

Before The
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

EX PARTE OR LATE FILED

In the Matter of)
)
)

Forward-Looking Mechanism)
for High Cost Support for)
Non-Rural LECs)

To: Common Carrier Bureau

CC Docket Nos. 96-45/97-160
DA 98-1055
APD No. 98-1

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

**EX PARTE COMMENTS OF THE ASOCIACION DE PROVEEDORES
COMPETITIVOS DE TELECOMUNICACIONES, INC.**

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TABLE OF CONTENTS

| | <u>PAGE NO.</u> |
|--|-----------------|
| SUMMARY | i |
| BACKGROUND | 2 |
| I. APCT Supports A Conditioned Extension Of Time Before Fully Implementing A New Universal Service Support Model In Puerto Rico | 5 |
| II. The PRTRB's Proposed Wholesale Use Of A BCPM Universal Service Support Model Must Be Rejected | 11 |
| A. The PRTRB's Universal Service Model Submission Should Be Rejected Because It Is Not Based Upon A Forward-Looking Economic Cost Study | 12 |
| B. The PRTRB's Universal Service Model Submission Should Be Rejected Because It Adopts A Model In Its Entirety Which The Commission Rejected As Inadequate | 15 |
| III. The Input Values Used In The PRTRB's Proposed Model Cannot Be Defended | 18 |
| A. Forward-Looking Versus Embedded Costs | 19 |
| B. Expense Levels | 22 |
| C. Density | 22 |
| D. Cost of Capital | 23 |
| E. HM 5.0a and Puerto Rico | 24 |
| CONCLUSION | 25 |

Summary

The Asociacion de Proveedores Competitivos de Telecomunicaciones, Inc. ("APCT") submits *ex parte* comments in connection with the universal service support model submitted by the Puerto Rico Telecommunications Regulatory Board (the "PRTRB") on May 26, 1998 and the request by the PRTRB to defer applicability of a forward looking economic cost model for determining universal service fund support in Puerto Rico for three years. APCT files these *ex parte* comments in light of the Commission's recent decision in the Universal Service Fifth Report and Order.

APCT supports the efforts of the PRTRB and PRTC to extend the date of applicability of a forward-looking economic cost universal service support model until January 1, 2001, although not for the same reasons proffered by the PRTRB and PRTC. Assuming that PRTC's current universal service subsidies total around \$140 million, and 25 percent is supported by the federal universal service fund, the government of Puerto Rico would have to impose over \$100 million in local universal service contributions to make up the shortfall. This would call for a tax of approximately 11 percent on all intrastate Puerto Rico telecommunications revenues, and a total tax of over 16 percent including federal and local universal service contributions. This regressive tax will be a huge entry and operational barrier for competitive carriers in Puerto Rico and could price many telecommunications services out of reach of thousands of consumers.

PRTC would have little incentive to pass these costs on to customers as long as their subsidies remain intact, but competitive carriers will have no choice but to pass the costs along and will suffer from PRTC's distinct price advantage. A flash-cut to the forward-looking methodology would result in the imposition of a local universal service contribution that would cripple competition and create an insurmountable barrier to entry in the Puerto Rico

telecommunications market. Thus, APCT submits that a transition period until January 1, 2001 would be appropriate.

The transition period would also serve another important purpose by allowing the Commission -- or the Commission and the PRTRB together -- time to conduct a regulatory audit of PRTC's operations and books. The reason Puerto Rico finds itself the recipient of such a large amount of federal universal service funding is rooted in PRTC's historic and ongoing inefficiencies and its legacy of cross-subsidization, cost shifting and lack of regulatory accountability within Puerto Rico. As APCT and others have pointed out, the local telecommunications marketplace and regulatory environment in Puerto Rico are characterized by a number of unique factors that are material considerations in determining the timing of the applicability to Puerto Rico of a forward-looking economic cost universal service support mechanism. These factors include (a) the status of PRTC as a government instrumentality operated pursuant to a complex web of cross-subsidization and cost shifting designed to achieve social and political objectives for the 23 years preceding the establishment of the PRTRB; (b) the lack of a regulatory commission in Puerto Rico during the same time period; (c) PRTC's statutory monopoly in local telecommunications during the same time period; and (d) the lack of direct federal regulatory accountability by PRTC during the same time period because of PRTC's participation, as the only Tier 1 LEC to do so, in the National Exchange Carrier Association pools. While technically a rate-of-return LEC at the federal level, PRTC was unregulated at the Commonwealth level thereby making verification of cost allocation and rate decisions virtually impossible.

APCT urges the Commission to attach certain conditions to any extension of the time when a forward-looking economic cost universal service support methodology must be implemented for Puerto Rico.

In short, APCT is concerned that PRTC may not be using the funds that it does receive for the universal service purposes for which they are intended. APCT is unaware of any other federal funding program where the recipient does not have to be accountable for the use of the money. As a result, APCT urges the Commission to condition any extension as follows. As previously stated by APCT, the conditions which should be imposed on PRTC include 1) the elimination of unlawful cross-subsidies; 2) cost-based rates and charges; 3) a "transition period" ending at a definite date -- in this case January 1, 2001; and 4) PRTC should be required to submit quarterly reports.

However, APCT would not support an extension of time for the implementation of a forward-looking economic cost methodology in Puerto Rico if the Commission adopts the Joint Board's recent recommendation to abandon the 25 percent federal/75 percent state universal service funding split and to implement a "hold-harmless" principle that would ensure non-rural carriers, including PRTC, at least as much federal universal service funding from a new support mechanism as they get from the current support mechanism. Under these circumstances, APCT's concern -- the damage to competition wrought by a flash-cut to a forward-looking economic cost universal service methodology -- would have been satisfactorily addressed.

Whether or not an extension of time is granted, the Commission should nonetheless immediately begin a thorough investigation of PRTC's operations to determine the legitimacy of the subsidies it receives. APCT has repeatedly pointed out that there has never been

a regulatory audit of any kind with respect to PRTC's rates and practices and submits that such an audit would reveal glaring inefficiencies. PRTC, as a government-owned entity, does not have to answer to shareholders or an independent board to justify its operating expenses, and it operates with minimal regulatory oversight because the PRTRB lacks the necessary authority to stem PRTC's abuses. Since the PRTRB is limited by law from investigating or setting any cost-based rates for PRTC, it is crucial for the Commission to conduct such an analysis to verify PRTC's current set of books and ensure that the embedded results of past abuses and their anticompetitive consequences are not perpetuated. By conducting a thorough financial analysis of PRTC's current during the transition period, and gaining a clearer picture of Puerto Rico's unique regulatory legacy, the Commission will facilitate a smoother shift to a forward-looking support methodology in the year 2001.

APCT also submits that, regardless of when a forward-looking economic cost methodology is to be implemented in Puerto Rico, the PRTRB's proposed wholesale use of a BCPM universal support model using PRTC's embedded cost data must be rejected because it does not comply with the requirement that the universal service support model be based on a forward-looking economic cost study and it is inconsistent with the Commission's treatment of the BCPM model in the Universal Service Fifth Report and Order.

