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January 14, 1999

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VIA HAND DELIVERY

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

Re: In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45

Dear Ms. Salas:

Enclosed please find an original and six copies of the Ad Hoc Telecommunications Users Committee's Erratum to Reply Comments in the above-referenced proceeding. The Ad Hoc Committee filed its Reply Comments January 13, 1999, but subsequently discovered that the document contained a few inadvertent, non-substantive errors, which the accompanying Erratum corrects. Specifically, the Erratum does the following: it includes a Table of Contents, which was omitted from the Reply Comments filed yesterday; it clarifies a reference in the fifth paragraph of the Summary; it corrects cite formatting in footnotes 2, 28, 33, 34, 39, 52, and 53; and it corrects cross references in footnotes 17, 18, 41, 43, and 44.

Also enclosed is a diskette containing the Erratum to Reply Comments as required by the Public Notice.

If you have any questions or concerns regarding the Erratum please do not hesitate to contact me at (202) 857-2560.

Respectfully submitted,

Kevin S. DiLallo

Kevin S. DiLallo

Enclosures

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

In the Matter of Federal-State Joint Board on Universal Service	)))))))	CC Docket No. 96-45 DA No. 98-2410

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ERRATUM TO
REPLY COMMENTS OF THE AD HOC
TELECOMMUNICATIONS USERS COMMITTEE

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SUMMARY

In the Second Recommended Decision, the Joint Board has largely maintained the *status quo*, rather than making the politically difficult policy decisions necessary to effectively reform the universal service system. As a result, the Joint Board's recommendations fall short of achieving the meaningful systematic improvements that Congress has envisioned.

For example, the Second Recommended Decision fails to balance the statutory considerations of affordability and reasonably comparable rates, and instead focuses on the objective of making rates "reasonably comparable" between high-cost and low-cost areas. Ad Hoc concurs with the other commenters who have asserted that it is critical to consider the issue of affordability so that high-income consumers in high-cost areas do not receive an unnecessary subsidy from the high-cost fund. The result of such subsidies is that low-income consumers in low-cost areas, such as the District of Columbia, pay higher rates to subsidize high-income consumers in high-cost areas.

Another flaw in the Second Recommended Decision is its expectation that the size of the high-cost fund will remain at the current level, if not increase. This expectation is unfounded, and Ad Hoc concurs with the commenters who have stated that the current size of the fund should be sufficient to address the needs of high-cost areas, since local telephone rates will likely decrease during the coming years. This is particularly so if the Commission considers the issue of affordability, as it should.

From the user's perspective, the greatest flaw in the Second Recommended Decision is its "hold harmless" policy, which would guarantee that each incumbent local exchange carrier ("ILEC") will sustain no decrease from its present level of high-cost

support. Under the "hold harmless" policy, where an ILEC would receive significantly lower universal service support if such support were based on forward-looking incremental costs rather than on the ILEC's historic embedded costs, the ILEC could calculate its support requirement based on its embedded costs. This approach is objectionable for several reasons. First, it would perpetuate historic economic inefficiencies in the universal service support system. Second, it would create a competitive advantage for ILECs vis-à-vis new entrants. Third, it would unnecessarily inflate the size of the universal service fund. And fourth, it would discourage innovation in new technologies (such as wireless) that could help achieve universal service objectives.

USTA's proposal to replace the PICC and CCLC with a surcharge on end users' retail purchases of telecommunications services should be rejected. It is economically irrational and fundamentally at odds with nearly two decades of Commission policy because it would recover non-traffic-sensitive ("NTS") costs through what amounts to a usage-sensitive surcharge. Moreover, institution of a revenue-based surcharge would chill demand for network usage and would inefficiently decrease consumption and innovative uses of modern telecommunications services.

Finally, carriers should not be permitted to abrogate unilaterally their existing customer contracts to recover their universal service contributions. Any Commission policy that would imply that carriers may do so would be flatly at odds with state contract law and Commission precedent regarding carrier modification of service arrangements.

