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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

July 16, 1998

Ms. Magalie R. Salas
Secretary
Federal Communications Commission
1919 M Street, N.W.
Room 222
Washington, D.C. 20054

Re: CC Docket Nos. 96-45, 97-160, DA 98-715, Federal State Board on Universal Service

Dear Ms. Salas:

On July 15, 1998, Mark Sievers and I from GTE met with Kathryn Brown, Chief, Common Carrier Bureau and Kathryn Schroeder to discuss the attached White Paper on universal service. In accordance with Section 1.1206(a)(2) of the Commission's Rules, 47 C.F.R. section 1.1206(a)(2) (1991), please include this letter in the record of the above proceeding. Please contact me if you have any questions.

Sincerely

Alan Ciamporcero

cc: Ms. Kathryn Brown
Attachment

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UNIVERSAL SERVICE:
MAKING IT WORK IN THE 21ST CENTURY

July 1998

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Overview

> *"Existing phone companies have been forced by regulators to offer basic service to low-income consumers at discounted prices, with those costs effectively subsidized by other customers. As new entrants go after the better -- i.e., richer – customers, new ways must be found to assure that all have access to basic services, with subsidies no longer hidden but applied fairly."* The New York Times, *July 5, 1998*

This is the nub of the universal service problem. Hidden subsidies make local phone service an outstanding bargain, putting it within the economic reach of virtually every American household. In fact, basic local service is priced on average at about one-half of its cost. This is made possible by approximately $20 billion in hidden subsidies -- from long distance, toll and special calling features -- and $1 billion in visible subsidies (excluding funding for schools, libraries and rural health care).

The combination of a relatively small visible fund and a large hidden fund worked well when the telephone industry was a regulated monopoly. As regulated monopolies, GTE and the "Baby Bells" delivered high-quality, reliable telephone service to 94% of the population - by far the best universal service in the world. Under this regulated system, consumers pay for universal service whenever they make a long distance call or use optional calling services. The result is that most consumers receive unlimited local calling for a monthly fee that is less than the price of a tank of gasoline – and far below the actual cost of providing that service.

But hidden subsidies simply will not work in a competitive market. They become counter-productive, stalling competition and innovation, and frustrating customers and service providers in equal measure. Retaining hidden subsidies in an open, competitive market causes bad things to happen – first, competition occurs only for those "richer" customers who generate the subsidies; and second, as a consequence of the first, the subsidies that make local service such an

outstanding bargain inevitably will disappear. After all, in a competitive market with regulations largely removed, customers are only attractive to a company if they can be served at a profit. That's a basic rule of business.

There is a solution. The system can be fixed in a fair way that would finally give consumers a chance to enjoy the benefits of a truly competitive market. Importantly, most consumers would not experience any net increase in their total monthly bills. In fact, most consumers would find their bills reduced.

In GTE's view, reforming universal service for the 21st century is a straightforward, three-part process:

1. Eliminate the hidden support in today's prices for telecommunications. This would pave the way for sizable rate reductions for most customers.

2. Replace today's hidden support with a new universal service fund based on today's *real* costs of delivering basic local telephone service. This portable fund would attract new carriers to compete to serve all customers while preserving affordable phone service for all Americans.

3. Allow market forces to determine competitively the future amount of universal service support through a process of competitive bidding. If companies can provide service at lower costs, they can bid down the level of support.

If we do this price restructuring job right – at the federal and state level – we can ensure the continuation of universal service *and* create competition – all at a fair cost to the consumer *and* without adding any money to the system. In this paper, we explain how*.

* The problem has both a state and federal dimension because there are hidden subsidies in both state and federal rates. This paper focuses on the federal part of the hidden subsidy – approximately $6.3 billion. While GTE's recommendation in this white paper addresses the *interstate* universal service funding mechanism, a corresponding solution also must be developed in each state

Why do we need universal service support?