Regardless of when Puerto Rico is required to implement a forward-looking economic cost universal service model, the PRTRB's universal service model submission should be rejected. First, the PRTRB's submission must be rejected because it is not based upon a forward-looking economic cost study. Use of PRTC's embedded costs only serves to perpetuate the entrenched cost shifting and cross-subsidization. To date, PRTC has not presented the PRTRB with any

forward-looking economic cost study. Nor has the PRTRB conducted such a study itself. Thus, what the PRTRB submitted to the Commission on May 26, 1998 is not what the Universal Service Order contemplated or required.

Second, the PRTRB's universal service model submission should be rejected because it represents the wholesale adoption of a model -- BCPM -- which the Commission has rejected as inadequate as the sole basis for a forward-looking economic cost universal service support mechanism. Third, the PRTRB's universal service model submission should be rejected because the changes it makes to six BCPM input factors are not and cannot be justified.

In short, should the Commission not adopt the recommendations of the Joint Board (which recommendations would guarantee that the federal government will continue to provide the current level of universal service funding in Puerto Rico such that no local Puerto Rico universal service taxes will result), APCT submits that the applicability to Puerto Rico of a forward-looking economic cost universal service support model should be extended until January 1, 2001 in order to prevent a harsh transition which would damage telecommunications competition in Puerto Rico and harm consumers. Any such extension should be conditioned as discussed in these comments and the Commission should conduct a thorough regulatory audit of PRTC's current books to assure proper use and levels of the universal service funding received by PRTC. Moreover, for all the reasons discussed in these comments, the Commission must reject the PRTRB's proposed use of a BCPM universal service support model, its use of PRTC's embedded cost data and the increased values of many of the default inputs.

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To: Common Carrier Bureau

**EX PARTE COMMENTS OF THE ASOCIACION DE PROVEEDORES
COMPETITIVOS DE TELECOMUNICACIONES, INC.**

The Asociacion de Proveedores Competitivos de Telecomunicaciones, Inc. ("APCT"),¹ by its attorneys, herein submits *ex parte* comments in connection with the universal service support model submitted by the Puerto Rico Telecommunications Regulatory Board (the "PRTRB") on May 26, 1998 and the request by the PRTRB to defer applicability of a forward looking economic cost model for determining universal service fund support in Puerto Rico for three years. On June 25, 1998 and July 9, 1998, APCT and others filed comments and reply comments in this matter. APCT files these *ex parte* comments in light of the Commission's recent decision in the Universal Service Fifth Report and Order.²

¹The English translation of the name of APCT is the Association of Competitive Telecommunications Providers, Inc.

²Federal-State Joint Board on Universal Service/Forward-Looking Mechanism for High Cost Support for Non-Rural LECs, Fifth Report and Order, CC Docket Nos. 96-45 and 97-160, FCC 98-279 (rel. Oct 28, 1998) ("Universal Service Fifth Report and Order"). The Commission has also solicited further discussion and evidence regarding input values to be used to estimate forward-looking economic costs (see Public Notice, "Common Carrier Bureau to Hold Three (continued...)

BACKGROUND

In its Universal Service Order,³ the Commission set forth a plan to satisfy the statutory requirements of the Telecommunications Act of 1996 (the “1996 Act”), including the directive that the Commission and the states devise methods to ensure that low-income consumers and consumers in rural, insular, and high cost areas have access to telecommunications services at rates reasonably comparable to rates in urban areas.⁴ In this decision, the Commission rejected the urgings of the Puerto Rico Telephone Company (“PRTC”) that Puerto Rico be treated as a rural area for purposes of the universal service support mechanism:

We do not accept the suggestion of the Puerto Rico Tel. Co., the twelfth largest telephone company in the nation [FN omitted] that non-rural carriers that serve Alaska or insular areas should be treated as rural carriers and allowed to postpone their conversion to the forward-looking economic cost methodology. Puerto Rico Tel. Co. argues that extreme weather and terrain conditions and high shipping costs justify its continued receipt of support based on embedded cost. The Joint Board’s recommendation to postpone application of forward-looking support mechanisms to rural carriers, however, was based on the size of rural carriers and the fact that rural carriers generally serve fewer subscribers and do not benefit from economies of scale and scope as much as non-rural carriers. [FN omitted] Even if they are not classified as rural carriers, non-rural carriers that serve Alaska or insular areas will continue to receive universal service support if their service areas are high cost areas. At the same time, however, large telephone companies such as Puerto Rico Tel. Co. should possess economies of scale and scope to deal efficiently with the cost of providing service in their areas,

²(...continued)

Workshops on Input Values to be Used to Estimate Forward-Looking Economic Costs for Purposes of Universal Service Support,” DA 98-2406 (rel. Nov. 25, 1998)), and APCT herein provides additional information concerning the changes to the input values used in the model submitted by the PRTRB.

³Federal-State Joint Board on Universal Service, Report and Order, 12 FCC Rcd 8776 (1997) (“Universal Service Order”).

⁴Id. at ¶¶ 1-2.

and thus, the level of that support will be determined through a forward-looking mechanism. Consequently, we agree with the Joint Board that non-rural carriers serving Alaska and insular areas should move to the forward-looking economic cost methodology at the same time as other non-rural carriers. We note, however, that we retain the ability to grant waivers of this requirement in appropriate cases.⁵

On April 22, 1998, the PRTRB submitted a letter to the Commission in which it proposed that Puerto Rico be allowed “to postpone conversion to forward-looking support for a transition period of no less than three years.”⁶ On April 27, 1998, PRTC submitted a “proposal” seeking a postponement until January 1, 2001 of the implementation of a forward-looking economic cost universal service methodology for non-rural carriers serving insular areas.⁷

In the Universal Service Order, the Commission announced that a state could submit its own forward-looking cost study to be used in lieu of the federal methodology for computation of the universal service amount for that state.⁸ The Commission went on to set forth ten criteria that such studies must meet in order to supplant the federal methodology.⁹ On May 26, 1998, while stating that it was “submit[ting] this report with misgivings,”¹⁰ the PRTRB was among 12 state

⁵Id. at ¶ 315.

⁶See Letter from Phoebe Forsythe Isales, President, PRTRB, to William E. Kennard regarding “Proposed Transition Plan for Universal Service Ex Parte Communication; CC Docket 96-45” (dated Apr. 22, 1998) (“April 1998 PRTRB Proposal”).

⁷See “Proposal of Puerto Rico Telephone Company,” CC Docket Nos. 96-45 and 97-160 and DA 98-175 (filed Apr. 27, 1998) (“April 1998 PRTC Proposal”).

⁸Universal Service Order at ¶ 248.

⁹Id. at 250.

¹⁰See Letter from Phoebe Forsythe Isales, President, PRTRB, to FCC Common Carrier Bureau (dated May 8, 1998 but received by FCC Secretary May 26, 1998) (“May 1998 PRTRB
(continued...)”) (continued...)

commissions that submitted its own “forward-looking cost study” to be used in lieu of the federal methodology in the case of its state.¹¹ The model submitted by the PRTRB uses the Benchmark Cost Proxy Model (“BCPM”) as its methodology but makes six types of input changes to the BCPM default values.¹² Comments and reply comments were filed on June 25, 1998 and July 9, 1998.