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

In the Matter of	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45 DA 98-2410

ERRATUM TO
REPLY COMMENTS OF THE AD HOC
TELECOMMUNICATIONS USERS COMMITTE

The Ad Hoc Telecommunications Users Committee (hereinafter "Ad Hoc" or "the Committee") submits these Reply Comments in response to the initial comments filed pursuant to the Public Notice[1] seeking comment on the Second Recommended Decision[2] of the Federal-State Joint Board on Universal Service ("Joint Board" or "Board") in the captioned proceeding.

INTRODUCTION

In its Second Recommended Decision, the Joint Board has attempted to navigate the treacherous waters of universal service reform; however, the Board has failed to make many politically difficult policy decisions and instead has largely

[1] Common Carrier Bureau Seeks Comment on Universal Service Joint Board's Second Recommended Decision, *Public Notice,* CC Dkt. 96-45, DA 98-2410 (rel Nov. 25, 1998).

[2] *Federal-State Joint Board on Universal Service*, CC Docket 96-45, *Second Recommended Decision*, FCC 98J-7 (released November 25, 1998) ("*Second Recommended Decision*" or "2d Rec. Decision").

maintained the *status quo*, rather than pursue the robust reform envisioned by Congress.

In assessing which of the Board's recommendations actually improve the universal service system and which recommendations merely tinker in the margins, it appears that the majority of the Second Recommended Decision are directed primarily to the latter.

DISCUSSION

I. The Purpose of Universal Service Support: Affordability vs. Reasonably Comparable Rates

A fundamental universal service principle set forth in Section 254 of the Communications Act of 1934, as amended, requires that "[q]uality services should be available at just, reasonable, and affordable rates."[3] In the Second Recommended Decision,[4] the Board appears to recognize the importance of both affordability and reasonably comparable rates,[5] but it makes no attempt to balance these two considerations. Indeed, the Board essentially ignores "affordability" as a criterion for support, concerning itself instead with making rates "reasonably comparable" between high-cost and low-cost areas. Ad Hoc —like several other parties to this proceeding — believes that the importance of "affordability" in deciding universal service policy can not be overstated.

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[3] 47 U.S.C. § 254(b)(1).

[4] *See* 2d Rec. Decision at Section IV ("Proposed Method for Ensuring Sufficient Support for Affordable and Reasonably Comparable Rates"), ¶ 27.

[5] *Id.; see also* 2d Rec. Decision at ¶ 14.

Since its inception, the specific purpose of providing universal service support has been to assure universal connectivity to the public switched network. Just because the monthly rate for basic telephone service, if based upon cost, would be above some average rate level does not necessarily mean that customers would not be able to afford it or would not subscribe to basic service at such a price level.

One of the few parties that addressed the affordability issue was the District of Columbia Public Service Commission ("DCPSC"). In its Comments, the DCPSC advocated a means test to gauge affordability and described how its constituents "contribute proportionately more to the high cost fund than any other State ... [but] receive *no* support from the Fund ... [even though] the District is second only to New Mexico in the percentage of residents living in poverty."[6] Ad Hoc supports the District's position that high-income consumers residing in high-cost states should not receive an unnecessary subsidy from the fund. Indeed, to the extent such subsidization results in higher rates than would otherwise apply for low-income customers in low-cost areas -- such as in the District of Columbia -- the effect of such a policy runs precisely counter to the statutory affordability requirement, and may well reduce connectivity in such areas while not improving access line penetration in subsidized high-cost, high-income exchanges.

Attached to these comments is a study by Economics and Technology, Inc.

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[6] Comments of the District of Columbia Public Service Commission, to the *Second Recommended Decision* in CC Dkt. No. 96-45, at p. 8 (emphasis in original) (December 23, 1998) [hereinafter *DCPSC Comments*].

("ETI"), which analyzes the relationship between high-cost and high-income areas.[7] The ETI study demonstrates that, absent income-based targeting, and at a hypothetical $30 support level, some 23.8% of annual high-cost support would be directed at "high cost" census block groups (CBGs) that had median household incomes in the top 30 percent in each state. Among such high-cost, high-income CBGs are Vail, Colorado; Greenwich, Connecticut; and Glencoe, Lake Forest, Barrington Hills, and Inverness, Illinois. Subsidization of such high-income communities makes no economic sense, because it does not result in increased connectivity but inflates rates for all services that contribute to high-cost support.