Universal service support helps ensure that telephone service will be available at affordable prices throughout the country. What's the challenge in making phone service universally available? Its cost. Current prices for residential services don't cover their costs. GTE's analysis shows that in the areas served by GTE, basic residential service is priced on average more than $20 per month *below* the level one would expect in a competitive market. Even if we include all the services that a local customer buys – such as toll and special calling features – most customers still don't cover their costs.

Chart 1 shows how prices work in Texas. Seventy-eight percent of customers do not cover the cost of providing service, even when the revenue from all the services the customer buys are included. And this calculation uses a very conservative estimate of costs -- the low rates for the underlying network elements (about 36% below the level of GTE's current service rates) determined by the Texas Public Utility Commission.

In the Telecommunications Act of 1996, ("Telecom Act") Congress made sweeping changes to the telephone industry – changes designed to stimulate competition in all segments of the industry. But Congress also clearly mandated that universal service continue at affordable prices. To accomplish this, Congress established clear policy directives:

- "Quality services should be available at just, reasonable and affordable rates." 47 U.S.C. § 254(b)(1)
- "All providers of telecommunications services should make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service." 47 U.S.C. § 254(b)(4)
- "There should be *specific, predictable and sufficient* Federal and State mechanisms to preserve and advance universal service." 47 U.S.C. § 254(b)(5)
- "Any such [universal service] support should be *explicit and sufficient* to achieve the purposes of this section." 47 U.S.C. § 254(e)

How do current phone rates support universal service?

Today, universal service funding is provided through a combination of explicit (i.e., visible) support from some relatively small state and federal pricing mechanisms, and large implicit (i.e., hidden) support from the rates for other services such as access, long distance, and optional services (e.g., call waiting, call forwarding).

Chart 2 ("GTE's Universal Service Support By Service") shows where universal service support comes from – and where it goes – for GTE's serving areas in 28 states. The yellow bars show the contribution currently generated by each major service category (revenue minus incremental cost) at today's prices. Interstate switched access (long distance), intrastate access (in-state long distance), intrastate toll (measured service), and special calling features each provide large contributions – the result of mandated markups by regulatory agencies of several hundred percent over their direct cost. In contrast, residential local service does not cover its costs -- by a wide margin.

Chart 2 also indicates what prices would look like in a competitive market, without regulation. The striped blue bars show the contribution that each category would generate if rates were balanced to yield the same revenue generated by current prices, but with a uniform markup over direct cost across all service categories. These prices reflect the underlying direct costs, but are also consistent with the current overall price level. The difference between the current prices (the red and yellow bars) and these "cost-based" prices (the blue bars) is a result of deliberate decisions by regulatory agencies. This represents the hidden universal service support that each category either generates or receives.

Chart 2 reveals several points about the current pattern of universal service subsidies:

- The current flow of support from all sources is very large – by design. The difference between the rates local residential customers actually pay, and the rates they *would* pay if rates were based on costs, is almost $23 per line per month. Interstate access alone provides about $1.2 billion of implicit support for GTE. For the industry as a whole, it provides about $6.3 billion. To sustain current support flows without affecting the prices of local services, federal universal service support must at least equal the level of support implicit in today's services.

- Most of the support being provided today is implicit in current prices, rather than explicit as required by the Telecom Act. To illustrate, GTE is the largest single recipient from the

current *explicit* high-cost fund, yet that accounts for only 7% of the total support GTE generates from interstate sources.

- Those who advocate a small universal service fund ignore the simple fact that a large fund *already exists* when we consider all sources of support – prices for access, long distance, optional calling, and business services, as well as explicit funds. Thus, consumers already are paying the price of universal service.

Why change the current system?

We didn't arrive at the current situation by accident. Deliberate public policy decisions made by both the Federal Communications Commission (FCC) and state regulatory bodies created a system that relies strongly on subsidy flows from other services to keep the price of local service far below cost. So why change?