On October 28, 1998, the Commission released its Universal Service Fifth Report and Order in which it adopted a federal methodology which is a hybrid of the models proposed by the industry, namely, BCPM and the HAI Model, and the model developed by Commission staff members, the Hybrid Cost Proxy Model (“HCPM”).¹³ In footnote 46 of that decision, the Commission stated:

1. In the *Universal Service Order*, the Commission rejected the suggestion of Puerto Rico Telephone Co. (PRTC) that non-rural carriers serving insular areas should be treated in the same manner as rural carriers and allowed to postpone their conversion to the forward-looking economic cost methodology. See *Universal Service Order*, 12 FCC Rcd at 8946, para. 315. The Telecommunications Regulatory Board of Puerto Rico has requested the

¹⁰(...continued)
Model Selection”).

¹¹See Public Notice “Common Carrier Bureau Seeks Comment on State Forward-Looking Cost Studies for Universal Service Support,” CC Docket Nos. 96-45, 97-160; APD No. 98-1, DA 98-1055 (rel. June 4, 1998). On July 2, 1998 APCT petitioned the PRTRB to withdraw the cost model submitted to the FCC because, *inter alia*, the model was prepared by the PRTRB without adherence to the requirements for administrative proceedings and without allowing telecommunications companies to make informed comments on the determination as required by relevant statutes and regulations. On July 10, 1998 the PRTRB denied that petition. On November 2, 1998 APCT filed an appeal of the order denying the petition, which remains pending before the Court of Appeals for Regional Circuit I in Puerto Rico.

¹²May 1998 PRTRB Model Selection at 1.

¹³Universal Service Fifth Report and Order at ¶¶ 3-4.

Commission to delay conversion to a forward-looking cost mechanism in Puerto Rico for a transition period "of no less than three years." *See* Letter from Phoebe Forsythe Isales, Telecommunications Regulatory Board of Puerto Rico, to William Kennard, FCC, dated April 22, 1998 at 2. The Commission does not address this issue today but intends to review the record and make a determination at a later date.¹⁴

In these *ex parte* comments, APCT will address the issues raised in this proceeding as they pertain to Puerto Rico in light of the Commission's Universal Service Fifth Report and Order and will provide additional information concerning the changes to the input values used in the model submitted by the PRTRB.

DISCUSSION

I. APCT Supports A Conditioned Extension Of Time Before Fully Implementing A New Universal Service Support Model In Puerto Rico.

APCT supports the efforts of the PRTRB and PRTC to extend the date of applicability of a forward-looking economic cost universal service support model until January 1, 2001, although not for the same reasons proffered by the PRTRB and PRTC. APCT urges the Commission to attach certain conditions to any extension of the time when a forward-looking economic cost universal service support methodology must be implemented for Puerto Rico. However, the PRTRB's proposed wholesale use of a BCPM universal support model using PRTC's embedded cost data must be rejected because it does not comply with the requirement that the universal service support model be based on a forward-looking economic cost study and it is inconsistent with the Commission's treatment of the BCPM model in the Universal Service Fifth Report and Order.

¹⁴*Id.* at ¶ 19, n.46.

Puerto Rico is set to receive approximately \$140 million or 55 percent of the total \$253 million in federal universal support for non-rural carriers in high-cost areas for 1998.¹⁵ As the primary if not sole recipient of those funds, PRTC has fought valiantly to maintain the current methodology -- which is based on PRTC's embedded costs -- for as long as possible, first by seeking treatment of Puerto Rico as a rural area in order to delay implementation of a forward-looking economic cost methodology until January 1, 2001 and, having been rebuffed, by seeking the same treatment for insular areas as afforded rural areas.¹⁶

The Commission properly rejected PRTC's effort to have the Commission treat Puerto Rico as a rural area¹⁷ and, for similar reasons, it should reject PRTC's April 27, 1998 effort to have insular areas effectively treated as rural areas for purposes of federal universal service support. On April 22, 1998, the PRTRB also asked for a delay of at least three years before the implementation of a forward-looking economic cost mechanism with respect to Puerto Rico, because, inter alia, the PRTRB believes there is uncertainty surrounding the accuracy of the proxy cost models for Puerto Rico, there is inaccurate census information regarding the location of residences and business in Puerto Rico, and because a reduction in funding would have a severe impact on Puerto Rico's penetration rate, which is already the lowest in the nation.¹⁸

¹⁵See Universal Service Fifth Report and Order, Statement of Commissioner Harold Furchtgott-Roth at 2.

¹⁶See April 1998 PRTC Proposal; Universal Service Order at ¶ 315.

¹⁷Universal Service Order at ¶ 315.

¹⁸See April 1998 PRTRB Proposal at 1-3.

Although it disagrees with the reasons tendered by the PRTRB and PRTC, APCT believes that an extension of time is warranted before implementing a new universal service support mechanism in Puerto Rico because of the effect a flash-cut to a forward-looking economic cost universal service methodology would have on the local universal service funding requirements and, in turn, on telecommunications competition in Puerto Rico.¹⁹ Assuming that PRTC's subsidies total around \$140 million, and 25 percent is supported by the federal universal service fund, the government of Puerto Rico would have to impose over \$100 million in local universal service contributions to make up the shortfall. This would call for a tax of approximately 11 percent on all intrastate Puerto Rico telecommunications revenues, and a total tax of over 16 percent including federal and local universal service contributions.²⁰ This regressive tax will be a huge entry and operational barrier for competitive carriers in Puerto Rico and could price many telecommunications services out of reach of thousands of consumers.

PRTC would have little incentive to pass these costs on to customers as long as their subsidies remain intact, but competitive carriers will have no choice but to pass the costs along and will suffer from PRTC's distinct price advantage. A flash-cut to the forward-looking methodology would result in the imposition of a local universal service contribution that would cripple competition and create an insurmountable barrier to entry in the Puerto Rico

¹⁹For example, the PRTRB's argument that census information may be inaccurate is a concern shared by many states with respect to data in their own states. There is no more uncertainty about census accuracy in Puerto Rico than in any state, and this would not justify an extension.

²⁰See In the Matter of Proposal to Revise the Methodology of Determining Universal Service Support, CC Docket Nos. 96-45 and 97-160, Comments of Celpage, Inc. (filed May 15, 1998) at 3. The 25 percent federal/75 percent state share of universal service support under the forward-looking economic cost model is set forth in the Universal Service Order at ¶¶ 268-272.

telecommunications market. Thus, APCT submits that a transition period until January 1, 2001 would be appropriate.

The transition period would also serve another important purpose by allowing the Commission -- or the Commission and the PRTRB together -- time to conduct a regulatory audit of PRTC's operations and books. The reason Puerto Rico finds itself the recipient of such a large amount of federal universal service funding is rooted in PRTC's historic and ongoing inefficiencies and its legacy of cross-subsidization, cost shifting and lack of regulatory accountability within Puerto Rico. As APCT and others have pointed out,²¹ the local telecommunications marketplace and regulatory environment in Puerto Rico are characterized by a number of unique factors that are material considerations in determining the timing of the applicability to Puerto Rico of a forward-looking economic cost universal service support mechanism. These factors include (a) the status of PRTC as a government instrumentality operated pursuant to a complex web of cross-subsidization and cost shifting designed to achieve social and political objectives for the 23 years preceding the establishment of the PRTRB; (b) the lack of a regulatory commission in Puerto Rico during the same time period; (c) PRTC's statutory monopoly in local telecommunications during the same time period; and (d) the lack of direct federal regulatory accountability by PRTC during the same time period because of PRTC's participation, as the only Tier 1 LEC to do so, in the National Exchange Carrier Association pools. While technically a rate-of-return LEC at the federal level, PRTC was unregulated at the

²¹See, e.g., In the Matter of State Forward Looking Cost Studies for Determining Universal Service Support, CC Docket Nos. 96-45 and 97-160, DA 98-1055, APD No. 98-1 Comments of Cellular Communications of Puerto Rico, Inc., Comments of Celpage, Inc., and Comments of Centennial Cellular Corp. (each filed June 25, 1998).

