cannot capture any nonprice factors the carrier might consider.

capture the full difference will underestimate the necessary support.<sup>35</sup>

**A. If The Cost Estimate Does Not Represent The Market Price Of Local Service, The Resulting Support Will Not Be Sufficient Or Competitively Neutral.**

The "price" the universal service provider sees is the sum of the rate the customer pays and the universal service support payment. If the proxy cost model chosen by the Commission underestimates the price of basic local service, then the support calculated using that model will be insufficient, since no carrier will be able to sustain service at less than the market price for any length of time.<sup>36</sup>

Further, if the model underestimates the market price, the plan will not be competitively neutral, because the price to which firms respond in making entry and investment decisions will be distorted.<sup>37</sup> The effect of any price control that attempts to hold the price of a product or service artificially low is well known: firms will be discouraged from entering that market, and firms already in the market, if they are constrained from exiting, will be discouraged from making any new investment. The California Small Business Association (CSBA) (at 11) correctly describes the effect on

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<sup>35</sup> GTE recognizes that the Federal plan might only cover the difference between a Federal benchmark and the cost estimate. However, the combined effect of the Federal plan and state plans must cover the entire difference between the affordable rate and cost if support for universal service is to be sufficient. Further, the 1996 Act charges the FCC with ensuring that universal service (*i.e.*, the combined effect of the Federal plan and state plans) is sufficient.

<sup>36</sup> See Universal Service Alliance at 2.

<sup>37</sup> The plan will also not be neutral if support is underestimated, because only the ILEC today has an obligation to provide service at that support level. Every other carrier has the option, if the support is too low, of not becoming a universal service provider -- leaving the entire burden of universal service to the ILEC.

market entry:

Because the size of the fund will be unrealistically low, there will be no economic incentive for new local service providers to build new facilities to compete with those of existing telephone companies. Facilities-based competition will continue to be concentrated only in high traffic commercial districts. In rural and suburban areas, competition will be limited to resale of existing services. Consequently, in these areas, consumers will not receive the far-reaching benefits of competition in the design, construction, and operation of physical networks.

Thus, there is no tradeoff between sufficiency and the goal of encouraging the development of competition. In fact, the opposite is true: if support is not sufficient, then the "price" to which firms respond in the market will be set artificially low, and competitive entry will be inhibited.

CSBA (at 12) also explains the effect of this insufficiency on investment by the ILEC:

By failing to establish a sufficient and reliable means of funding the cost of universal service, the *Joint Board's Recommendations* ensure that existing telephone companies will not have either the financial ability or incentive to modernize their networks to provide basic and advanced services needed by residential and business customers in rural and suburban areas.<sup>38</sup>

**B. The Proxy Cost Estimate Must Be Validated Against Actual Cost Experience And Any Differences Must Be Explained.**

GTE has consistently supported the development of a proxy cost model as part of a universal service plan. However, as GTE (at 27-28) notes, there is good reason to

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<sup>38</sup> Emphasis in original. See also, Universal Service Alliance at 3: "the Commission should provide a *realistic* level of funding rather than single-mindedly seeking to arrive at the lowest level of support possible. The Commission obviously should not provide for inflated costs but, at the same time, it must provide sufficient funds for telecommunications carriers to make investments needed to maintain and modernize their network." Emphasis in original.

be concerned that a proxy cost estimate, based on a simulation model, will underestimate the market price for basic local service. Such "bottoms-up" models have not generally been used in the past to estimate cost levels, but only to estimate incremental cost relationships. As estimators of levels, such models are inherently sensitive to their inputs and assumptions, and prone to error. GSA (at 5-7) explains why a proxy cost estimate is intrinsically less accurate than a carrier's actual costs, because it cannot consider all of the factors that affect the cost necessary to serve a given geographic area.<sup>39</sup> The Wyoming Public Service Commission ("WPSC") (at 8) says: "The models, in short, have not produced a sufficient substitute for reality." CSBA (at 2) expresses similar concerns that the model is "likely to underestimate the cost of providing service in high-cost areas."<sup>40</sup>

If the Commission is to estimate the market price through the use of a proxy model, it must take the following steps to minimize the risk that the cost estimate will be in error:

First, the Commission should seek to ensure that the inputs and assumptions used in the proxy cost models represent, as closely as possible, the actual cost

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<sup>39</sup> GSA at 7 also "urges the Commission to examine all proxy models carefully to ensure that they accurately represent local conditions, and to allow the use of proxy models only when carrier costs are not available." Because the actual cost experienced by ILECs captures information that is not represented in the proxy model, the Commission cannot simply dismiss any discrepancy. It certainly cannot simply assume, as some commenters appear to do, that the model is "efficient", and the ILEC is not.