The ETI study illustrates how a non-targeted universal service support program inefficiently burdens lower-income customers by flowing unnecessary subsidies to wealthy communities. If the current system of relying on "reasonably comparable" rates[8] is maintained, it will produce more subsidization than is necessary to assure universal connectivity to the public switched network. Moreover, communities and constituents that truly need support due to their inability to afford service are harmed by a system that flows subsidies to communities that do not need it; therefore, a sizable portion of the current fund may well represent an unnecessary drag on the efficiency of the nation's telecommunications industry and an undesirable burden on portions of the population.

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[7] Economics and Technology, Inc., "Defining the Universal Service "Affordability" Requirement: A Proposal for Considering Community Income as a Factor in Universal Service Support," submitted with Comments Of Time Warner Communications Holdings, Inc., Regarding Universal Service Methodology in *Federal-State Joint Board on Universal Service; Revised Methodology for Determining Universal Service Support for Non-Rural Carriers,* CC Dockets Nos. 96-45, 97-160 (DA 98-715) (April 27, 1998).

[8] 2d Rec. Decision at ¶ 18.

Significant savings may be achievable under a funding scheme based on "affordability" rather than "reasonably comparable rates." Support should be limited to those areas in which consumers cannot afford to be connected to the network. If high-cost and high-income areas no longer receive support, debates regarding the size of the fund and the so-called "hold harmless provision." discussed below, might well become moot.

II. The Level of Federal High-Cost Universal Service Support

Given that users, not carriers, ultimately will likely bear the burden of funding the high-cost support mechanism, the size of the fund should be a threshold issue in this proceeding. The Second Recommended Decision anticipates retaining, rather than expanding, the existing level of federal high-cost support, but it leaves open the possibility that the high-cost fund may increase:

> We do not believe, however, that current circumstances warrant a high cost support mechanism that results in a significantly larger federal support amount than exists today. We recognize that some states currently may not receive support sufficient to enable reasonably comparable rates, and thus we believe the support level may rise somewhat.[9]

Several rural state utility commissions argued in their Joint Comments that the Board is premature in concluding that the fund should not increase, stating that "[i]t is particularly difficult to understand how these statements can be made lacking a finalized cost model. Without cost data, it is logically impossible to determine whether a

(..continued)

[9] 2d Rec. Decision at ¶ 49.

fund 'at or near today's levels' will meet the statutory criteria."[10] SBC echoed this sentiment, stating that "the Joint Board is rash to limit the fund to only insignificant increases."[11]

Ad Hoc concurs with the comments of other parties who have concluded that the size of the current fund is sufficient to cover the needs of high-cost areas,[12] especially if "affordability" is accorded any consideration. Ameritech, for example, is correct in stating that "there has been no showing that such a dramatic increase in the amount of high cost support is necessary."[13]

Moreover, the "hold harmless" provision in the Second Recommended Decision, discussed below, could block future decreases in the fund even though consistent and persistent decreases in local telephone service rates will continue in coming years, resulting in greater "affordability" and correspondingly less need for support. Accordingly, the "hold harmless" provision of the Second Recommended Decision should be rejected.

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[10] Comments of the Arkansas Public Service Commission, Kansas Corporation Commission, Maine Public Utilities Commission, Montana Public Utilities Commission, New Hampshire Public Utilities Commission, New Mexico Public Utilities Commission, Vermont Public Service Board, and West Virginia Public Service Commission, to the *Second Recommended Decision* in CC Dkt. No. 96-45, at p. 3 (December 22, 1998).

[11] Comments of SBC Communications Inc., to the *Second Recommended Decision* in CC Dkt. No. 96-45, at p. 5 (December 23, 1998) [hereinafter *SBC Comments*].

[12] See, e.g., Comments of the People of the State of California and the California Public Utilities Commission, to the *Second Recommended Decision* in CC Dkt. No. 96-45 at p. 6 (December 23, 1998) [hereinafter *California Comments*].