Commonwealth level thereby making verification of cost allocation and rate decisions virtually impossible.

Indeed, whether or not an extension of time is granted, the Commission should nonetheless immediately begin a thorough investigation of PRTC's operations to determine the legitimacy of the subsidies it receives. APCT has repeatedly pointed out that there has never been a regulatory audit of any kind with respect to PRTC's rates and practices and submits that such an audit would reveal glaring inefficiencies. PRTC, as a government-owned entity, does not have to answer to shareholders or an independent board to justify its operating expenses, and it operates with minimal regulatory oversight because the PRTRB lacks the necessary authority to stem PRTC's abuses.²² Since the PRTRB is limited by law from investigating or setting any cost-based rates for PRTC, it is crucial for the Commission to conduct such an analysis. By conducting a thorough financial analysis of PRTC during the transition period, and gaining a clearer picture of Puerto Rico's unique regulatory legacy, the Commission will facilitate a smoother shift to a forward-looking support methodology in the year 2001.

Although the proposed privatization of PRTC -- effected by the pending sale to GTE -- may prospectively alleviate certain concerns, the real purpose of an audit is to verify PRTC's current set of books and ensure that the embedded results of past abuses and their anticompetitive

²²See e.g. a recent article in the San Juan Star, in which the head of the PRTRB, Phoebe Forsythe Isales, admitted that the PRTRB is a "new" entity that may need more power under the law, but that "the only one that has the ability of revising the law that created the board is the Legislature." Michelle Kantrow Vazquez, "Telecom Regulatory Board lobbying to augment authority," San Juan Star, Nov. 16, 1998 at 40. Even after the prospective purchase of PRTC by GTE, the government of Puerto Rico would have significant continuing involvement as it would retain a 46 percent stake in PRTC. See Application for Transfers of Control filed by PRTC and GTE on July 24, 1998 at 4.

consequences are not perpetuated. The fact that GTE will assume control makes it even more important that the audit take place. In order to provide a satisfactory baseline, this audit must be performed prior to the required conversion of GTE/PRTC to price cap regulation.²³

In short, APCT is concerned that PRTC may not be using the funds that it does receive for the universal service purposes for which they are intended. APCT is unaware of any other federal funding program where the recipient does not have to be accountable for the use of the money. As a result, APCT urges the Commission to condition any extension as follows. As previously stated by APCT, the conditions which should be imposed on PRTC include 1) the elimination of unlawful cross-subsidies; 2) cost-based rates and charges; 3) a "transition period" ending at a definite date -- in this case January 1, 2001; and 4) PRTC should be required to submit quarterly reports.²⁴ The Commission should allow PRTC to continue to receive existing universal service supports until January 1, 2001 because, due to decades of government ownership, unlawful cross-subsidies, and lack of independent regulatory oversight, PRTC will not be able to maintain service in Puerto Rico at acceptable rates if it must rely on the proposed proxy models. Even though continuing to fund PRTC at current federal levels would reward PRTC for its

²³The Commission's rules require that when a price cap regulated carrier, such as GTE, assumes control of a rate of return carrier, such as PRTC, the controlled carrier must convert to a price cap status within one year. 47 C.F.R. § 61.41(c)(2). As PRTC prepares for this conversion, the Commission must ensure that PRTC's interstate rate base accurately reflects the costs that are properly allocable to the interstate jurisdiction.

²⁴See In the Matter of Proposal to Revise the Methodology of Determining Universal Service Support, CC Docket Nos. 96-45 and 97-160, Comments of APCT (filed May 15, 1998) ("May 1998 APCT Comments") and Reply Comments of APCT (filed May 29, 1998). See also In the Matter of State Forward-Looking Cost Studies for Universal Service Support, CC Docket Nos. 96-45 and 97-160; DA 98-1055; APD No. 98-1, Comments of APCT (filed June 25, 1998) at 2-3.

inefficient and anticompetitive behavior, sudden elimination of the subsidies given to PRTC would wreak financial havoc on competitive telecommunications carriers and their customers in Puerto Rico. Accordingly, PRTC must be made accountable for its use of universal service support even during the transition period.

APCT is aware of the Joint Board's recent recommendation which, if adopted by the Commission, will abandon the 25 percent federal/75 percent state universal service funding split.²⁵ The Joint Board also recommended a "hold-harmless" principle that would ensure non-rural carriers, including PRTC, at least as much federal universal service funding from a new support mechanism as they get from the current support mechanism.²⁶ Under these circumstances, APCT's concern -- the damage to competition wrought by a flash-cut to a forward-looking economic cost universal service methodology -- would have been satisfactorily addressed. Therefore, APCT would not support an extension of time for the implementation of a forward-looking economic cost methodology in Puerto Rico if it is guaranteed that the federal government will continue to provide the current level of universal service funding in Puerto Rico and that there will be no local Puerto Rico universal service taxes.

II. The PRTRB's Proposed Wholesale Use Of A BCPM Universal Service Support Model Must Be Rejected.

Whether a forward-looking economic cost methodology is implemented now or on January 1, 2001, the universal service support model chosen by the PRTRB is inadequate.

²⁵See In the Matter of Federal-State Joint Board on Universal Service, Second Recommended Decision, CC Docket No. 96-45, FCC 98J-7 at ¶ 4 (rel. Nov. 25, 1998).

²⁶Id. at ¶¶ 51-53

A. The PRTRB's Universal Service Model Submission Should Be Rejected Because It Is Not Based Upon A Forward-Looking Economic Cost Study

In its Universal Service Fifth Report and Order, the Commission adopted a model platform to estimate the cost of providing supported services by examining the aspects of the model that are essentially fixed -- such as assumptions about the design of the network and network engineering and fixed characteristics such as soil and terrain -- and leaving for later determination a selection of various inputs for the model.²⁷ In the Universal Service Order, the Commission provided the states with an opportunity to submit forward-looking economic cost studies for use in calculating federal support for non-rural eligible telecommunications carriers, rural, insular and high cost areas to be distributed beginning January 1, 1999.²⁸ The Commission explained the cost studies to be submitted by interested states as follows:

We believe that the states can provide valuable assistance in our efforts to determine the cost of providing service in their areas because the states have been reviewing cost studies for several years and most recently have been reviewing forward-looking economic cost studies in the context of local interconnection, unbundling, and resale arbitrations and in the review of statements of generally available terms and conditions.²⁹

* * *

We affirm our belief, however, that the underlying state-conducted cost studies can be an appropriate basis upon which to determine the cost of providing universal service. We also affirm that state-conducted cost studies have the advantage of permitting states to coordinate the basis for pricing unbundled network elements and determining universal service support. This coordination can improve regulatory consistency and avoid such marketplace distortions as unbundled network element cost calculations unequal to

²⁷Universal Service Fifth Report and Order at ¶ 2.

²⁸Universal Service Order at ¶ 248.