First, if we don't change the system, it is highly unlikely that many residential customers will ever enjoy the benefits of a competitive market. One look at the costs associated with providing residential service on Chart 2 proves it. Who would provide basic residential service when the market price is below its cost? Carriers will naturally focus their competitive efforts on other parts of the market, such as toll and access, and provide residential service only if it is necessary to attract those customers.

Local competition *is* occurring where new entrants can make a profit. A recent report by an industry analyst found that, in the first quarter of 1998, *alternative local carriers added more new business lines than did traditional local phone companies*. But, clearly, the Telecom Act will not deliver competition for the majority of residential telephone consumers if policy makers leave the current subsidized rates in place.

The hidden support that subsidizes most residence customers today cannot be made available to any new carrier that attempts to serve those customers – it is generated by rates charged to *other* customers of the existing telephone companies. In its present form, this support can never be made "portable" to new carriers. Only if a new universal service fund makes this support explicit will it become available to potential competitors. This would attach enough revenue to local service to make it a reasonable business proposition for a new entrant.

Second, as the FCC, state regulators, and scores of economists and phone companies have recognized, competition will inevitably eliminate the support hidden in the prices on the left-hand side of the previous chart. Telephone companies are charging more to customers who make

heavy use of services like access and long distance than these services actually cost. New competitors are able to serve those customers for less, either by building their own facilities, or by renting them from the telephone companies at cost-based rates. The inescapable effect – although it may take some time to happen – will be the loss of the hidden subsidies and, consequently, extreme pressure on the price of basic service. If these hidden subsidies aren't replaced, prices for basic services could increase dramatically.

Third, the large implicit fund we have today is very inefficient and unfair. Many customers are "contributing" to universal service at very high rates. For example, our analysis of a national survey of residential telephone bills shows that customers who make less than $10,000 a year average $20 of long distance calls a month. Part of their long distance calling subsidizes other, financially better off consumers who make no long distance calls. Customers in rural areas tend to make more long distance calls, so subsidizing local service through high long distance rates is counter-productive; it hurts the very customers we are attempting to help. In contrast, competitors and large customers can avoid these universal service contributions by buying their telephone services as unbundled network elements and dedicated access arrangements that are priced close to cost.

Finally, the Telecom Act flatly prohibits continued reliance on implicit support. Even if we wanted to maintain the hidden support, Congress said we couldn't. Continued reliance on existing price structures simply fails the Telecom Act's requirement to create explicit funding.

What must an explicit federal universal service mechanism accomplish?

The funding to support universal service is already in the system. The total revenue on the charts does not need to be altered or increased. Policy makers need only rearrange the sources of revenues through an economically sound mechanism.

Further, the FCC need not adopt a federal universal service mechanism to address the entire problem shown on the charts. Much of the current implicit support comes from state rates today, and should be replaced by state rebalancing or by explicit state funding, or some combination. What amount of support must the federal mechanism supply for the overall result to be sufficient?

GTE has offered three targets for the federal plan:

- Sufficient – First, the federal plan should be sufficient to replace the current flow of implicit support from interstate access. GTE has estimated this flow at $6.3 billion annually for non-

rural telephone companies. This includes the current recovery of those carriers' contributions to the school and library fund; if that amount were recovered through a separate mechanism, the remaining implicit support would be about $5.2 billion.

- High-Cost States – The federal plan should provide a certain amount of new explicit support to states with very high costs or low funding bases. This amount should be chosen to strike a balance between high- and low-cost states. Some states, such as Wyoming, have very high cost areas that need to be supported, but no low-cost urban areas to provide contributions to a universal service mechanism. If Wyoming regulators tried to solve that state's universal service needs entirely through a state fund, then Wyoming customers would face a heavy surcharge – perhaps 40-50% on all telecommunications purchases – for the necessary funding.

- Non-Rural Companies – The new federal plan should replace the explicit funding provided to non-rural telephone companies by the current high-cost fund, which is about $217 million annually. The new fund should do no harm; it should not eliminate support already incorporated in state rates.