[13] Comments of Ameritech, to the *Second Recommended Decision* in CC Dkt. No. 96-45 at p. 7 (December 23, 1998).

III. The "Hold Harmless" Provision

From the user's perspective, perhaps the most untenable aspect of the Second Recommended Decision is its "hold harmless" policy, which assures each incumbent local exchange carrier ("ILEC") that it will sustain no decrease from present levels of high-cost support.[14] This approach would permit an ILEC's historic embedded costs to supersede often considerably lower forward-looking incremental costs where application of a universal service funding requirement based on the latter would result in significantly lower support levels. In other words, it would perpetuate indefinitely the very ILEC inefficiencies that competition and incentive (*i.e.,* price cap) regulation should reduce. The system would effectively impose historic ILEC costs upon potentially more efficient new entrants, precluding the possibility of competitively-determined prices driven to efficient, forward-looking economic costs. In contrast, the use of forward-looking proxy costs as the basis for high-cost support, without any "hold harmless" mechanism, would overcome the legacy of historic monopoly inefficiencies.

It is not surprising that the smaller (*i.e.,* non-BOC) ILECs — who are the principal recipients of high-cost funding under the present funding scheme — oppose the unconditional use of forward-looking proxy costs to establish future funding levels. A "hold harmless" provision would, of course, appease the smaller ILECs by substituting their "actual" embedded legacy costs for proxy costs whenever the former exceeded the latter.

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[14] 2d Rec. Decision at ¶ 53.

If ILECs are guaranteed to continue recovering their embedded investment, they will have the incentive and ability to expand their historic market power and existing infrastructure for their own competitive advantage, without an offsetting economic benefit for the customers who funded their growth. The fact that ILEC shareholders ascribe far greater value to these exploitation opportunities than the amount of any stranded cost is easily confirmed by the persistent willingness of investors to bid ILEC share prices to multiples of their net book value. Moreover, ILECs have been surprisingly candid in disclosing their intentions to exploit their resources for competitive gain. For example, in his rebuttal testimony submitted before the Illinois Commerce Commission in support of the pending SBC/Ameritech merger,[15] SBC Senior Vice President James S. Kahan readily concedes the necessity of relying upon SBC's and Ameritech's combined resources to support a national local out-of-region entry strategy:

> The question is how will SBC, Ameritech or any other RBOC enter the competitive fray in a meaningful way. . . . SBC believes that the only meaningful way to do that is through the National-Local Strategy. However, the National-Local Strategy represents a truly massive undertaking: 30 major markets that cover portions of over 20 states, 8,000 employees, and billions of dollars of new spending.
>
> Unsurprisingly, SBC and Ameritech project negative cumulative cash flows and earnings from the project for nearly a decade. Neither company alone could suffer the earnings dilution that implementation of the plan will entail. A unilateral undertaking to "go national" by either SBC or Ameritech would have an entirely unacceptable impact on the price of its stock. Only the merger will spread the earnings dilution over a sufficiently large shareholder and revenue

(..continued)

[15] Rebuttal testimony of James S. Kahan on behalf of SBC Communications Inc., in ICC Docket No. 98-0555, *SBC Communications Inc., SBC Delaware Inc., Ameritech Corporation, Illinois Bell Telephone Company, d/b/a Ameritech Illinois, and Ameritech Illinois Metro, Inc., Joint Application for approval of the reorganization of Illinois Bell Telephone Company, d/b/a Ameritech Illinois, and the reorganization of Ameritech Illinois Metro, Inc. in accordance with Section 7-204 of The Public Utilities Act and for all other appropriate relief.*

base, to make the undertaking acceptable to our shareholders and the investment community.[16]

In earlier submissions to the Commission, the Ad Hoc Committee offered a solution to the so-called "legacy" or "stranded" cost problem.[17] That solution began with the proposition that it is patently unfair for an ILEC to be made whole with respect to its embedded rate base while simultaneously exploiting its historic market dominance, established infrastructure and customer base, and sheer financial strength to create unlimited earnings opportunities, without a countervailing obligation to use its profits to offset any residual "legacy costs" or otherwise compensate its captive monopoly customers for their historic support and absorption of virtually all the ILEC's acquisition, construction and ongoing maintenance risk.