²⁹Id. at ¶ 247.

universal service cost calculations for the elements that provide supported services. Such marketplace distortions may generate unintended and inefficient arbitrage opportunities. Thus, it is reasonable for the Commission to rely on this work by a state in determining federal universal service support for rural, insular, and high cost areas.³⁰

Therefore, as the basis for calculating federal universal service support in their states, we will use forward-looking economic cost studies conducted by state commissions that choose to submit such cost studies to determine universal service support. As discussed further below, we today adopt criteria appropriate for determining federal universal service support to guide the states as they conduct those studies.³¹

It is clear that the reason the Commission thought state-conducted cost studies would be useful in determining federal universal service was because “states have been reviewing cost studies for several years and most recently have been reviewing forward-looking economic cost studies in the context of local interconnection, unbundling, and resale arbitrations and in the review of statements of generally available terms and conditions.”

However, the PRTRB has not been reviewing cost studies for several years and it has not been “reviewing forward-looking economic cost studies in the context of local interconnection, unbundling, and resale arbitrations and in the review of statements of generally available terms and conditions.” As the Commission is aware, Puerto Rico had no regulatory commission at all until 1997 and in the brief time that the PRTRB has been operational, it has not been presented with a forward-looking economic cost study by PRTC. The rates in the interconnection agreements that PRTC has entered into pursuant to arbitration procedures are not

³⁰Id.

³¹Id. at ¶ 248.

based on a forward-looking economic cost study.³² They are based on PRTC's actual embedded costs.³³ In interpreting the cost standard contained in Section 252(d)(2) of the Communications Act of 1934, as amended (the "Act"), in the Centennial Arbitration, PRTC took a position contrary to that of the Commission when it argued that the cost standard for transport and termination of traffic should not require a forward-looking economic cost methodology. Instead, PRTC used a cost study based on its actual embedded costs because, in its view, forward-looking costs are not verifiable.³⁴ When faced with a choice between the use of the Commission's default values and rates derived from PRTC's embedded actual costs, the PRTRB opted for the latter because in its view PRTC's embedded costs at least are Puerto Rico specific.

Now, the PRTRB seeks to use that same embedded cost study in a universal service model that is explicitly required to be based on a forward-looking economic cost study.³⁵ On this

³²See, e.g., Petition of Centennial Cellular Corp. for Arbitration Pursuant to 47 U.S.C. § 252(b) and the Telecommunications Law of Puerto Rico, Chap. III, Art. 5(b), PRTRB File Nos. 96-2 and 97-1 (the "Centennial Arbitration").

³³See id.

³⁴See Testimony of David C. Blessing on behalf of PRTC, Centennial Arbitration, at 31 ("Since PRTC's actual costs are readily available, the need for a proxy model to estimate them is negated") and also at 48 ("the studies presented by PRTC are cost-based and use the best available data -- actual cost data from PRTC. . . . I disagree with the FCC that hypothetical forward-looking investment and cost data should be used in these studies. Theoretically, actual data are always superior to hypothetical data, and . . . it is clear that the actual cost data used in PRTC's studies is the most appropriate.").

³⁵See May 1998 PRTRB Model Selection. See Universal Service Fifth Report and Order at ¶ 228 ("embedded costs provide the wrong signals to potential entrants and existing carriers. The use of embedded cost would discourage prudent investment planning because carriers could receive support for inefficient as well as efficient investment. . . . Consequently, we agree with the Joint Board's conclusion that support based on embedded cost could jeopardize the provision of universal service.").

basis alone, the PRTRB's universal service model submission should be rejected. Use of PRTC's embedded costs only serves to perpetuate the entrenched cost shifting and cross-subsidization. To date, PRTC has not presented the PRTRB with any forward-looking economic cost study. Nor has the PRTRB conducted such a study itself. Thus, what the PRTRB submitted to the Commission on May 26, 1998 is not what the Universal Service Order contemplated or required.

B. The PRTRB's Universal Service Model Submission Should Be Rejected Because It Adopts A Model In Its Entirety Which The Commission Rejected As Inadequate.

In adopting a federal universal service model, the Commission was required to develop a model that complied with the ten criteria which were set out in the Universal Service Order.³⁶ Both the Commission adopted platform and the state submissions were required to meet these criteria.³⁷ In the Universal Service Fifth Report and Order, the Commission found the BCPM model, which was chosen by PRTRB, to be inadequate.

In this Order we adopt neither the HAI model, which had been proposed by AT&T and MCI, nor the BCPM model, which was sponsored by US West, BellSouth and Sprint, as submitted. Neither of these models permitted the Commission to adopt a framework or platform that would estimate the cost of building a telephone network to the subscriber's actual geographical location, taking into account the actual clustering of customers groupings such as neighborhoods and towns. Neither model, as submitted, sufficiently allows the Commission to vary engineering assumptions to account for the fact that, by statute, universal service is an "evolving concept." We also do

³⁶Universal Service Order at ¶ 250 ("Whether forward-looking economic cost is determined according to a state-conducted cost study or a Commission-determined methodology, we must prescribe certain criteria to ensure consistency in calculations of federal universal service support.")

³⁷Id. ("Consistent with the eight criteria set out in the Joint Board recommendation, [fn omitted] we agree that all methodologies used to calculate the forward-looking economic cost of providing universal service in rural, insular and high cost areas must meet the following criteria . . .") (emphasis added).

not adopt, in its entirety, the HCPM which had been developed by Commission staff.³⁸

The PRTRB adopted the BCPM model in its entirety although it made six types of input changes. In view of the Universal Service Fifth Report and Order, the Commission must reject the BCPM model proposed by the PRTRB for the following reasons:

The Commission concluded “that the federal mechanism should use a clustering methodology, rather than a grid-based methodology, to determine serving areas.”³⁹ In so doing, the Commission rejected the BCPM grid-based algorithm as not “reflect[ing] the most cost-effective method of distributing customers into serving areas.”⁴⁰

As stated by the Commission, “[i]n designing outside plant, a model will most fully comply with the Universal Service Order’s criteria if it designs a network that reflects as accurately as possible the available data on customer locations, adheres to sound engineering and forward-looking, cost-minimizing principles, and does not impede the provision of advanced services.”⁴¹ That model, according to the Commission, is not BCPM.⁴² With respect to customer location, the BCPM model was found to have infirmities because, “by relocating customers so as to distribute them uniformly in square or rectangular distribution areas, [BCPM] create[s] an apparent systematic downward bias in the required amount of distribution plant that is

³⁸Universal Service Fifth Report and Order at ¶ 3.

³⁹Id. at ¶ 46.

⁴⁰Id.

⁴¹Id. at ¶ 54.

⁴²Id. at ¶¶ 54, 60.

constructed in less dense areas.”⁴³ With respect to cost minimization, the Commission also rejected BCPM, noting that BCPM would not “recompute the type of technology deployed in response to a change in relative input prices, a key feature of ensuring that costs are minimized, subject to technological and service quality constraints.”⁴⁴

In making a determination concerning the maximum loop length that the federal mechanism should permit, the Commission examined “whether the models use the least-cost, most efficient, and reasonable technology while not impeding the provision of advanced services.”⁴⁵ The maximum copper length, at which carriers will use fiber instead of copper wire, will affect the model’s cost estimates because a longer loop length will permit more customers to be served from a single digital loop carrier remote terminal (“DLC”) and reducing the number of DLCs tends to reduce the overall cost. The Commission rejected the maximum copper length in the BCPM model as “burdening the federal universal service support mechanism with the additional cost necessary to support a network that is capable of delivering very advanced services, to which only a small portion of customers currently subscribe.”⁴⁶

Even as to areas where BCPM was not expressly found to be insufficient, the Commission chose the HAI model over BCPM. For example, the Commission found that the HAI model “employs a more reliable method of assigning an associated cost to the network functions or elements, such as switching and signaling, necessary to produce supported

⁴³Id. at ¶¶ 57, 60.