How should explicit federal support be targeted?

GTE recommends that the FCC target federal universal service support by calculating the cost of service on as small a geographic area as practical. Then, the FCC should establish affordability benchmarks and provide support to cover costs above those benchmarks. There are no specific benchmarks that are reasonable *a priori*; a set of benchmarks and percentages is reasonable if it replaces the current hidden federal contribution – about $6.3 billion – with explicit and portable funding.

For example, the FCC is considering a 25/75 plan with a benchmark of about $31 per line for residential customers and $51 for business customers. In that plan, the federal fund would provide 25% of the cost of service above a $31 benchmark in a specific area. States would be responsible for the remaining 75%. Under such a plan, the price of basic service obviously could increase substantially in many areas.

A better approach would use several different benchmarks and federal/state percentages. To illustrate the approach, assume a plan with three benchmarks at $20, $25, and $40. In this example, the federal plan would provide 25% of the support over $20, 50% of the support over $25, and 100% of the support over $40. Under this plan (using the BCPM model version 3.1 and

the FCC staff's common inputs), the fund would produce about $5.7 billion in federal support annually.

The benchmarks and percentages affect both the aggregate level of support and the distribution of support throughout the country. However, the litmus test for any combination of benchmarks and percentages is whether it generates funds sufficient to cover the support that is generated today – thus helping to keep prices as affordable as they are today.

Obviously, some mechanism must be employed to estimate costs in various areas throughout the country. The FCC has been experimenting with various computer-generated cost models to gauge the costs of providing basic service in different areas. It is vital that the FCC select its cost model platform and inputs to that model *before* it finalizes its choice of benchmarks. Otherwise, the FCC cannot be certain that the plan will produce a reasonable outcome or a sufficient level of support.

The FCC has struggled for nearly three years to produce a cost model that is completely reliable. Several times it has encountered difficulties, and has delayed the process to allow more time to refine the model. It is time for the FCC to recognize that the cost model will never be perfect, and to plan accordingly. While the FCC staff will no doubt improve the model, given the latest delay in the FCC's schedule, it is equally important now to design a universal service plan that is not vulnerable to inevitable errors in the model. This is why the FCC should adopt the clear, externally-verifiable objectives GTE has proposed.

How should federal support be applied?

The support generated by the federal fund should be applied toward the three targets, using a "cascading" approach similar to the one the Commission has applied to common line charges:

- First, the support should replace any current high-cost funding to non-rural telephone companies.
- Second, any net increase in federal support should be applied toward reductions in interstate switched access charges. This should continue until the per-minute rate has reached some reference level; GTE has used $.008 (eight-tenths of a cent) per minute in its calculations.
- Third, any amount remaining should be provided to the states. The benchmarks and percentages should be chosen to ensure that the amount is sufficient to achieve the desired distribution of support to the states where it is needed.

GTE has proposed the use of a sliding scale of benchmarks and percentages because one or two benchmarks will not provide the Commission with enough flexibility and policy variables to ensure that all of its targets are met.

How should the universal service funds be raised?

GTE proposes that the funding needed for the federal plan should be generated through a uniform percentage surcharge *on both state and interstate retail revenues*. For the example GTE has outlined above, a surcharge of about 3.4% would be sufficient to raise the necessary funds for an interstate plan. Because interstate access provides a disproportionate share of implicit universal service funding today, it would be difficult to eliminate that implicit support, and generate the necessary explicit funding, on a base of interstate revenues alone.

As a matter of consistency and for similar reasons, GTE also proposes that states should base their funding mechanisms on both state and interstate revenues. In this way, both the federal and state plans will have the largest possible funding base and the lowest possible contribution rate, and all carriers and services will pay on the same basis, at the same rate.

What are the effects on customers?

The vast majority of all telephone customers would benefit under GTE's proposal. A new explicit fund would be fairer, more efficient, and more competitive than the current system – and should result in immediate lower prices. And all customers would benefit in the long-run as a result of network upgrades and improved service generated by competition. It would require every customer to pay a surcharge of about 3.4% for federal support purposes. For the average basic-service only customer, this works out to approximately 72 cents per month – an amount unlikely to threaten affordability for most consumers, especially when combined with available Lifeline or Link-Up programs.

Based on an analysis of a PNR & Associates survey of over five thousand residential customers' telephone bills, the average customer would see little change or realize a lower total bill, assuming a 3.4% surcharge and a 13% reduction in long distance charges. The table below shows the impact by income levels:

TABLE 1: IMPACT OF A 3.4% SURCHARGE ON RESIDENTIAL CUSTOMERS BY INCOME LEVEL

Household Income	Current Average Telephone Bill (Local + Long Distance)	New Average Telephone Bill with 3.4% surcharge and 13% long distance reduction	Average Monthly Telephone Bill Reductions
Less than $10,000 (8% of customers)	$47.65	$47.33	(32¢)
$10,000 – $29,999 (32% of customers)	$51.10	$50.67	(43¢)
$30,000 - $59,999 (30% of customers)	$58.49	$57.89	(60¢)
More than $60,000 (30% of customers)	$67.56	$66.68	(88¢)
National Average	$57.09	$56.49	(60¢)

Thus, the PNR survey data suggest that residential customers with annual incomes less than $10,000 would see their average monthly telephone bills *decrease* by about 32¢ a month. Not only low-income customers would benefit, but *every* income group would see an average bill *decrease* as a result of GTE's proposal. *In aggregate, the average residential monthly bill would decrease by about 60¢ under GTE's proposal.*

The impact on customers depends, of course, on their actual long distance usage and their average local telephone bill. But, in today's world, few customers have no long distance usage. The table below shows the local and long distance usage for various customer groups by their total monthly bill.

TABLE 2: IMPACT OF A 3.4% SURCHARGE ON RESIDENTIAL CUSTOMERS BY MONTHLY BILL

Monthly Bill Size (% of customers)	Local Portion of Total Bill	Long Distance Portion of Total Bill	Current Average Total Bill	Proposed Average Total Bill w/ 3.4% Surcharge and 13% Long Distance Reduction	Average Monthly Change
Very Small < $25.51 (15%)	$17.04	$3.98	$21.02	$21.32	30¢
Medium $25.51-35.82 (19%)	$24.28	$8.14	$32.42	$32.71	29¢
Medium $35.82-48.89 (20%)	$29.01	$14.61	$43.62	$43.67	5¢
Medium $48.89-70.21 (22%)	$35.21	$24.44	$59.65	$59.32	(33¢)
Large > $70.21 (24%)	$47.73	$65.04	$112.77	$110.44	($2.33)
Average (100%)	$30.65	$26.44	$57.09	$56.46	(60¢)

Some customers with the least amount of long distance usage would see a small monthly increase. But in the worst case – the class of customers with very small amounts of long distance usage – the impact of GTE's proposal would average only 30 cents per month. And it is important to remember that these are the same customers who could be hurt most if regulators fail to adopt universal service reform.

The analysis shown in the tables above is an extremely conservative picture of the benefits of GTE's proposal, for two reasons. *First*, the FCC has recently implemented new flat-rated charges, or "PICCs," to long distance carriers. These IXCs, in turn, have passed the charges through to their long-distance customers. For an MCI residential customer, for example, this charge is $1.07 per month – *regardless* of whether the customer actually makes any long-distance calls. GTE's proposal would make it possible to eliminate these charges. The effect of

this is not considered in the tables. Thus, if you were an MCI customer in the "very small" usage category in Table 2, your bill would increase by 30 cents, but this would be more than offset by the elimination of the $1.07 monthly flat charge from your bill. *Second*, lower long distance prices would allow customers to make, and benefit from, more long distance calls – about $3 billion worth per year.

In sum, there is no economic reason why public policy makers should shrink from adopting a new, explicit universal service fund that is sufficient to do the job. Rather than asking how long we can jury-rig the old, inefficient system, policy makers should be moving ahead to adopt a new approach that will produce a wide range of benefits for consumers. GTE's plan accomplishes these objectives.

How would competitive bidding determine USF support?

The method of determining universal service subsidies described above – comparing cost estimates to a sliding scale of benchmarks – *should be used only once*, to establish an *initial* level of support. Going forward, GTE proposes that a process of competitive bidding would provide a more market-based approach to determining subsidy levels. As new carriers enter local markets, and wish to become universal service providers, GTE's proposal would allow them to initiate a bidding process for the areas they wish to serve. The results of the bidding would supersede the initial subsidy arrangements produced using cost models and benchmarks.

Competitive bidding would put an end to debates about cost models and revenue estimates. Instead, each bidder would base its bid on its own best estimate of costs and revenues – and any other factors the bidders find relevant. Competitive bidding is the method government agencies normally use when they purchase goods and services, to ensure that the public gets the best possible deal. Why shouldn't the same approach be used when we hire firms to provide universal service? Bidding would provide market discipline for incumbent telephone companies, for new competitive carriers, and for regulators as well.

Auctions would provide a "safety valve" to correct possible errors in the initial level of support. Such errors are likely to occur, given the vagaries of the available cost models. Over time, auctions would also automatically take into account changes in costs, in technology, and in the definition of universal service. Without auctions, these changes would require regulators to develop new cost models every year or two – with all of the debates and uncertainty that would entail. Competitive bidding would allow regulators to move away from traditional regulation, and rely more heavily on market forces, as the Telecom Act intended. Moving the determination

of the universal service out of the hearing room and the courtroom, and into the marketplace, can only work to the advantage of America's consumers.

If you want to know more about universal service auctions, visit www.digitalrelease.com and enter "phone solutions" in the search engine.

What about support for schools and libraries?

Finally, we should clarify the difference between the need to retool the universal service plan and the Act's requirements to bring advanced telecommunications services to America's schools and libraries. It would be ill-advised to concentrate solely on serving schools and libraries, at the risk of endangering phone service to the families of students. There are ways to fund the needs of schools and libraries without affecting affordable service to families. In fact, there is a solution being considered in Congress that would require no new funding.

In the Telecom Act, Congress intended for schools and libraries to receive a discount on "advanced telecommunications services." GTE supports the overall objectives of this program. A common thread running through many of GTE's corporate grants and community support programs is information technology, which plays a critical role in accelerating learning and preparing students for the 21st century. But we have significant objections to how the FCC has implemented the program.

In its universal service order, the FCC created an annual $2.5 billion program to be funded by higher business and multi-line access fees. The Commission also expanded the definition of the qualifying services to include items such as wiring, computers, software, teacher training, and presumably, even the new walls needed to accommodate the new wiring. Not only is the scope excessive, but the funds would be directed to firms that have paid nothing to support the program.

Recently, the FCC scaled back the program budget and more narrowly defined the qualifying services. But GTE still believes the FCC's implementation goes far beyond what Congress intended.

Congress is developing a solution that meets the needs of the education community and eliminates the excesses of the FCC's plan. Louisiana Congressman W. J. "Billy" Tauzin has proposed halving the current 3% federal excise tax on telecommunications services and using the remaining revenue to fund the schools and libraries program.

There are many advantages to this proposal:

- It adequately addresses the education needs that Congress envisioned;
- Lawmakers can size the amount of the tax cut to fund whatever services are necessary for the program; and,
- By cutting the current excise tax, consumers and businesses also would realize immediate savings on telecommunications services.

But the major objective of policy makers should be to solve the funding issue for universal service to high-cost areas. Unless this is done properly, universal service throughout this country will be jeopardized in the 21st century.