<sup>40</sup> See also Iowa Utilities Board at 3-4. CSE Foundation at 6 notes that a proxy model will not reveal what "actual and potential providers will demand in order to serve such a market."

minimization problem faced by a firm in the real world. This means that input prices should be representative of what carriers actually pay today, that the networks the model builds should be complete and sufficient to provide the defined basic service, and that the model should recognize that a carrier must optimize its costs over time, rather than on a static, one-time basis.<sup>41</sup> The model must, as the *Recommended Decision* recognizes, include a reasonable contribution toward joint and common costs - a contribution consistent with the one a carrier would expect from basic local service in a competitive market. All current proxy models also assume that a sole supplier will capture 100% of the demand in the market -- an odd assumption for a plan that is supposed to be designed for a competitive environment.<sup>42</sup> By making the proxy model as realistic as possible, the Commission will minimize arbitrary differences between the estimates and actual costs. GTE looks forward to working with the Commission staff and other parties in pursuing this objective through the workshop process. However, the Commission must also recognize that the proxy model will always estimate cost

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<sup>41</sup> Any firm faced with this dynamic optimization problem will have to solve it subject to the need to accommodate growth in demand, uncertainty, and the indivisibility of most network facilities. These factors impose real costs -- for entrants as well as for incumbents -- which cannot be ignored.

<sup>42</sup> By doing so, the models assume economies of scale that no provider in a competitive market will be able to realize. This same assumption also reinforces the static nature of the model, since it assumes away any uncertainty each competitive firm would have concerning the level, growth, and geographic composition of its demand. This creates an apparent, but misleading, divergence between the cost of an incumbent and the forward-looking cost of an efficient entrant.

with some error, and should design its universal service plan with this defect in mind.<sup>43</sup>

Second, regardless of the apparent reasonableness of the inputs and assumptions of a proxy model, its accuracy can only be verified by comparing its output to actual cost experience in the real world. If the model's predictions differ from actual data, the Commission must be prepared to justify these differences.

While several parties support the use of forward-looking costs as a basis for universal service support,<sup>44</sup> these parties fail to consider why such costs would differ from the actual costs experienced by an ILEC today.<sup>45</sup> In fact, forward-looking costs are not simply unrelated to current costs. As GTE (at 28-31) explains, the estimate produced by a proxy model may differ from actual cost for a limited number of specific reasons. The two most likely explanations are the presence of under-depreciated plant on the ILECs' books and error in the proxy model.

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<sup>43</sup> See Texas PUC at 7: "our experience thus far with the proxy models leaves us less than confident that the costs of nonbasic local and access services are included in the cost models."

<sup>44</sup> See, for example, AT&T at 2, AirTouch at 4.

<sup>45</sup> For example, AT&T at 13 says: "[I]t is imperative that the Commission adopt a model that fully disassociates itself from embedded costs and capitalizes on the benefits of current technology." However, AT&T does show that embedded costs are irrelevant to the determination of price. In fact, in order for a competitive market to be in equilibrium, firms in the market must cover their total (*i.e.*, embedded) cost. If new technology, or better methods, makes it possible to supply at a lower price, firms adopting the new technology will initially price close to the old price, and earn rents. As more capacity is installed which incorporates the new technology, the price will be driven down toward the new cost level. But this only happens as firms actually implement the new technology, and at any point in the process the mix of technology in the embedded plant of the industry does play a role in determining prices. In any event, the distinction drawn in the *Recommended Decision* between the incumbent's costs, and those of an efficient entrant, is largely incorrect, if cost minimization is correctly viewed as an optimization over time.

Another possible explanation is that the ILEC has installed or operated its plant inefficiently. However, the Commission has no basis in the record for such a finding. As ITCs (at 6) notes, concerns over ILEC inefficiency raised by some parties "remain as opinions without any recorded basis in fact." This stands in strong contrast to the evidence in the record that the proxy models are prone to error, and that ILEC depreciation rates have not fully recognized expenses from past periods.<sup>46</sup> Therefore, if the Commission adopts an estimated cost which differs in level from the actual cost experience of the ILECs, it must, in order to avoid being arbitrary, explain the difference, and justify its choice of the model result in preference to reality.

Third, in order to avoid the likelihood that the proxy model will incorrectly estimate the overall level of cost, the Commission should use the proxy cost estimates only as a means for geographically disaggregating the ILECs' actual cost. The aggregate level of cost should be established at the study area by referring to the actual cost experienced by the ILEC.<sup>47</sup> Information from the proxy model should then be used to distribute this study area cost to individual small geographic areas. GTE agrees with the many parties who urge the adoption of small geographic units, such as CBGs, to

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<sup>46</sup> Still another possible source of a difference between forward-looking costs and embedded cost could be a change in input prices. In this context, however, it should be noted that a change in the price of a capital input -- such as the price of a switch or a pair gain device, for example -- should also be captured in economic depreciation of the ILEC's embedded investment, for reasons discussed *infra*.

<sup>47</sup> This cost could be adjusted for any factors which the Commission decides to address separately. For example, as GTE will discuss *infra*, the ILEC's embedded cost may include costs deferred from earlier periods because of the depreciation practices ILECs have been required to use. If an amortization program is adopted to deal with these deferred costs, then they may properly be removed from the costs used to set the level of ongoing high-cost support.

limit the heterogeneity of cost within each area, and to avoid unreasonable averaging.<sup>48</sup>

**C. Any Costs From Previous Periods Whose Recovery Has Been Deferred Through Regulated Depreciation Practices Should Be Recovered And Amortized Separately.**

As discussed *supra*, one of the reasons for a discrepancy between embedded cost and forward-looking cost could be the presence on the ILEC's books of costs that were properly incurred in previous periods, but whose recovery has been deferred because of the depreciation practices that regulated ILECs have been required to apply. The *Recommended Decision* does not address the recovery of these costs. GTE urges the Commission to establish an amortization program separate from the high-cost support program to deal with this issue.

Any firm engaged over some period of time in an activity that requires investment in long-lived equipment must optimize over time the purchases of such equipment. This will involve tradeoffs between the size of each increment placed and the time periods between placements. In solving this problem, the firm must consider placement costs, the difference between the initial purchase price of an asset and the cost of adding increments of capacity to it, and the likelihood of changes in technology or in input prices while it is holding any particular stock of equipment.

Once a particular piece of equipment has been purchased, its subsequent value will change over time. The purpose of economic depreciation is to recognize such changes in value as costs of doing business at the time they occur. Suppose, for example, that a carrier purchased a switch at the beginning of 1992. Suppose that,

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<sup>48</sup> See, for example, Teleport at 5, WorldCom at 15, MCI at 2, Sprint at 4, Cox at 6 and 21.

during 1992, the price of new switches of comparable capability declined by 20%. If economic depreciation had been applied correctly, the value of the old switch on the books of the company should have fallen accordingly. The depreciated value of the old switch should be set so that the stream of benefits generated by a dollar of investment in that switch was roughly consistent with the stream of benefits generated by the same dollar invested in a new switch.<sup>49</sup> This decline in value would have been an expense associated with doing business in 1992, and should, insofar as the firm could recognize this expense, have been recovered through rates in 1992.

However, because ILECs have been constrained in the depreciation expense that they could recognize in each previous year, some of these expenses were not recognized and recovered in the years they were incurred. As Cincinnati Bell (at 10) observes: "Both the Commission and the Board must recognize that it was regulatory action which mandated the levels and timing for recovery of depreciation and return which were allowed to be recovered from the investments made by incumbent LECs...." As a result, the level of net investment on the books of the ILECs today includes amounts which have been deferred from past periods. These are costs which the ILECs incurred in their roles as universal service providers in those prior years.

GTE urges the Commission, first, to identify the amount of underdepreciated

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<sup>49</sup> This example considers a decline in the price of the switch itself. A similar effect could be caused if placement costs decrease, or if the cost of maintaining new equipment decreases, or if the capability of new switches increases. Note that in each case, correct economic depreciation would resolve the difference between old costs and new costs by decreasing the value of the old plant. This would show up as an expense during the year the change occurred, not as a difference between embedded and forward-looking cost in some future year.

investment on the books of the ILECs today.<sup>50</sup> As noted *supra*, this is essential in any event in the process of verifying the output of any proxy cost model against actual cost experience of the companies. Second, an amortization program should be established, under which these costs would be recovered through a competitively neutral funding mechanism independent of the ILEC's own rates. At the same time, these costs should be removed from the cost basis used for determination of the ongoing, portable support for universal service providers. These deferred costs are unique to the ILECs, and are associated with the ILECs' performance as universal service carriers in the past, not with any provider's performance of universal service obligations in the future.

**V. THE RECOMMENDED DECISION'S PROPOSED RELIANCE UPON A REVENUE BENCHMARK AS A DETERMINANT OF HOW MUCH UNIVERSAL SERVICE SUPPORT IS NEEDED MUST BE REJECTED AS CONTRARY TO THE 1996 ACT'S EXPRESS PROVISIONS.**

The Joint Board proposes that the need for universal service support be determined by comparing the forward-looking cost of providing service with the per-customer nationwide average revenues from local service, access service and vertical services.<sup>51</sup> As a means of determining the amount of support required, the recommendation is unreasonable. Because this recommendation conflicts with the 1996 Act, the Commission must reject the proposed reliance upon a nationwide average revenue benchmark that includes revenues from services that are not

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<sup>50</sup> The Commission has asked for input regarding treatment of "under-depreciation" in the *Access Reform NPRM* at ¶ 124. This is another example of the crucial need for coordinated action between the various proceedings created in response to the 1996 Act.

<sup>51</sup> *Recommended Decision* at ¶¶ 309-310.

contained within the definition of the supported service. However, there is no reason why the Federal benchmark should be based on the same factors that would determine the total need for support. Instead, the Federal benchmark should be chosen to provide a reasonable division of funding between the Federal plan and state plans.

The 1996 Act establishes a mandate that only explicit support be used to subsidize universal service.<sup>52</sup> This means that if the cost-based price for the defined universal service is not affordable, then explicit and sufficient support must be provided. CSBA (at 4) correctly identifies the main flaw in the Joint Board's proposal, stating that because "discretionary services are not among the services supported by the universal service fund . . . the Joint Board's recommendations would require that discretionary services cross-subsidize supported services."<sup>53</sup>

Nowhere is the Joint Board's proposed reliance on hidden subsidies clearer than in the comments of parties supporting the Joint Board recommendation.<sup>54</sup> Ad Hoc (at 12-13) supports use of access and all other discretionary service revenues, and unabashedly calls for the Commission to continue the long-standing use of yellow page advertising revenues "as a source of financial support for the below-cost pricing of basic

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<sup>52</sup> 47 U.S.C. § 254(e).

<sup>53</sup> See *also*, MCI at 9: The nationwide average revenue benchmark "is in conflict with the requirement of the Act that subsidies be made explicit, rather than implicit." Texas PUC at 7: "[I]nclusion of the discretionary and access service revenues would appear to provide incentives that may perpetuate the implicit subsidy that FTA96 clearly intended to remove."

<sup>54</sup> See *e.g.*, WorldCom at 21, CompTel at 11.

local exchange telephone service."<sup>55</sup> Congress made a conscious decision to discontinue such hidden subsidies, and the Commission has no choice but to honor the express directive of Congress.

MFS (at 26) notes: "It is not clear that the average revenues per line . . . would be economically meaningful other than to provide an average of the agglomeration of pricing distortions that have developed in the telecommunications industry." Thus the Joint Board's proposal would simply embed into the new universal service plan the rate distortions that have been caused by the need to fund universal service implicitly in the past. The welfare losses associated with these rate distortions are even greater than those estimated by AirTouch (at 10-13) for a large universal service plan, since the implicit support is not generated in as neutral a manner as the explicit support ought to be.