⁴⁴Id. at ¶ 62.

⁴⁵Id. at ¶ 68.

⁴⁶Id. at ¶ 70.

services.”⁴⁷ The Commission found that BCPM does not even provide a signaling function in its switching calculations, and decided to use the HAI Switching and Interoffice Facilities module.⁴⁸ The Commission also decided against using BCPM for computing expenses and general support facilities (“GSF”) because the HAI approach provides practical benefits that outweigh those of using BCPM.⁴⁹

Thus, the PRTRB’s wholesale adoption of the BCPM model must be rejected for the same reasons that the Commission deemed the model inadequate to be adopted in its entirety.

III. The Input Values Used In The PRTRB’s Proposed Model Cannot Be Defended.

In selecting the BCPM model, the PRTRB stated that it “made six types of input changes to the BCPM default values . . . in order to model specifically Puerto Rico’s unique service characteristics.”⁵⁰ Those six changes, which were merely listed and not supported, are: 1) decrease the percentage of ARMIS local calls versus toll calls; 2) increase the percentage of residence lines versus business lines; 3) increase the percentage allocation of the DMS switch; 4) decrease the minimum number of cable pairs per business location; 5) alter the variables used in the support table ratios; 6) generally increase the variables used as to the per line monthly operating expenses for small, medium and large companies.⁵¹

⁴⁷Id. at ¶ 79

⁴⁸Id.

⁴⁹Id. at ¶ 91.

⁵⁰May 1998 PRTRB Model Selection at 1.

⁵¹Id. at 1-3.

On June 25, 1998, APCT commented on the proposed model filed by the PRTRB and attached the declaration of economist A. Daniel Kelley (the “June 1998 Kelley Declaration”). According to Dr. Kelley, the PRTRB model has “several fundamental flaws” because the PRTRB “used embedded rather than forward-looking expenses,” and because “[t]he ‘unique service characteristics’ of Puerto Rico do not justify the use of either the BCPM defaults or the full embedded costs used by the PRTRB.”⁵² Dr. Kelley noted that the PRTRB modified the BCPM model by increasing the values of many of the default BCPM inputs with the result that Puerto Rico would receive a subsidy of \$190,972,908.00.⁵³

Attached hereto is another declaration of Dr. Kelley (the “December 1998 Kelley Declaration”) which addresses the input values of the PRTRB proposed model in light of the subsequent defense of these values by the PRTRB and PRTC. Dr. Kelley stands by his earlier conclusion that the model submitted by the PRTRB generates unreasonable results and that the modest ten percent reduction to embedded costs levels made by the PRTRB for purposes of running the BCPM still leaves the inputs substantially higher than embedded costs for other telephone companies.⁵⁴

A. Forward-Looking Versus Embedded Costs

The June 1998 Kelley Declaration concluded that “it is simply implausible that a forward-looking study could result in a subsidy requirement that is higher than the current

⁵²June 1998 Kelley Declaration at 1.

⁵³Id.

⁵⁴December 1998 Kelley Declaration at 1.

requirement, which has always been based on embedded costs.”⁵⁵ The PRTRB took issue with this conclusion citing the “. . . possibility that forward-looking results can be higher than embedded results.”⁵⁶ The possibility that forward-looking costs may be higher than embedded costs for certain local telephone company cost components in no way demonstrates that embedded costs for the company as a whole are lower than forward-looking costs in this instance.⁵⁷

The PRTRB’s example that equip, furnish and install (“EFI”) costs for new outside plant equipment and cables can be higher than the actual installation cost for equipment placed into service over decades does not tell the whole story. Although wage rates are higher today, substantial advances have been made in installation techniques. Instead of labor-intensive installation, sophisticated new trenching tools are being used with the overall result that installation costs have fallen in recent years.⁵⁸ Moreover, as the EFI acronym suggests, installation costs are only one component of the total cost of outside plant, and telecommunications equipment costs are generally falling.⁵⁹

The June 1998 Kelley Declaration shows that embedded costs in Puerto Rico are much higher than embedded costs in the U.S., both on average and for companies that might be

⁵⁵June 1998 Kelley Declaration at 8.

⁵⁶Reply Comments of PRTRB (filed July 9, 1998) (“PRTRB Reply Comments”) at 4.

⁵⁷December 1998 Kelley Declaration at 2.

⁵⁸Id.

⁵⁹Id.

considered comparable.⁶⁰ The May 1998 PRTRB Model Selection, replaces BCPM default values with PRTC's embedded costs and reduces those costs by ten percent.⁶¹ There are several problems with PRTRB's model. First, as discussed above, the proposed model should not have used embedded costs. Second, the PRTRB states that input values were changed because of "Puerto Rico's unique service characteristics,"⁶² but fails to substantiate those "unique" characteristics or to otherwise justify embedded costs that are higher than the costs generated by other telephone companies. Third, PRTRB arbitrarily reduces PRTC's embedded costs by ten percent, again, without even attempting to explain its reasoning. Thus, the PRTRB's proposed model is entirely superficial.

The modest ten percent adjustment factor that the PRTRB applied does not change the conclusion that the costs used by the PRTRB exceed embedded costs for almost every other telephone company. Economic and technical analysis on the part of the PRTRB is required to explain why any unique characteristics result in higher costs, and some economic basis must be provided by the PRTRB for assuming that a ten percent reduction in those excessive costs is an adequate way to estimate forward-looking costs.⁶³

⁶⁰June 1998 Kelley Declaration at 5-7.

⁶¹See May 1998 PRTRB Model Selection at 2; PRTRB Reply Comments at 5.

⁶²May 1998 PRTRB Model Selection at 1.

⁶³December 1998 Kelley Declaration at 3.

B. Expense Levels

The PRTRB claims that the default expense ratios in the BCPM “. . . are themselves simply an average of embedded costs from selected RBOCS.”⁶⁴ Indeed, the PRTRB’s statement is incorrect as the BCPM expenses are supposedly based on surveys in which telephone companies were asked to provide forward-looking cost estimates.⁶⁵ Even assuming arguendo that BCPM expenses are based on embedded costs for other telephone companies, the PRTRB still has the burden of showing why embedded costs in Puerto Rico are so high.⁶⁶

C. Density

The PRTRB suggests that certain areas in Puerto Rico are sparsely populated.⁶⁷ While this is undoubtedly true, the overall density in Puerto Rico is quite high with only six percent of the lines in Puerto Rico in the three lowest density zones (as opposed, for example, to Wyoming, in which 28 percent of US West’s lines are in the three lowest density zones).⁶⁸ It is not possible in these circumstances that the number of lines in rural areas justify the overall subsidy levels that the PRTRB is requesting.⁶⁹

⁶⁴PRTRB Reply Comments at 5.

⁶⁵December 1998 Kelley Declaration at 3.

⁶⁶Id. at 3-4.

⁶⁷PRTRB Reply Comments at 8.

⁶⁸December 1998 Kelley Declaration at 4.

⁶⁹Id.

D. Cost of Capital

The PRTRB and PRTC object to using the actual cost of capital for PRTC for calculating subsidy amounts.⁷⁰ The portable universal service needs of competitive entrants should be considered, but a larger public concern is the inefficient investment that could be stimulated if subsidies are based on inflated PRTRB costs. The Commission must weigh the benefits of competition for the business of subsidized customers against the windfall for PRTC that will be created if subsidies are based on an assumed cost of capital substantially higher than the actual.⁷¹

As a government-owned entity, PRTC has not had to go to financial markets to raise capital and thus has not had to incur the market cost of capital. Instead, its parent has floated tax-free bonds at rates well below the cost of capital faced by all other LECs as well as PRTC's competitors.⁷² Thus, PRTC has greatly benefitted from a below-market cost of capital.

The federally authorized cost of capital for rate of return LECs, including PRTC, is 11.25 percent.⁷³ Accordingly, the BCPM default level is also set at 11.25 percent. Given PRTC's well below-market cost of capital, allowing it to use 11.25 percent as its percentage cost of capital is to allow PRTC to pad its costs. Faced with this fact in another proceeding, PRTC hid behind

⁷⁰PRTRB Reply Comments at 8-9; PRTC Reply Comments at 7-8.

⁷¹December 1998 Kelley Declaration at 5.

⁷²PRTC's actual cost of capital may be less than half of the BCPM default level. See June 1998 Kelley Declaration at 8 ("Puerto Rico development bonds are currently yielding 5.12 percent. Therefore, the 11.25 BCPM default is too large by a factor of at least two.").

⁷³See Universal Service Order at ¶ 250, n. 656 (citing Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, *Order*, 5 FCC Rcd 7507 (1990), *recon.*, 6 FCC Rcd 7193 (1991)).

the 11.25 percent prescription, saying it uses 11.25 percent as its rate of return because it is required to do so by the Commission and arguing that only PRTC can request an individualized rate of return.⁷⁴ Of course, PRTC has never requested an individualized rate of return because it has no incentive to seek to decrease its rate of return. Any universal service model adopted for Puerto Rico must accurately reflect PRTC's true cost of capital. It is particularly telling that PRTC would argue that a "proxy" (the 11.25 percent rate of return prescription) should be used with regard to the cost of capital in the PRTRB model rather than PRTC's actual cost of capital, while it has so strenuously argued that input values in the BCPM model should be changed to reflect actual Puerto Rico cost data rather than proxy data.⁷⁵ The PRTRB and PRTC cannot have it both ways. If a non-Puerto Rico specific proxy is good enough for cost of capital, non-Puerto Rico specific proxies should be good enough for the input values.

E. HM 5.0a and Puerto Rico

The PRTRB's proposition that HM 5.0a⁷⁶ is "unable to provide reliable support costs for Puerto Rico" is incorrect.⁷⁷ The PRTRB failed to acknowledge that since the time of the initial filing of the model with the Commission, additional data have been gathered for Puerto

⁷⁴See PRTC's Rebuttal at 7, [PRTC's] New Expanded Interconnection Tariff, CC Docket No. 96-160 (filed Apr. 28, 1997).

⁷⁵See also Testimony of David C. Blessing cited above, "actual data are always superior to hypothetical data . . ."

⁷⁶The HM 5.0a model is also referred to as the HAI Model, Version 5.0a, or "HAI" model. Versions of HAI filed before February 3, 1998 were known as the Hatfield Model. See Universal Service Fifth Report and Order at ¶ 17, n. 41.

⁷⁷PRTRB Reply Comments at 2, n. 4.

Rico and included in the model.⁷⁸ Any characteristics unique to Puerto Rico that demand higher subsidies per line than anywhere else should be clearly spelled out along with the economic implications. The June 1998 Kelley Declaration showed that, if anything, the unique characteristics of Puerto Rico justify lower than average subsidies,⁷⁹ and the Reply Comments of the PRTRB and PRTC do not rebut that analysis.

CONCLUSION

Should the Commission not adopt the recommendations of the Joint Board (which recommendations would guarantee that the federal government will continue to provide the current level of universal service funding in Puerto Rico such that no local Puerto Rico universal service taxes will result), APCT submits that the applicability to Puerto Rico of a forward-looking economic cost universal service support model should be extended until January 1, 2001 in order to prevent a harsh transition which would damage telecommunications competition in Puerto Rico and harm consumers. Any such extension should be conditioned as discussed in these comments and the Commission should conduct a thorough regulatory audit of PRTC's current books to assure proper use and levels of the universal service funding received by PRTC. Moreover, for all the reasons discussed in these comments, the Commission must reject the PRTRB's proposed

⁷⁸December 1998 Kelley Declaration at 5.

⁷⁹June 1998 Kelley Declaration at 6.

use of a BCPM universal service support model and its use of PRTC's embedded cost data and the increases in the values of many of the default inputs.

Respectfully submitted,

ASOCIACION DE PROVEEDORES
COMPETITIVOS DE
TELECOMUNICACIONES, INC.

A handwritten signature in black ink, reading "Richard Rubin". The signature is written in a cursive style with a horizontal line underneath it.

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Its Attorneys

December 23, 1998

90596.2

Reply Declaration of A. Daniel Kelley

I submitted a Declaration on behalf of the Association of Competitive Telecommunications providers of Puerto Rico ("ACTP") on June 25, 1998. In that Declaration, I demonstrated that the Telecommunications Regulatory Board of Puerto Rico ("PRTRB") proposed universal service cost model is flawed in significant respects and should not be relied upon in setting subsidy amounts. This Reply Declaration responds to Reply Comments submitted on July 9, 1998 by the PRTRB and the Puerto Rico Telephone Company ("PRTC"). My qualifications and a resume are attached to the original Declaration.

SUMMARY

Nothing contained in the Reply Comments changes my conclusion that the proposed cost model submitted by the PRTRB generates unreasonable results. My June 25 Declaration contained a great deal of data and analysis showing that embedded costs in Puerto Rico are much higher than for comparable firms in the mainland U.S. The modest reduction to embedded costs levels made by the PRTRB for purposes of running the BCPM still leaves the inputs substantially higher than embedded costs for other telephone companies.¹ Even the adjusted input values bear no relation to the forward-looking costs required by the Commission for use in establishing universal service subsidy amounts.

I respond to specific comments from PRTC and the PRTRB below.

¹ As my June 25 Declaration noted, the input levels are actually close to embedded costs as contained in FCC data. I have not seen the original data that the PRTRB used for purposes of their 10 percent adjustment.

FORWARD-LOOKING VERSUS EMBEDDED COSTS

My original Declaration concluded that “it is simply implausible that a forward-looking study could result in a subsidy requirement that is higher than the current requirement, which has always been based on embedded costs.” The PRTRB takes issue with this conclusion due to the “. . . possibility that forward-looking results can be higher than embedded results.” (p. 4) There is no question that for certain local telephone company cost components, it is possible for forward-looking costs to exceed embedded costs. But citing to this logical possibility in no way demonstrates that it is plausible that embedded costs for the company as a whole are lower than forward-looking costs.