Under Ad Hoc's proposed solution to the legacy cost issue, ILECs would be offered a choice between "make whole" and "make money."[18] An ILEC that seeks full recovery of its embedded costs, whether through a universal service support mechanism or any other device, would be required to flow all excess earnings arising from exploitation of its infrastructure and other corporate resources "above the line" to offset any stranded costs remaining on its books and compensate monopoly ratepayers

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[16] Rebuttal Testimony of James S. Kahan on Behalf of SBC Communications, Inc., in ICC Docket No. 98-0555, *supra,* note 15, at p. 57.

[17] *E.g.,* Comments of the Ad Hoc Telecommunications Users Committee filed February 14, 1997 in response to the *Notice of Proposed Rulemaking* in *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing; Usage of the Public Switched Network by Information Service and Internet Access Providers,* CC Dkts. Nos. 96-262, 94-1, 91-213, 96-263, *Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry*, FCC 96-488, 11 FCC Rcd 21354 (released December 24, 1996).

[18] The Commission sought comment on this proposal in its *Notice of Proposed Rulemaking* in CC Dkt. No. 96-262, *supra,* note 17, 11 FCC Rcd at 21470, ¶ 265.

for accepting the full risk of ILEC investment recovery. Alternatively, an ILEC that elects to "make money" would forego any entitlement to recovery of stranded costs, in return for which it would be permitted to pursue new business and profit opportunities, subject only to general prohibitions against cross-subsidization and anticompetitive behavior, such as in Section 254(k) of the Communications Act.[19]

The establishment of any "hold harmless" provision, as the Second Recommended Decision proposes, would be consistent with the "make whole" election envisioned by Ad Hoc, so long as an ILEC seeking "hold harmless" protection was required to flow all earnings derived from their core resource base "above the line," to help defray the recurring costs of maintaining and operating its common network. If, on the other hand, an ILEC wanted the ability to exploit its network and other resources as a means for increasing earnings above what would be permissible under traditional forms of economic regulation, it would not be afforded the opportunity to be "made whole."

Several parties who have supported the "hold harmless" provision take the position that no state should receive less support than it currently receives.[20] Such an approach would freeze both the size and distribution of high-cost support at levels that may bear little relationship to the future industry environment. As noted above, the declining real cost of telecommunications should, over time, result in progressively less need for high-cost support as a successively larger proportion of subscriber access

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[19] 47 U.S.C. § 254(k).

[20] *See, e.g.,* Comments of GTE, to the *Second Recommended Decision* in CC Dkt. No. 96-45, at p. 22 (December 23, 1998) [hereinafter *GTE Comments*]

lines falls below the "affordability" threshold -- no matter how that threshold may be defined.

Furthermore, it is entirely possible that, over time, the application of new wireless and digital technology to traditionally high-cost areas will result in disproportionately greater cost reductions in this category than for the "average" subscriber access line. "Hold harmless" works to subsidize inefficiency and direct economic resources and technological innovation away from those segments of the local telephone market in which they may hold the greatest promise. If competition, not regulated monopoly, is to be the future industry paradigm, then blind adherence to historic cost conditions as a basis for high-cost funding would be both anachronistic and counterproductive to the development of effective competition in all market segments.

As the CPUC has noted in its Comments, the 1996 Telecommunications Act does not require a hold harmless provision.[21] And Ad Hoc concurs with the position of the Maryland Public Service Commission and other state commenters regarding "hold harmless," namely, that the Board has misinterpreted Section 254 of the Act: "Section 254 speaks of the preservation of universal service, not the preservation of universal service *funding*."[22]

The transition to competitive telecommunications markets includes an expectation that costs will decrease as companies become more efficient. As costs

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[21] *California Comments* at p. 6.