Further, as CSBA (at 4) correctly observes "revenues from discretionary services are not a reliable source of funding high-cost areas." Similarly, GTE (at 20-21) notes that rates for many discretionary services have been set at artificially high levels to generate support for universal service, and that in a competitive market those rates are not sustainable. MFS (at 24) makes the same point when it predicts that "[a]s

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<sup>55</sup> Ad Hoc also calls for a higher revenue benchmark for ILECs (due to inclusion of yellow page revenues), and a lower revenue benchmark for CLECs. *Id.* Compare with Washington UTC at 2: "The key requirement in achieving competitive neutrality in universal service funding is to ensure that neither eligibility nor level of funding depend on the identify of the carrier providing service in a particular high-cost area." If any revenues other than those for the basic local service are counted, then the revenue that can be expected for any given customer will not be the same for different carriers, just as the revenue from any given carrier will not be the same across customers.

competition develops in all segments of the local exchange market, that will reduce prices" and cause the national average revenue benchmark to decline.<sup>56</sup>

Further, because the distribution of demand for discretionary services is skewed, an average amount of revenue will not be available for each customer. MCI (at 9) says: "The problem with relying on the average level of revenues as a benchmark is that for customers with below-average usage of discretionary and access services, the combination of universal service funds plus the revenues collected from that customer will not cover the full cost of the loop (and other network elements needed to provide him with service.)" If a carrier could not charge the customer a compensatory local rate, this would create "a disincentive to serve below-average customers." *Id.* This problem is compounded by the *Recommended Decision's* failure to link receipt of universal service support to an obligation to serve. *Eltels* without a service obligation will focus their attention on customers with high levels of usage, and will avoid customers for whom the plan creates a "disincentive to serve." *Id.* ILECs will be left with the below-average customers, for whom the support level will be insufficient.

The *Recommended Decision's* proposal, if used to determine the total need for funding, would fail to provide either the "predictable" or "sufficient" support as required

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<sup>56</sup> This is true not only for vertical services but also for access services. See Texas PUC at 7: "it is not clear to the Texas PUC what will happen if access rates are significantly changed through [the access reform] process." The Commission's *Access Reform NPRM* contemplates that access price levels would fall over a transitional period. If the Commission were to adopt the Joint Board's revenue benchmark scheme, the access revenue component of that benchmark would require frequent adjustment, e.g., monthly, to reflect this decline.

by the 1996 Act.<sup>57</sup> GTE agrees with MCI (at 10) that the only revenues that are relevant for calculation of the need for universal service support are those which "are mandatory for a residential customer to pay to obtain the package of universal service as defined by the Commission." Certainly the Commission should be aware of the total support needed, in order to craft an overall approach to universal service that ensures that the sum of state and Federal plans is sufficient.

However, as GTE (at 50-56) explains, the Federal plan need not provide all of the support that is required. The decision as to what proportion of the total support should be generated by the Federal plan is not related to either average revenues or average costs. It should instead depend on the relative advantages of Federal funding when compared to state funding. The Federal benchmark should then be set at the level which yields the best proportion of Federal funding and state funding.

The Vermont Comments submits an analysis of the revenue base available within each state, and considers the likely funding need of each state.<sup>58</sup> The Vermont Comments concludes that a policy which required each state to fund all or most of its needs from its own intrastate revenue base would impose a severe burden on many states, particularly small states with a relatively low proportion of intrastate revenue, and those with high-costs together with low revenues.<sup>59</sup> This suggests that a Federal

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<sup>57</sup> 47 U.S.C. § 254(b)(5).

<sup>58</sup> State of Vermont Department of Libraries, State of Vermont Department of Public Service, and State of Vermont Public Service Board ("Vermont Comments") at 7-8 and attachment. GTE previously provided a similar analysis. See GTE's Comments, D.96-45, April 12, 1996, at Attachment B.

<sup>59</sup> See *also*, Delaware PSC at 4-6.

fund should be large enough to fund offsetting reductions in interstate access rates, and also to fund some of the need for offsetting reductions in state rates as well. This will involve a limited transfer of funds across states. However, if the Federal fund were to generate the full amount of universal service support needed, it would lead to quite significant transfers from states with high revenues and/or low funding needs. The Commission needs to strike an appropriate balance between these extremes.<sup>60</sup>

**VI. IN ESTABLISHING A COST MEASURE FOR UNIVERSAL SERVICE, THE COMMISSION MUST KEEP IN MIND LEGAL AND CONSTITUTIONAL CONCERNS.**

GTE will actively participate in workshops, and will offer comments and suggestions regarding the development of a cost estimate which will most accurately represent the price that a carrier would set for the defined basic local service in a competitive market. However, as described *supra* and in GTE' Comments (at 26-31), there is a significant risk that the cost estimate will be in error. This will particularly be the case if the Commission does not properly validate the cost estimate to ensure that it accurately predicts the actual cost experience of carriers providing universal service today. While there may be a valid reason why the cost estimate used for high cost support may differ from the actual cost of ILECs -- such as underdepreciated investment which should be addressed separately -- any such difference should be explained and justified. As GTE has shown *supra*, the Commission can best ensure

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<sup>60</sup> Chairman Hundt has publicly discussed the possibility that the Federal fund (including high-cost, education, and low-income) would total between eight and twelve billion dollars. It would perhaps be useful, as a starting point, to determine the benchmark levels that would generate funds of those sizes, given the cost estimates the Commission decides upon.

that the level of the cost estimate is valid by relying on the proxy model only to generate information concerning cost relationships across geographic areas. By doing so, the Commission will design the plan to ensure that the overall level of the cost estimate is insulated from the known propensity of a proxy model to err in predicting cost levels.<sup>61</sup>

If the Commission does not take reasonable steps to reconcile the cost estimate against actual data, it will greatly exacerbate the risk of substantial error, *i.e.*, of a misestimate of the cost of government intervention (the real cost of requiring a high level of service to high-cost areas and restricting charges to the customer to a level below cost). Such an error could easily be a significant magnitude; fifty percent or more. The penalties of such an error would be enormous in terms of impact on the companies and the public.

Nothing in the 1996 Act purports to change the statutory right of an ILEC to a fair chance at recovering its actual costs prudently invested, and of course the coterminous constitutional right of the ILEC remains unimpaired.<sup>62</sup> To the extent the mechanism adopted by the Commission falls short of covering the difference between the maximum rate the ILEC is allowed to charge and the costs the ILEC is required to incur -- given that subsection 254(e) denies any opportunity to recover the shortfall from revenues hidden in the price of other services -- there will be a denial by government of a fair opportunity to recover costs prudently incurred in carrying out the mandate of government, and thus confiscation.

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<sup>61</sup> In fact, at the time the Joint Board issued its *Recommended Decision*, it had not selected a proxy model, and had no means by which to assess its validity.

<sup>62</sup> See GTE's Comments at 41-46.

Whatever methodology the Commission employs to set the appropriate level and shape of universal service support must assure an outcome that is not confiscatory. As demonstrated by the D.C. Circuit in the 1988 AT&T case,<sup>63</sup> the courts will examine carefully an innovative approach to regulation and will strike down that which fails a fair test of confiscatory effect. Moreover, the FCC has historically taken seriously its statutory obligations. Congress expects the FCC to implement a sensible and workable solution that will permit a bridge from the monopoly past to the competitive future. It would be foolhardy to entrust the entire burden of responsibility to a model that has not been tested against real world data.

GTE's primary recommendation, as discussed *infra*, is a competitive bidding approach that would relate the economics of telecommunications to the only test that ultimately matters, a market test. If the Commission does not decide on competitive bidding -- at least not for the time being -- the second-best approach would be to make certain that any methodology employed to determine universal service support fairly relates back to a sensible and realistic notion of cost.<sup>64</sup>

The core issue involves ILECs being obliged to bear extraordinary burdens in serving high-cost areas at levels of service dictated by government when government action prevents the ILEC from recovering its cost of service. In traditional ratemaking, the shortfall would be made up elsewhere in the process, but that alternative is now

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<sup>63</sup> AT&T v. FCC, 836 F.2d 1386 (D.C. Cir. 1988), *conditional application for review en banc denied*, No. 85-1778, Slip. Op. (November 2, 1988).

<sup>64</sup> Even if bidding is adopted, a reasonable cost basis will be needed to establish initial levels of support.

foreclosed by the 1996 Act. Traditional alternatives are foreclosed and the traditional judicial deference associated therewith would also be foreclosed because what would be happening is an uncompensated taking. Considerations of fairness and sound public policy combine with the Just Compensation (Takings) Clause of the Fifth Amendment to command rejection of any such action. The FCC can, and should, and must, create a plan that avoids an unlawful, an unconstitutional outcome -- which of course would represent terrible public policy. GTE's discussion *supra* outlines how this could be accomplished.

**VII. THE COMMISSION SHOULD TAKE EXPEDITIOUS ACTION TO DEVELOP A COMPETITIVE AUCTION MECHANISM FOR UNIVERSAL SERVICE.**

**A. Competitive Bidding Is the Only Market-Based Method for Determining Support.**

The *Recommended Decision* (at ¶ 349) proposes that the Commission "continue to investigate how to structure a fair and effective competitive bidding system." It finds that "a properly structured competitive bidding system could have significant advantages over other mechanisms used to develop the level of universal service support." *Id.* at ¶ 341. GTE urges the Commission to take immediate action to develop a "properly structured" bidding system, as the *Recommended Decision* suggests.

A wide range of parties agrees that an auction mechanism would have "significant advantages." The *Recommended Decision* (at ¶ 342) finds that bidding holds the promise of using a "market-based" approach in place of traditional regulation. AirTouch (at 22) agrees that the Commission "should introduce market incentives," and urges the Commission to adopt competitive bidding as a means to this end. Citizens for a Sound Economy ("CSE Foundation") (at 15) also agrees that "more emphasis should

be placed on the use of market-based solutions such as competitive bidding for the receipt of subsidies", pointing out (at 7) that "a competitive bidding model would effectively reduce the role of regulators."<sup>65</sup> GSA "believes that a competitive bidding system could be structured to harness the efficiency of market forces without eroding service quality."<sup>66</sup>

The *Recommended Decision* (at ¶ 342) also recognizes that bidding would capture "the bidding carriers' assessments of the costs of serving the market...." Ameritech (at 11) agrees that "under a bid model, it would be the serving entity's responsibility to determine its own costs, to bid accordingly, and then to live with the consequences." CSE Foundation (at 7) says that "Market-based mechanisms are important because they can reveal the true cost estimates of actual or potential providers whose futures depend on their ability to offer competitive and profitable service."

The *Recommended Decision* (at ¶ 342) notes that an auction can capture factors other than cost that would affect the compensation a carrier would require to offer universal service that cannot be "incorporated into a cost model." CSE Foundation (at 6) agrees that proxy models "do not reveal what actual and potential providers will demand in order to serve such a market" and suggests that "the best way to incorporate these estimates is through the use of competitive bidding." Sprint Spectrum also points out that bidding will capture the effects of new technologies, such as wireless, and of

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<sup>65</sup> See also Sprint Spectrum at 6: "A second advantage of competitive bidding is its tendency to reduce the role of regulation in universal service."

<sup>66</sup> GSA at 10.

changes in the definition of universal service without the need to update a proxy model.<sup>67</sup>

Many parties have expressed concern over the potential size of the universal service fund. AirTouch, for example, notes (at 5-13) that the collection of any funding will create welfare losses, and urges the Commission to minimize the need for funding.<sup>68</sup> Sprint Spectrum (at 2) proposes that control of the size of the fund should be adopted as an "additional principle" under Section 254. A deficiency of a system based on proxies is that it "includes no mechanism or incentive for carriers to reduce their demand on the fund below the number produced by the static proxy/benchmark formula."<sup>69</sup>

In contrast, as the *Recommended Decision* (at ¶ 343) observes, a properly structured bidding system "could reduce the amount of overall support needed for

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<sup>67</sup> "The costs of regulation will begin with the contentious effort to adopt a proxy model, and will continue with the inevitable updating of the model to take into account evolving technology or changes in the definition of universal service." Sprint Spectrum at 6 and n.14.

<sup>68</sup> GTE points out that the need for funding is ultimately determined by the size of the market intervention that needs to be supported, not by the size of the explicit universal service fund. The real way to reduce this funding need is to reduce the market intervention by allowing local rates to move toward market levels. If some portion of the need for funding is not explicitly recognized, then to the extent that the market intervention can be maintained at all, it must be supported implicitly by the prices of other services, such as access, toll, and vertical services. Distortions in the prices of those services also create welfare losses. So the "deadweight loss" AirTouch seeks to estimate is already occurring today -- it simply is not being acknowledged explicitly. Replacing implicit support with explicit support will not increase this "deadweight loss." In fact, to the extent that the explicit funding is raised in a manner that avoids some of the relative price distortions that occur today, the welfare cost of raising the necessary funds will be reduced.

<sup>69</sup> Sprint Spectrum at n.13.

universal service" and over time "competitive bidding would convert the efficiency gains from new technologies or improved productivity into cost savings for universal service." Sprint Spectrum (at 5) agrees that bidding "will exert continual downward pressure on the overall size of the high-cost fund," and (at 6) "will discipline carriers to improve the efficiency of their technology and operations on a continuing basis, and will insure that they share those efficiencies with the consumers who ultimately pay for any system of subsidies." Ameritech (at 11) says that "a bid process could result in limiting the amount of universal service funding to support a given area to only what is absolutely necessary." GSA (at 9-10) agrees: "A properly structured bidding system would reduce the support required to assist carriers in rural, insular, and high-cost areas, create incentives for carriers to improve efficiency, and reduce the costs associated with administering the universal service fund."

GTE shares the concern of those parties who wish to minimize the size of the universal service fund. However, this cannot be accomplished simply by arbitrarily underestimating the need for universal service. The welfare losses caused by universal service support will not be minimized by making some of the support implicit, rather than explicit. Further, any such approach would not meet the statutory requirement that the explicit funding must be sufficient. The actual need for universal service support can be minimized by ensuring that the most efficient suppliers are chosen to be supported, that the amount of support needed is estimated as accurately as possible, that the chosen suppliers have an incentive to minimize their costs, and that the plan has a mechanism for capturing efficiency gains and reflecting them in the support

amount.<sup>70</sup> The auction approach is the only proposal in the record which offers a way to accomplish these objectives.

In fact, GTE's proposal is the only plan suggested by any party that is explicitly based on a clearly defined set of objectives that take into account the benefits from competition, the gains from minimizing the cost of supply, and the costs of raising the necessary funding.<sup>71</sup> Thus, GTE is the only party whose proposal explicitly considers the "deadweight loss" that concerns AirTouch. GTE's plan would minimize such losses, not by ignoring portions of the problem, but rather by crafting the most efficient solution to the entire problem.

WorldCom (at 22) "shares the Joint Board's preference for a true market-based approach to universal service." However, WorldCom (*id.*) expresses concern that GTE's proposal "appears to assume the presence of multiple competitors in each and every local market." In fact, this is exactly what GTE does not do. GTE recognizes that competitors willing to undertake universal service obligations will enter different markets gradually over time, and GTE's proposal is specifically designed to accommodate this market development. Carriers wishing to become universal service carriers in given areas would notify the state commission of their intent to bid, and this notice would

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<sup>70</sup> Note that the mechanism used to reduce the fund over time should not destroy the carrier's incentive to achieve efficiency gains over time. Proposals made by some parties to reduce support when carriers reduce prices would create disincentives to lower costs or to reduce prices.

<sup>71</sup> See Statement of Paul R. Milgrom at 9, Attached to GTE's Comments In Response To Questions, D.96-45, August 2, 1996.

trigger an auction in those areas.<sup>72</sup> The initial level of support would be determined by comparing the estimate of actual cost with the rate the incumbent is allowed to charge for basic local service; this amount would be superseded by the result of an auction, when and if an auction is triggered in a particular area. Bidding would be reopened at regular intervals after the initial auction.

Sprint Spectrum (at 5-7) supports an approach which is very similar to that proposed by GTE. Sprint Spectrum recommends that cost estimates "should be used only to establish support levels for the incumbent, wireline carriers in areas where new entrants have not yet offered to bid against them."<sup>73</sup> "Thereafter, competitive bidding should be used instead of proxy costs to set the level of support wherever more than one carrier is prepared to offer universal service."<sup>74</sup>

**B. The Commission Should Issue A Further NPRM Expeditiously To Develop A Specific Auction Mechanism.**

Because the Joint Board recognizes the advantages of an auction mechanism, it recommended (at ¶ 349) that the Commission should investigate how to structure a fair and effective bidding system. To carry out this recommendation, the Commission should issue a Further NPRM as soon as possible to build upon the existing public record and create a sufficient record on the specifics of a workable auction mechanism.

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<sup>72</sup> For administrative convenience, GTE proposes that all areas noticed during a given, preannounced period, should be auctioned together as part of a "bidding cycle."

<sup>73</sup> Sprint Spectrum at 7.

<sup>74</sup> *Id.* at 5.