The example provided by the Board is that “the equip, furnish and install (‘EFI’) cost for new outside plant equipment and cables can be higher than the actual installation cost for equipment placed in service over decades.”² (p. 4) It is certainly true that wage rates are higher today than they were in years past. However, it is incorrect to extrapolate from this fact to reach an empirical conclusion about EFI costs. First, substantial advances have been made in installation techniques. The process of installing outside plant is much more capital intensive now than in prior years because of the development of more sophisticated trenching equipment. Thus, even though wages may be higher now than in the past, the wage component of EFI costs has likely fallen. In other words, instead of labor-intensive installation, new trenching tools are being used with the overall result that installation costs have fallen in recent years.

² The Board also notes that “the life of existing plant-in-service and depreciation reserves . . .” affect the relationship between embedded and incremental costs. My original Declaration appropriately focused on the expense ratios selected by the Board, not on the capital costs estimated by BCPM.

Second, as the EFI acronym suggests, installation costs are only one component of the total cost of outside plant. Telecommunication equipment costs are generally falling. Third, even if it were true that the forward-looking EFI costs of outside plant are higher than embedded, it does not follow that the cost of universal service would be higher. Outside plant is only one component of total investment and the cost of carrying that investment is only one component of total costs.

Finally, the PRTRB ignores a more fundamental point. My Declaration shows that embedded costs in Puerto Rico are much higher than embedded costs in the U.S., both on average and for companies that might be considered to be comparable. The modest 10 percent adjustment factor that the PRTRB applied does not change the conclusion that the costs used by the PRTRB exceed embedded costs for almost every other telephone company.

It is simply insufficient to state that “Puerto Rico’s unique service characteristics” of justify embedded costs that are out of line with the costs generated by other telephone companies. First, the “unique service characteristics” must be described and substantiated. The PRTRB has not done that. Second, economic and technical analysis is required to explain why any unique characteristics result in higher costs. Third, it is necessary to provide some economic basis for assuming that a ten percent reduction in those excessive costs is an adequate way to estimate forward-looking costs.

COMPARISON TO HAWAII

The Board has invited further comparison of Puerto Rico with Hawaii. As I noted in my original Declaration, the Hawaii Public Utilities Commission adopted a version of

the HAI Model together with most of the HM3.1 default inputs.³ The result is a substantially lower universal service cost per line for Hawaii, even though Hawaii is less densely populated. GTE Hawaii objected to the use of the Model defaults, claiming that expenses should have been based on actual costs. The Hawaii Commission rejected the GTE claim.⁴

EXPENSE LEVELS

The PRTRB claims that the default expense ratios in the BCPM “. . . are themselves simply an average of embedded costs from selected RBOCS.” (p. 5) This statement is incorrect. The BCPM expenses are supposedly based on surveys in which telephone companies were asked to provide forward-looking cost estimates.⁵ Second, assuming for a moment that BCPM expenses are based on embedded costs for other telephone companies, the PRTRB still has the burden of showing why embedded costs in Puerto Rico are so high.

According to the PRTRB, “. . . the Declaration of Kelley claims that the Board erred in using total company expense to investment ratios.” (p. 7) This comment is evidently directed to the discussion of Table 2 in my original Declaration. I pointed out that total company per line expenses assumed by the Board are higher than embedded for some accounts, even though providing basic universal service is only one of the activities

³ The Hawaii Commission used a lower rate of return, a higher overhead rate, and a 90 percent assignment of loop costs.

⁴ See Hawaii Public Utilities Commission, In The Matter of Instituting a Proceeding On Communications, Including an Investigation of The Communications Infrastructure of The State Of Hawaii, Docket No. 7702, Order No. 16331, p. 3.

⁵ I would also note that the allegedly “implausible default values for the HAI platform” cited by the PRTRB at p. 4, note 6 are actually higher than BCPM default expense values in many instances.

of the company. That discussion in my original Declaration did not address the use of total company expense to investment ratios.

Finally, the Board claims that the default values for Accounts 6421, 6422 and 6423 are zero. (p. 5, fn. 8) The default values for these accounts in HM5.0a are not set to zero. The default values can be found in the “96 Actuals” worksheet in the Expense Module.

DENSITY

The PRTRB suggests that there are areas in Puerto Rico that are sparsely populated. (p. 8) This is undoubtedly true. Nevertheless, overall density in Puerto Rico is quite high. Only six percent of the lines in Puerto Rico are in the three lowest density zones. (By contrast, 28 percent of the US West lines in Wyoming are in three lowest density zones). Therefore, it is simply not possible in these circumstances that there are enough lines in rural areas to justify the overall subsidy levels that the PRTRB is requesting.

According to the PRTRB, I suggested in my Declaration that “RBOCs have the same ‘character’ in the intermountain region’ as does Puerto Rico.” (p. 8) I could not find such a statement in my Declaration. Nevertheless, there is a valid point to be made. Many telephone companies that serve sparsely populated areas do not require subsidies at the level that the PRTRB is asking for densely populated Puerto Rico.

COST OF CAPITAL

Both the PRTRB and PRTC object to using the actual cost of capital of PRTC for calculating subsidy amounts. The PRTRB raises a valid point when it suggests that “the portable universal service needs of competitive entrants” should be considered. (p. 8) On

the other hand, a larger public policy concern is the inefficient investment that could be stimulated if subsidies are based on the inflated PRTRB costs. This Commission must weigh the benefits of competition for the business of subsidized customers against the windfall for PRTC that will be created if subsidies are based on an assumed cost of capital substantially higher than the actual.

HM 5.0a AND PUERTO RICO

The PRTRB cites a December 15, 1997 AT&T *ex parte* for the proposition that HM 5.0a is “unable to provide reliable support costs for Puerto Rico.” (p. 2, note 4) The PRTRB fails to note that the December 15 letter accompanied the initial filing of the model with this Commission. Since that time, additional data have been gathered for Puerto Rico and included in the model.⁶

⁶ Sprint’s claims about the HM distribution plant module are simply wrong and have been fully and completely rebutted. See the June 10, 1998 *ex parte* Presentation to Ms. Magalie Roman Salas from Richard N. Clark in CC Docket No. 96-45. Also see AT&T’s Reply Comments in this proceeding. In spite of the problems associated with the model selection process in Puerto Rico described in detail in the ACP comments, my original Declaration addressed only input issues.

CONCLUSION

If there are characteristics unique to Puerto Rico that demand higher subsidies per line than just about anywhere else, those characteristics and their economic implications must be spelled out. My June 25, 1998 Declaration showed that, if anything, the unique characteristics of Puerto Rico justify lower than average subsidies. The analysis in my original declaration has not been rebutted in the Reply Comments of the PRTRB and PRTC.

I declare, under penalty of perjury, that the foregoing is true and correct. Executed on December 22, 1998.

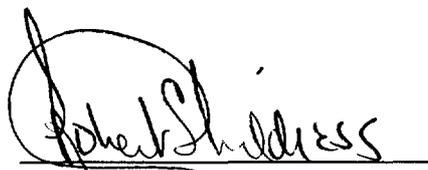
A. Daniel Kelley

CERTIFICATE OF SERVICE

I, Robert S. Childress, a secretary at the law firm of Fleischman and Walsh, L.L.P., hereby certify that a copy of the foregoing "*Ex Parte Comments of the Asociacion De Proveedores Competitivos De Telecomunicaciones, Inc.*" on behalf of Asociacion de Proveedores Competitivos de Telecomunicaciones, Inc. was served this 23th day of December, 1998, via first class mail, postage prepaid, upon the following:

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