subsidy requirements relative to other states, and ought to be given "super-subsidies." However, it is *precisely* these states that would receive a larger relative subsidy under a plan with a single national benchmark. The five states whose non-rural carriers receive the greatest forward-looking subsidies as a share of state revenues are Mississippi, Wyoming, West Virginia, Nebraska, and Idaho. Non-rural carriers in these states receive subsidies equal to approximately 2 percent of state revenues. In contrast, non-rural carriers in urban states such as District of Columbia, New Jersey, Rhode Island, Massachusetts and Connecticut receive forward looking subsidies no greater than 1/10 of one-percent of state revenues.[21] As one would expect, states that are predominantly rural, receive forward-looking subsidies 20 times greater than the subsidies more urban states would receive relative to state revenues. South Dakota and Colorado are unable to show that a forward-looking cost model, coupled with a single national benchmark does not accurately capture cost differences among states.

E. The Ad Hoc proposal breaks almost every sound public policy principle

Ad Hoc proposes a pre-ordained redistribution of funds, with no concern for the impact on consumers or competition.

- It proposes that "all of the money produced would be used by state commissions to reduce intrastate rates" (at p. 28), while proclaiming that "revenues for the federal high cost support program should be derived from a charge on only the interstate revenues of interstate carriers" (at p. 2), thereby imposing a double burden on interstate customers.
- It claims that this double burden on interstate customers is "progressive" because customers who use a high volume of interstate services and therefore will contribute

[21]Data obtained from TIAP Appendix D, at 56.

proportionately more to the fund "are generally business customers and higher income residential customers. It is unlikely, therefore, that low-income individuals, even in low-cost states, would be significantly burdened by this proposal." Yet in this age of mobility, the double burden on long distance customers certainly will affect families with children in the military, families with members who have left economically depressed regions in search of employment, and recent immigrants with families overseas. By contrast, there already is a Universal Service funding mechanism in place to subsidize the local rates and installation charges for low income households.

- Ad Hoc recognizes that "If a state does not successfully coordinate its universal service policy and its wholesale pricing policy...the result could be the waste of high cost support," (at p. 12), and even recognizes that this could "frustrat[e] Congress' intent that subsidies be made explicit" (at fn. 22), yet it would not tie the amount of interstate Universal Service funding received to the degree of UNE loop deaveraging.
- Ad Hoc argues that by using a Universal Service funding mechanism that compares the nationwide average cost to a state's embedded costs, when a LEC in a state undertakes a major new investment project "[f]or these states, increased facilities investment will promptly result in increased support to the state..."[22] The problem with Ad Hoc's proposal is a company that increases its cost for *any* reason, for example speculative investment in excess capacity, or excessive profit margins approved by state regulators, will immediately be subsidized by customers in other states. Ad Hoc's proposal creates a vehicle for ILECs to get state regulators to approve inefficient, speculative investments,

[22]Ad Hoc at 31.

and resultant increases in monopoly profits, by convincing the regulators that this would be somewhat of a "free lunch" that would be funded by an increase in state subsidy receipts from the interstate jurisdiction. Playing on state regulators' natural interest in keeping their state's infrastructure at the cutting edge, and with the burden of paying for that infrastructure substantially moved from state residents to federal funding, the ILECs can be expected to push aggressively for investments that are not justified by economic demand. Moreover, basing subsidies on embedded company costs could result in funding inefficient, high-cost providers and not funding efficient providers. In contrast, a national affordability benchmark coupled with a company-specific forward-looking cost estimate would not reward companies for inefficient investment or excess profits. These unnecessary costs would not be included in the forward looking estimate, and so would not be subsidized. On the other hand, any company that can provide service more efficiently than the model projects would be rewarded with additional subsidies.[23]

- Ad Hoc states that "Federal funds would be distributed to state commissions, and the federal distribution would therefore be competitively neutral....[S]tate commissions would also demonstrate...that they would not establish a preference for a particular kind of carrier or technology." But competitive neutrality relates just as much to how the subsidy is collected as to how it is distributed. If the burden is imposed on interstate providers and the benefits of double recovery go to non-rural LECs, and if as is envisioned by the Act interstate and local providers eventually will be competing with one another, this does not represent a competitively neutral funding mechanism.

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[23]Of course, over time, the model should be adjusted to reflect this more efficient method.

- Finally, Ad Hoc proposes that current support levels for rural companies be maintained to avoid "near-term" disruption for rural companies, but makes that guaranteed support open-ended by not proposing a sunset or review date.

IV. It is possible to construct a high-cost Universal Service fund for non-rural carriers that is fully consistent with sound public policy principles

While none of the proposals put forth to date are fully consistent with sound public policy principles, a number of them contain elements that could be part of a good Universal Service funding mechanism. The concern of the Ad Hoc group with containing the size of the fund,[24] the recognition by BellSouth that the funds collected by an explicit interstate fund must be matched dollar for dollar by reductions in interstate access charges,[25] the proposal by AT&T not to add a new explicit funding mechanism where the states have not deaveraged loop rates,[26] all are elements that should be included in a Universal Service funding mechanism. In this section, MCI puts together the various pieces of the Universal Service funding mechanism puzzle to construct a mechanism that meets all sound public policy principles.

The MCI proposal is explicitly tied to the other two activities mandated by the Act — implementation of rules for the interconnection of CLECs' local networks to incumbent local exchange carriers' ILECs' networks (in particular, the terms, conditions, and rates for unbundled network elements) and access charge reform. The MCI proposal is based on two lessons learned

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[24]Ad Hoc at 10.

[25]BellSouth Proposal at 3.

[26]The lack of UNE loop deaveraging was one of the key elements motivating AT&T's proposal to maintain the existing funding mechanism. See, Presentation of Joel Lubin, AT&T Corporation, CC Docket 96-45 Universal Service En Banc, March 6, 1998.

from the experience of the past two years: (1) implementation of a new Universal Service methodology cannot be accomplished in a vacuum; it must be part of an integrated regulatory framework that fosters efficient competitive entry; and (2) any government-imposed requirement to collect funds must employ an efficient mechanism that does not disrupt the relationship between providers and customers.

The MCI proposal for an explicit interstate high cost Universal Service fund for non-rural LECs is as follows:

- For each state, calculate the size of the interstate subsidy by comparing the affordability benchmark to the forward-looking economic cost of providing, calculated using the same cost zones as the state uses for setting deaveraged loop rates. Thus, the more fully the state has deaveraged loop rates to allow local competition to develop, the greater the potential interstate subsidy.[27] Where states have deaveraged loop rates to allow CLECs and ILECs to compete fully in the market, the interstate jurisdiction would assume full responsibility for funding the high cost fund for non-rural telephone companies.
- Calculate the share borne by each interstate service provider by multiplying the total subsidy needed in the state by the carrier's share of retail interstate revenues. Retail interstate revenues include the retail interstate revenues of LECs, IXCs, and all other

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[27]The FCC, in its Public Notice, indicated that one of the goals should be to ensure that no state receives reduced interstate support as a result of Universal Service reform. MCI does not agree with this goal because existing funding levels are not based on an explicit calculation of Universal Service need. Although MCI does not agree with this goal, the MCI proposal could readily accommodate it by simply adding a provision that ensures each state will continue to receive its current level of interstate subsidies for non-rural LECs. However, as explained in footnote 16, above, the actual calculations suggest that there is no empirical need for a hold harmless provision for non-rural LECs. If such a hold-harmless provision nonetheless were included, it should be explicitly limited to a short transition period of at most two years.

telecommunications carriers. LEC retail interstate revenues are generated by subscriber line charges (SLC), special access services provided to end users, the full array of interstate services provided by non-BOC non-rural carriers, plus those interstate services that the BOCs have received waivers to provide.

- Do not allow the LECs to recover the assessment on their retail interstate services from their wholesale customers (the IXCs) through the inclusion of these costs in access charges or through any other method, or else the IXCs will be doubly burdened.
- Encourage all contributors, including the LECs and IXCs, to identify the Universal Service assessment on customer bills as a federal high cost non-rural Universal Service fee. One way to do this is to allow the subsidy to be collected as a percentage charge on each interstate customer's retail charges.
- The dollar reduction in implicit interstate subsidies for every dollar collected by the explicit Universal Service fund would be accomplished in the following order: (1) pay off the additional interstate revenue requirement allocation made under Rule 36.631; (2) reduce interstate access charges, starting with the CCLC, then, if needed, the PICC, and then, if needed, the local switching charge.
- If the entire national high cost Universal Service fund for non-rural LECs is being funded from interstate services, any state Universal Service fund must be imposed only on intrastate services and collected only from intrastate rates.

It is important to note that the MCI proposal must be taken as a whole to be consistent with public policy principles. For example, if 100% interstate funding were implemented, but

implicit interstate subsidies were not reduced, this would create a highly distorted and anticompetitive funding mechanism. Similarly, if 100% interstate funding were implemented, but the LEC share of the burden were passed through to IXCs through increases in access charges, then the IXCs would be doubly burdened, and the LECs unburdened. Moreover, if the LECs did not explicitly identify how their portion of the Universal Service burden was being passed through in the access charges, the IXCs would not even have the ability to show their customers that the price increases they would have to make were due to the LECs' as well as their own portion of the Universal Service burden.

Thus, this proposal is consistent with sound public policy principles, but could be undermined if not fully implemented. Nonetheless, its public policy benefits are great:

- An explicit fund is created that potentially can address 100% of high-cost non-rural LEC Universal Service support needs.
- The fund is tied directly to the way the interconnection provisions of the Telecommunications Act are implemented in each state. State subsidy receipts would be kept small if UNE loop rates have not been deaveraged in a state, but would automatically ratchet up once deaveraging has been implemented.
- It provides states with the incentive to deaverage loop rates by relieving those that do so from Universal Service funding responsibilities.
- It reduces the non-rural LECs' strong anticompetitive incentive to oppose deaveraged loop rates (that will foster local competition) by making the high cost non-rural LECs eligible for substantially more support than they receive today (using the HAI model, funding would increase from $0.3 billion today to $2.2 billion if all states were to meet the

eligibility requirements by setting proper rates for unbundled loops).

- By providing an explicit source of Universal Service support at the 100% level, it eliminates Universal Service support as a reason for states to have to undertake contentious rate rebalancing proceedings.
- By (1) reducing interstate access charges on a one-for-one basis with the new funding, and (2) prohibiting the LECs from collecting the assessment on their interstate retail services from their wholesale services (i.e., raising rates for interstate access charges imposed on the IXCs), it ensures that one segment of the industry — the interexchange carriers — and one set of customers — IXC customers — are not double billed for universal service. No industry segment is placed at an artificial competitive disadvantage.
- It does not require any modification to existing jurisdictional separations rules.

V. Conclusion

For the above-mentioned reasons, MCI encourages the Commission to adopt the proposals and recommendations made by MCI in these Comments.

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STATEMENT OF VERIFICATION

I have read the foregoing and, to the best of my knowledge, information and belief, there is good ground to support it, and it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on May 15, 1998.

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