[22] Comments of the Maryland Public Service Commission, the Connecticut Department of Public Utility Control, the Delaware Public Service Commission, the Illinois Commerce Commission, and the Massachusetts Department of Telecommunications and Energy, to the *Second Recommended Decision* in CC Dkt. No. 96-45 at p. 7 (emphasis in original) (December 23, 1998).

decrease due to efficiency gains, the only economically sound expectation is that the universal service fund should similarly decrease. The "hold harmless" provision is inconsistent with this expectation and with the Board's conclusion that the overall size of the fund need not necessarily increase, because "hold harmless" ensures that ILECs will be made whole and that the size of the fund will not decrease – and may actually increase.[23]

Many of the ILECs support the "hold harmless" principle.[24] BellSouth, for example, highlights the incongruity of "hold harmless" and the use of forward-looking costs, stating that:

> [h]onoring this commitment [hold harmless] effectively keeps in place the jurisdictional separations-based determination of high cost study areas and interstate high cost support. This separations-based calculation becomes the floor of the federal universal service fund. A forward-looking methodology has no place in this calculation and is unnecessary.[25]

What remains, then, is a choice between "hold harmless" and using forward-looking costs to determine support. From the user's perspective, providing support on a forward-looking, rather than embedded, basis should be the primary principle guiding disbursements from the universal service fund.

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[23] 2d Rec. Decision at ¶ 48.

[24] *See, e.g., GTE Comments*, at p. 23 and *SBC Comments*, at p. 6.

[25] Comments of BellSouth, to the *Second Recommended Decision* in CC Dkt. No. 96-45, at p. 5 (December 23, 1998) [hereinafter *BellSouth Comments*].

IV. National Cost Benchmark

The Second Recommended Decision proposes basing support levels entirely upon an ILEC's costs, relative to the national cost benchmark.[26] Many of the parties commenting on the Second Recommended Decision agree with the position that using a cost benchmark is preferable to using a revenue benchmark;[27] however, this position does not consider whether an ILEC's actual revenues are sufficient to recover its forward-looking costs.

In its May 8, 1998 Report and Order in this docket, the Commission adopted the Ad Hoc Committee's position that "revenues" should include, in addition to the basic monthly dial tone rate, charges for local usage, switched access (paid by interexchange carriers ("IXCs") and vertical services (such as call waiting and caller ID).[28] Services that cannot exist independently of the subscriber line, such as local usage and vertical features, derive value from the subscriber line and should contribute to its cost before the need for any high-cost support is calculated. Under this approach, a nominally "high cost" ILEC should not draw universal service funding if its revenues from all these sources were sufficient to cover its costs.

Ad Hoc is concerned that using a national cost benchmark may increase the size of the fund, which may already be over inflated, and that disbursing subsidies without first assessing whether or not a carrier's revenues exceed it's costs is a retrenchment

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26 2d Rec. Decision at ¶ 43.

27 See, e.g., *California Comments* at p. 2.

28 *Federal-State Joint Board on Universal Service*, CC Docket 96-45, *Report and Order*, 12 FCC Rcd 8776, (released May 8, 1997) ("*Report and Order*") at ¶ 200.

from economic costing principles.

V. Size of Area Over Which Costs are Averaged

The Second Recommended Decision recommends retaining the existing "study areas" as the basis for measuring costs, rather than adopting the far more granular wire center or Census Block Group (CBG) levels of disaggregation.[29] Ad Hoc strongly supports this position, if the Commission fails to adopt Ad Hoc's has recommendations regarding consideration of affordability. If subsidies are not targeted specifically to low-income communities, disaggregation below the study area level will result in an excessively large funding requirement.

A "study area" is the entire service area of an ILEC within a state. Most BOCs exhibit relatively low costs when examined at the "study area" level, whereas individual BOC wire centers (or the more disaggregated CBGs) would exhibit far greater variability. Support would only be provided to non-rural ILECs whose costs were significantly above a national "benchmark;" the Second Recommended Decision suggests that the threshold level should be somewhere between 115% and 150% of the national average cost.[30]

Ad Hoc disagrees with the position that using an area less than the current study area is appropriate. SBC has stated that due to "highly competitive" telecommunications markets, "it is inappropriate to recommend a mechanism that

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[29] 2d Rec. Decision at ¶ 33.

[30] *Id.* at ¶ 43.

relies, at least in part, on recovery based on existing local service subsidies."[31] