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Glenn Brown
Executive Director-
Public Policy

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April 21, 1998

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Magalie Roman Salas, Secretary
Federal Communications Commission
1919 M Street, NW, Room 222, SC-1170
Washington, DC 20554

RE: Dockets CC 96-45/97-160

Dear Ms. Roman Salas:

Today, Kathleen Abernathy, Vice President, Federal Regulatory and Glenn Brown, Executive Director-Public Policy, both of U S WEST, met with Paul Gallant, Legal Advisor to Commissioner Gloria Tristani, to discuss Universal Service issues. The attached charts were used during our discussion.

In accordance with Section 1.1206(a)(2) of the Commission's Rules, the original and four copies of this letter, are being filed with your office for inclusion in the public record for the above-mentioned proceedings. Acknowledgment of date of receipt of this transmittal is requested. A duplicate of this letter is provided for this purpose.

Please contact me if you have questions.

Sincerely,



Attachments

cc: Paul Gallant

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UNIVERSAL SERVICE OVERVIEW

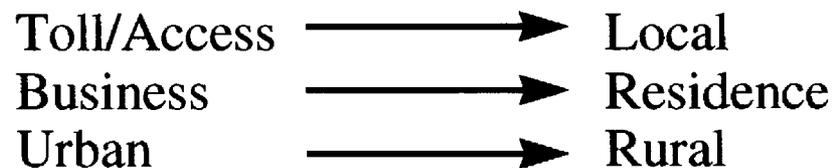
April 21, 1998



UNIVERSAL SERVICE PROBLEM

- Goal of Low Basic Service Prices
- High Degree of Rate Averaging
- Two Sources of Historical Universal Service Subsidy

- 1. Explicit About \$1B
- 2. Implicit \$5B - \$19B



- Telecom Act of 1996 Changed Everything

IMPACTS OF 1996 ACT

- Prices Must Be Just, Reasonable and Affordable
- Implicit Support Must Be Replaced by Explicit Support
 - Specific
 - Predictable
 - Sufficient
- Customers in Rural and High-Cost Areas Should Have Services (Including Access to Advanced Services) and Prices Comparable to Those in Urban Areas
- Phased Implementation of New Explicit Support (Per FCC)
 - “Non-Rural” LECs January 1, 1999
 - “Rural” LECs 2001 Through 2003
- Ability to raise basic service prices will be limited

THE FCC'S DECISION

- Issued May 8, 1997
- Schools and Libraries
 - \$2.25B Fund
 - Funding Based on State and Interstate Revenues
 - Sliding Scale of Discounts
- Rural, Insular and High Cost Areas
 - Funding 75% States / 25% Federal
 - “Non-Rural” Telephone Companies
 - Support = Forward-Looking Cost - Benchmark
 - 14 Month Process to Select Proxy Cost Model
 - “Rural” Telephone Companies
 - Continue Present Mechanisms
 - Transition to Forward-Looking Mechanism Beginning in 2001

KEY ELEMENTS FOR UNIVERSAL SERVICE FUNDING

1. Structure of the Fund
 - National Fund
 - 25% Interstate / 75% Intrastate
 - Alternatives ??
2. Amount of Funding Required
 - The Proxy Cost Models
3. Targeting of Support
 - Statewide Averages
 - Wire Center Averages
 - Below the Wire Center
4. Removal of Implicit Support

FUNDING STRUCTURE

- The FCC Decision Requires a 75/25 Split of Funding Between the State and Federal Jurisdictions
- 75/25 Will Threaten Affordability in Some States
 - Primary Drivers:
 - Number of High Cost Customers
 - Range of Costs
 - Number of Low Cost Customers to Spread Burden Over

Funding Alternatives

1. NATIONAL FUND

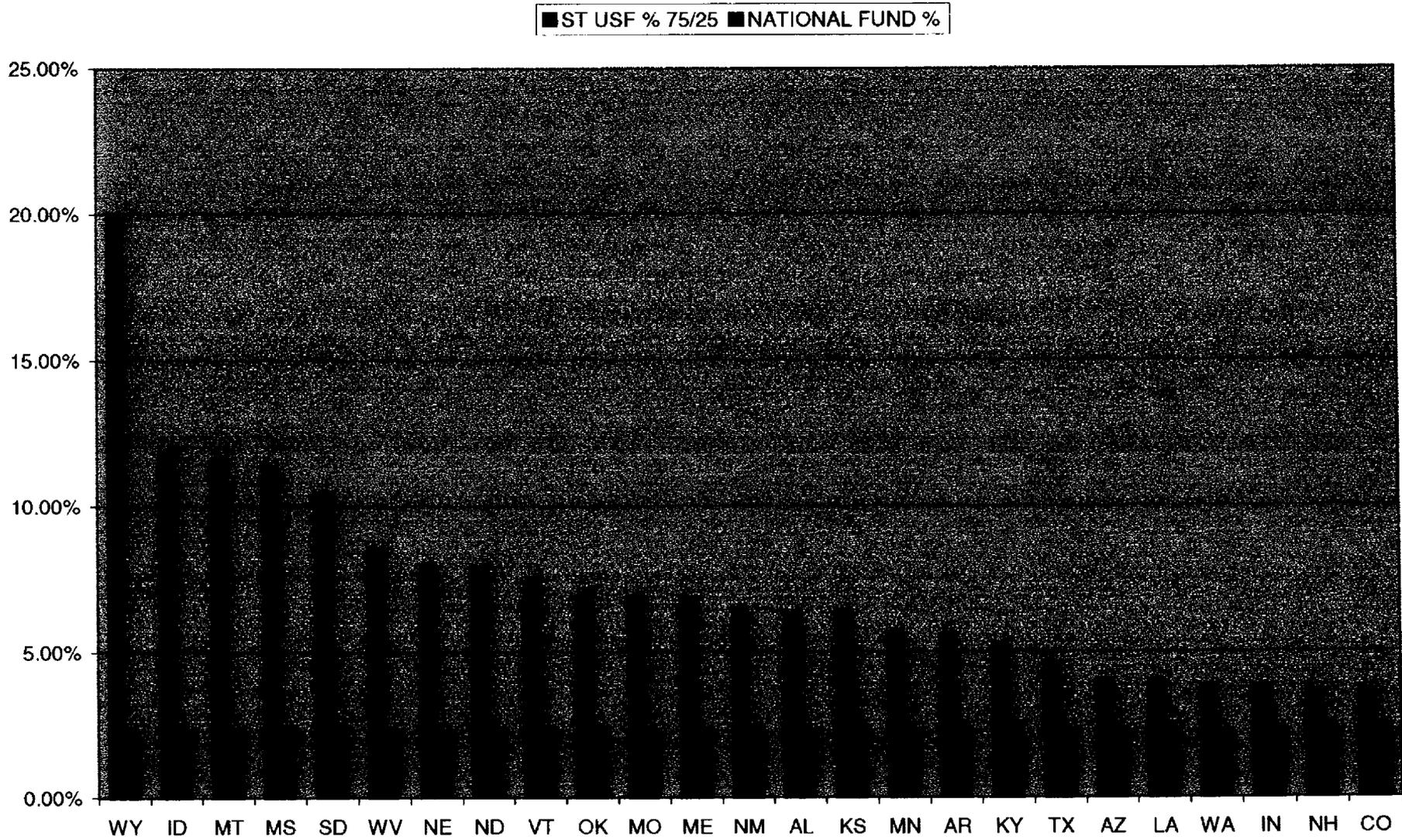
$$\text{National \%} = \frac{\text{National Funding Requirements}}{\text{State + Interstate Revenues}}$$

2. SEPARATE STATE AND INTERSTATE FUNDS

$$\text{State \%} = \frac{75\% \text{ Of State Funding Requirements}}{\text{State Revenues}}$$

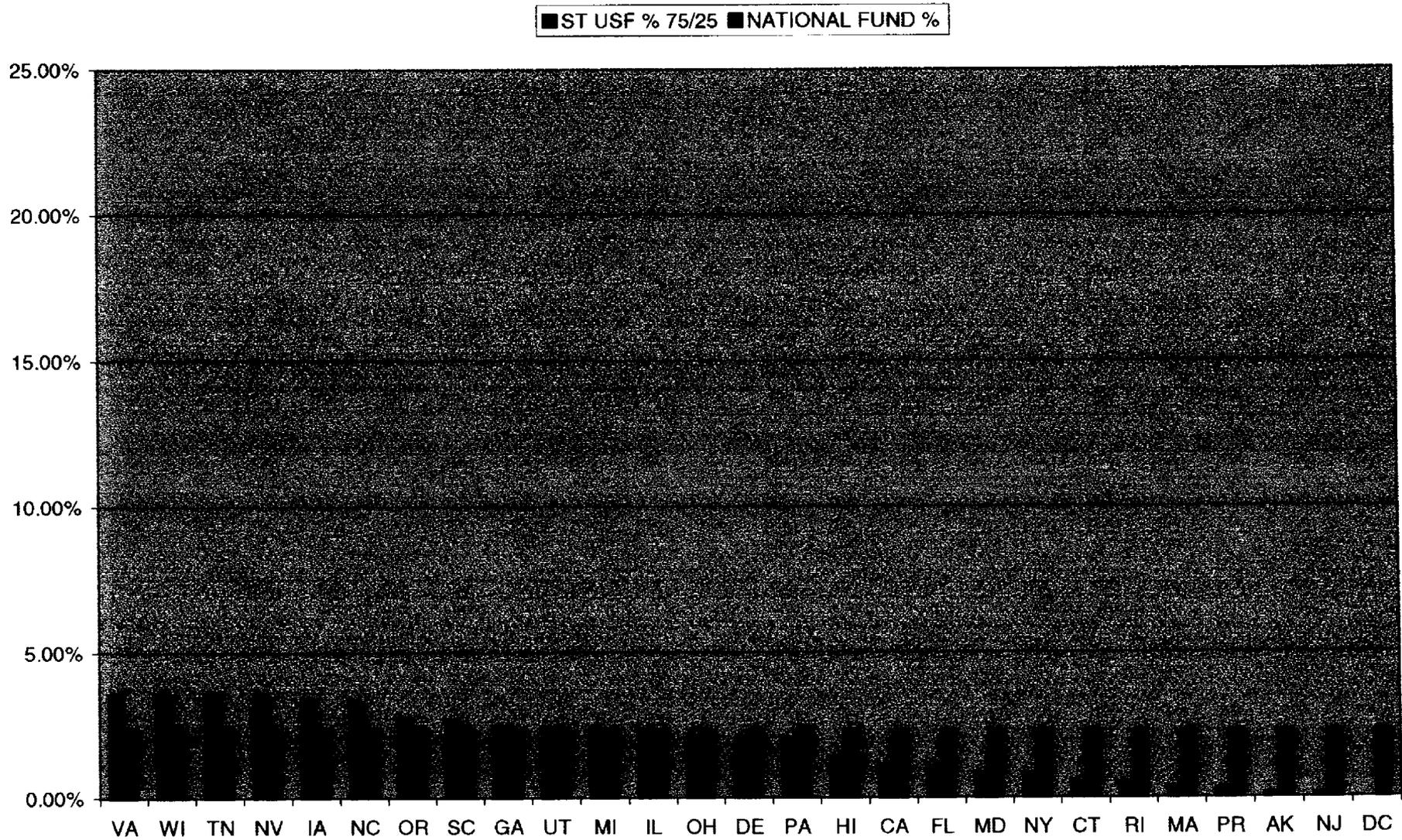
$$\text{Interstate \%} = \frac{25\% \text{ Of National Funding Requirements}}{\text{Interstate Revenues}}$$

Non-Rural LECs "Common Inputs" (4.5B Fund)



Note: This chart assumes a fund size of \$4.5B derived from using FCC "common inputs" in the BCPM3 model. The actual fund size will be determined after completion of further proceedings to finalize model inputs.

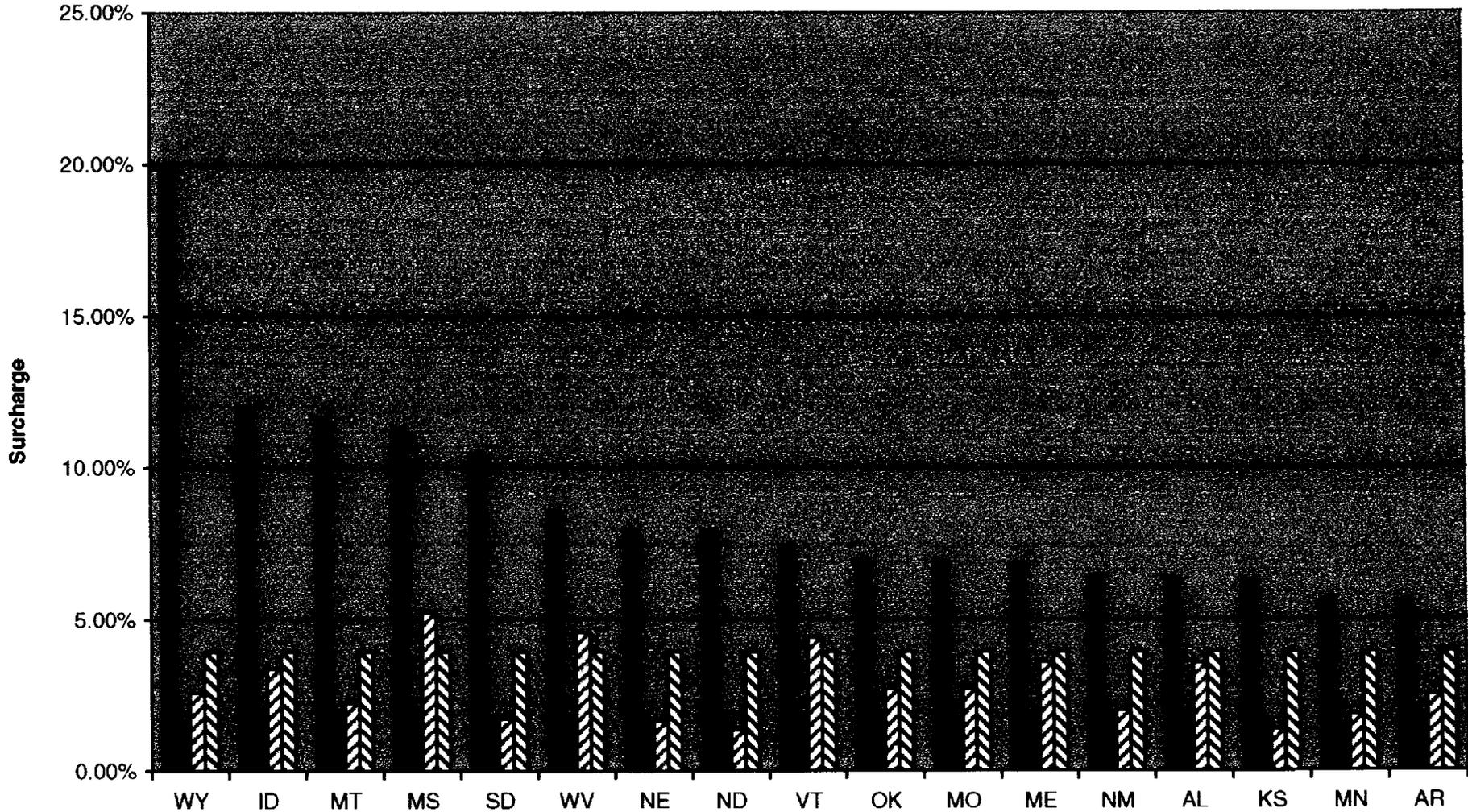
Non-Rural LECs FCC "Common Inputs (\$4.5B Fund)



Note: This chart assumes a fund size of \$4.5B derived from using FCC "common inputs" in the BCPM3 model. The actual fund size will be determined after completion of further proceedings to finalize model inputs.

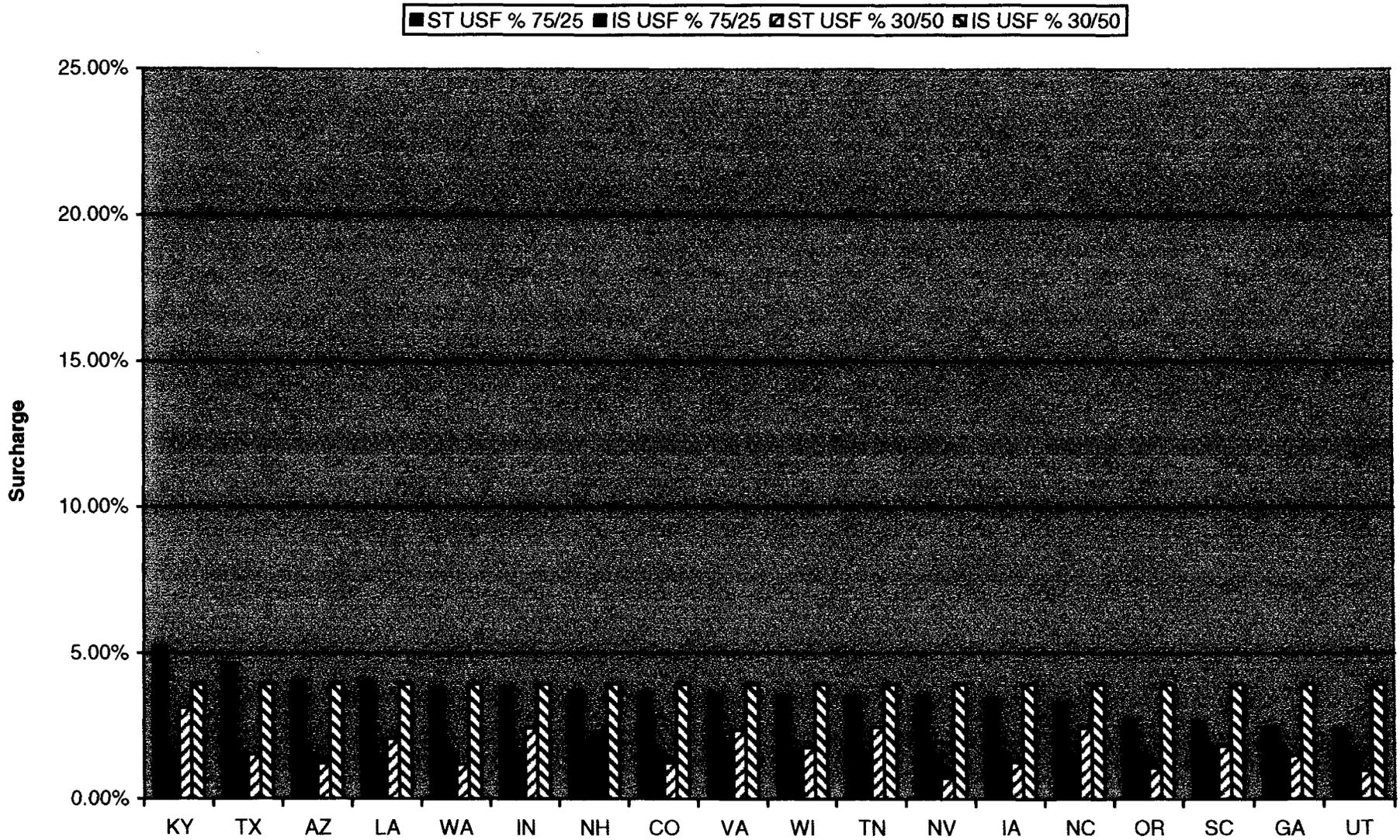
Non-Rural LECs, Common Inputs (1 Of 3)

■ ST USF % 75/25 ■ IS USF % 75/25 ▨ ST USF % 30/50 ▩ IS USF % 30/50



Note: This chart assumes a fund size of \$4.5B derived from using FCC "common inputs" in the BCPM3 model. The actual fund size will be determined after completion of further proceedings to finalize model inputs.

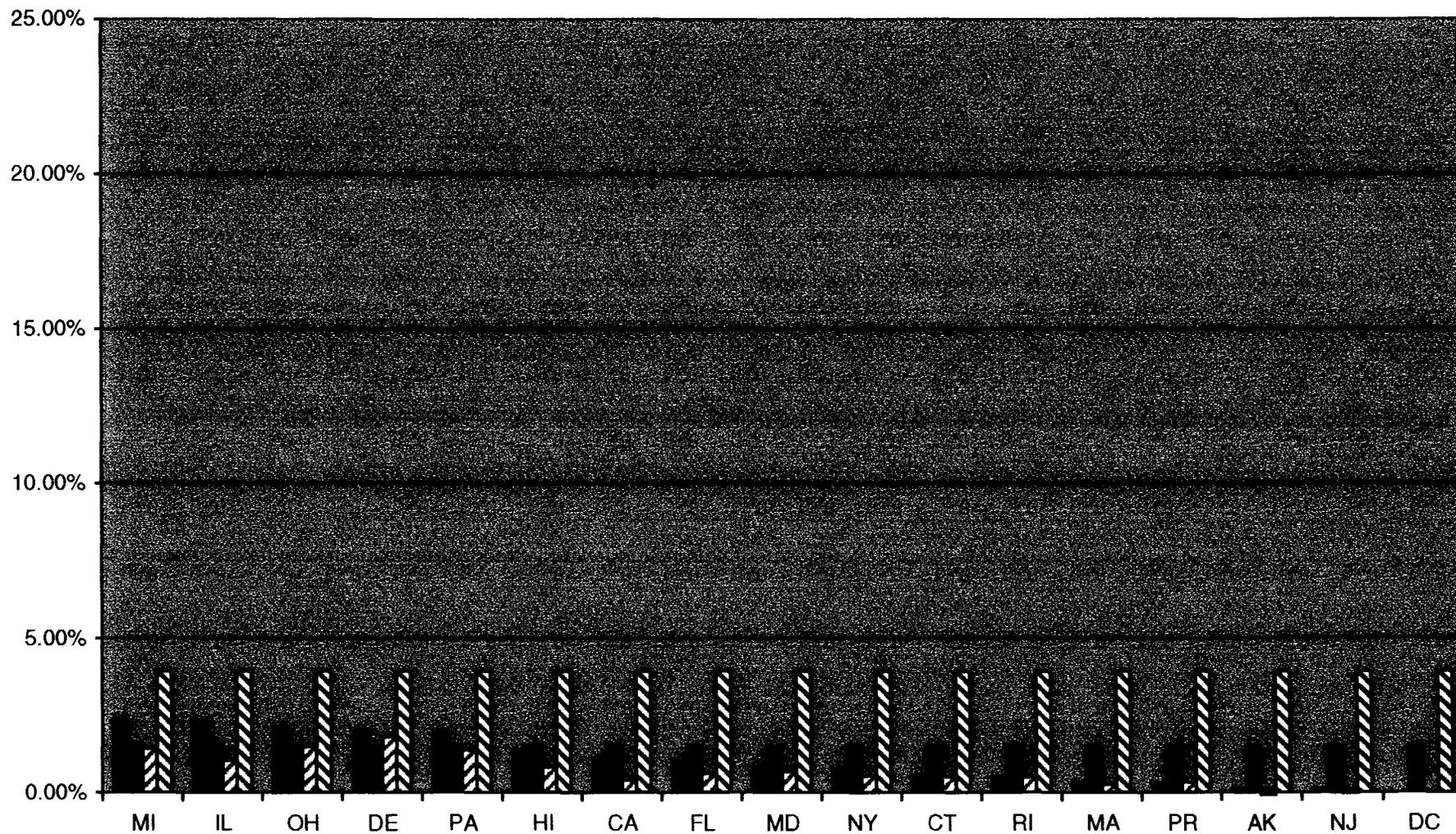
Non- Rural LECs, Common Inputs (2 of 3)



Note: This chart assumes a fund size of \$4.5B derived from using FCC "common inputs" in the BCPM3 model. The actual fund size will be determined after completion of further proceedings to finalize model inputs.

Non-Rural LECs, Common Inputs (3 of 3)

■ ST USF % 75/25 ■ IS USF % 75/25 ▨ ST USF % 30/50 ▩ IS USF % 30/50



Note: This chart assumes a fund size of \$4.5B derived from using FCC "common inputs" in the BCPM3 model. The actual fund size will be determined after completion of further proceedings to finalize model inputs.

THE PROXY COST MODELS

- The Contenders:
 - HAI (formerly Hatfield) Model (AT&T and MCI)
 - Benchmark Cost Proxy Model (U S WEST, BellSouth and Sprint)
- The Issues:
 - Customer Location
 - Loop Design
 - Input Factors
 - Material Prices
 - Capital Cost Factors
 - Objectives of the Study
 - Universal Service Funding
 - Unbundled Network Elements (UNEs)

FCC PROXY CRITERIA

1. Technology must be least cost and not impede provision of advanced services.
2. All network functions must have an associated cost.
3. Only long-run forward-looking costs may be included.
4. Rate of return must be current FCC or State prescribed.
5. Depreciation rates must be within FCC-authorized range.
6. Must include the cost of serving all businesses and households.
7. Reasonable allocation of joint and common costs.
8. The model and all underlying data, formulae, computations and software must be available to all interested parties. All data must be verifiable, engineering assumptions reasonable, an outputs plausible.
9. Must be able to modify critical assumptions and engineering principles.
10. Must deaverage support to the wire center, and if possible, the CBG, CB or grid cell.

COMPARISON OF MODEL RUNS

	<u>TOTAL NON- RURAL LECs FUND</u>
BCPM3 w/Default Inputs	\$8.9B
BCPM3 w/Common Inputs *	\$4.5B
HAI 5.0 w/Common Inputs *	\$4.7B
HAI 5.0 w/Default Inputs	\$2.8B

* Common inputs were prescribed by FCC Staff to facilitate comparison of models. Neither model sponsor endorses these inputs as the correct basis for the determination of high-cost support.

COMPARISON OF COMMON INPUT RUNS

	Fund Size (\$M)		Fund Size (\$M)		HAI as % of BCPM	
	Wire Center		Census Block Group		WC	CBG
	HAI 5.0	BCPM3	HAI 5.0	BCPM3		
Ameritech	\$121.7	\$121.6	\$184.5	\$205.0	100%	90%
Bell Atlantic	\$414.5	\$298.1	\$563.3	\$426.4	139%	132%
Bell South	\$472.8	\$466.0	\$749.8	\$699.8	101%	107%
GTE	\$746.5	\$922.9	\$896.8	\$1,116.1	81%	80%
SBC	\$417.2	\$484.5	\$628.6	\$706.0	86%	89%
United	\$267.6	\$236.0	\$350.1	\$315.5	113%	111%
U S WEST	\$377.7	\$471.6	\$621.4	\$663.7	80%	94%
Others	\$330.1	\$259.5	\$415.6	\$333.8	127%	125%
Total	\$3,148.1	\$3,260.2	\$4,410.1	\$4,466.3	97%	99%

* Common inputs were prescribed by FCC Staff to facilitate comparison of models. Neither model sponsor endorses these inputs as the correct basis for the determination of high-cost support.

DIFFERENCES ARE EVEN WIDER AT THE STUDY AREA LEVEL

	<u>Monthly Cost</u>			<u>High Cost Funding</u>		
	<u>HAI 5.0a</u>	<u>BCPM3</u>	<u>DIFF</u>	<u>HAI 5.0a</u>	<u>BCPM3</u>	<u>DIFF</u>
North Dakota	\$28.61	\$35.78	80%	\$12.2M	\$22.1M	55%
Montana	\$31.32	\$42.30	74%	\$24.3M	\$39.7M	61%
New York	\$20.79	\$21.74	98%	\$84.1M	\$58.6M	143%
Maryland	\$22.80	\$23.31	98%	\$31.7M	\$16.0M	199%

* Common inputs were prescribed by FCC Staff to facilitate comparison of models. Neither model sponsor endorses these inputs as the correct basis for the determination of high-cost support.

REASONS FOR DIFFERENCES

- **USE OF GEOCODEDED DATA**
 - HAI 5.0 USES GEOCODED DATA TO DEFINE “CLUSTERS” OF CUSTOMERS
 - ONCE BOUNDARIES OF CLUSTER ARE DEFINED, GEOCODED DATA IS DISCARDED
 - FOR NETWORK DESIGN, CUSTOMERS ARE ASSUMED TO BE UNIFORMLY DISTRIBUTED WITHIN THE CLUSTER, AND THE RT IS LOCATED AT THE CENTER OF THE CLUSTER
- **ABILITY TO ACCURATELY GEOCODE CUSTOMERS**
 - GEOCODING IS DONE FROM CUSTOMER ADDRESSES
 - GOOD “HIT RATE” IN URBAN AREAS, POOR IN RURAL
 - LOCATION “ASSUMED” FOR NON GEOCODED CUSTOMERS

REASONS FOR DIFFERENCES

- BCPM3 USES A SMALLER DESIGN AREA, AND ADDITIONAL DATA
 - BCPM3 USES SMALL “GRIDS”
 - BCPM3 USES GEOCODED ROAD DATA TO ASSIGN CUSTOMERS TO GRIDS, AND LOCATE CUSTOMERS WITHIN GRIDS
 - BCPM3 PRESERVES THIS CUSTOMERS LOCATION DATA THROUGHOUT THE NETWORK DESIGN PROCESS
- BCPM3 PROVIDES A MORE GRANULAR VIEW OF NETWORK DESIGN AND COSTS
- HAI USES A PROPRIETARY ALGORITHM TO LOCATE CUSTOMERS AND DESIGN PLANT WHICH SYSTEMATICALLY UNDER-PROVIDES DISTRIBUTION PLANT

PUTTING IT IN PERSPECTIVE

1. “FORWARD-LOOKING” INVOLVES CERTAIN CONCESSIONS TO REALITY:
 - Networks aren’t built with one “efficient” build-out
 - Planners do not have perfect knowledge
 - Today’s “forward-looking” is tomorrow’s “embedded”
2. THE HAI MODEL ASSUMES THE MOST OPTIMISTIC CASE IN EVERY CASE:
 - Perfect structure sharing
 - Eclectic mix of state-of-the-art and antiquated technologies, running flat-out
 - The HAI network exists in the mind of the economist, not the world of the engineer

PUBLIC POLICY PERSPECTIVES

UNE PRICING

MAJOR OBJECTIVES

- Encourage local market entry
- Price at cost (TELRIC)
- Keep the costs low

IF COSTS ARE UNDERESTIMATED

- More competitors enter market (through resale)
- Adverse financial impact to the incumbent

IF COSTS ARE OVERESTIMATED

- Local entry discouraged

UNIVERSAL SERVICE

MAJOR OBJECTIVES

- “Specific, Predictable and Sufficient” support
- Affordable rural service
- Access to advanced services

IF COSTS ARE UNDERESTIMATED

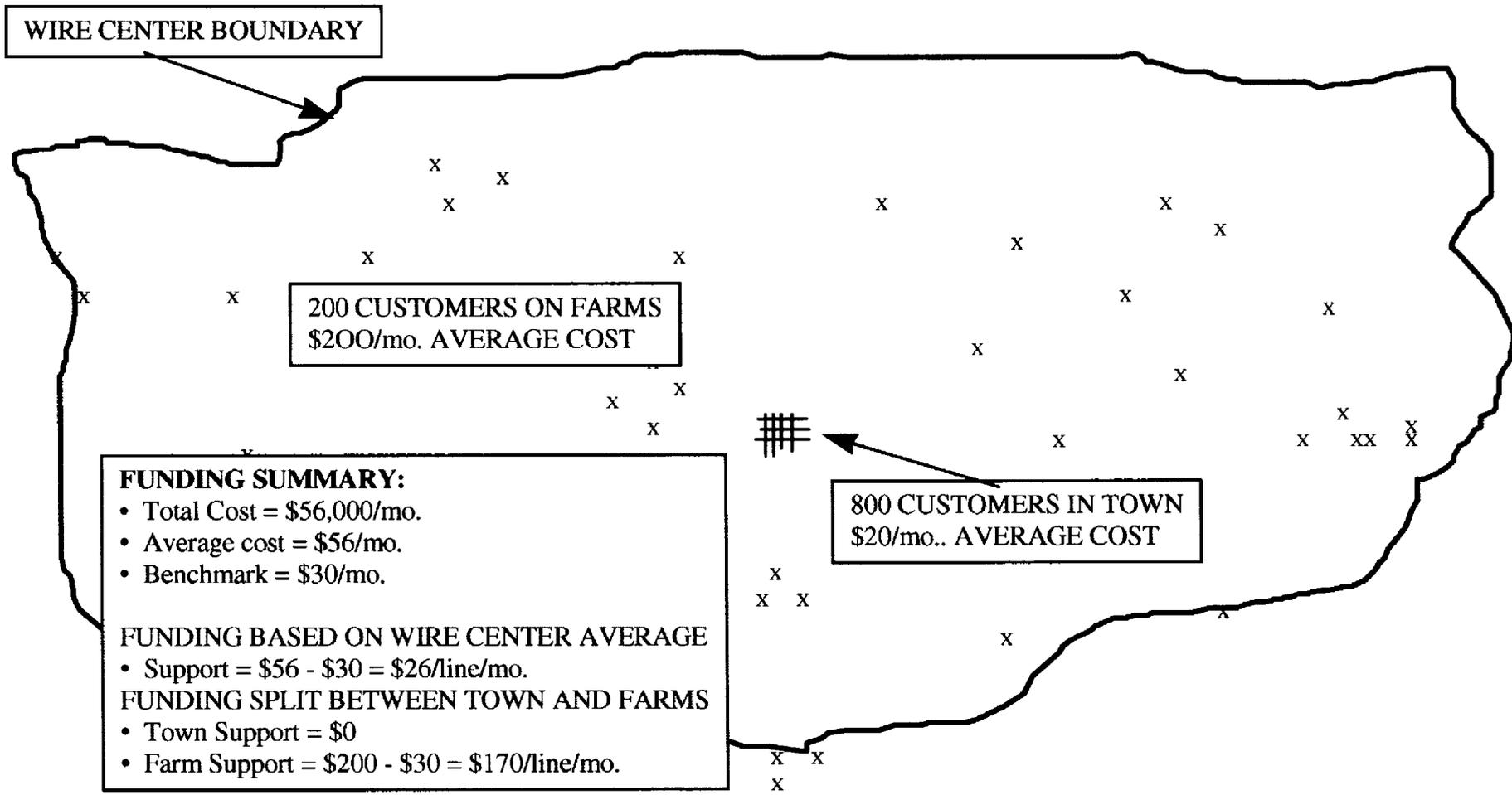
- Providers will not construct facilities to serve high-cost rural areas
- Rural rates will rise
- Rural customers will not have access to advanced services

IF COSTS ARE OVERESTIMATED

- ILECs and others will overpay to fund
- “Gaming” of the system

UNE pricing may involve incentives to err on the low side. However underestimation of costs for universal service support can have severe public policy consequences. The HAI model was developed primarily for UNE pricing, and tends to understate costs. The BCPM attempts to neither understate nor overstate forward-looking costs.

SUPPORT MUST BE TARGETED BELOW THE WIRE CENTER



RATE REBALANCING

- Removal of implicit support presents a once-in-a-career opportunity to rebalance rates.
- The greater the rate rebalancing freedom granted by regulators, the smaller will be the size of the required explicit support fund.
- Rate rebalancing should benefit the evolution of competition.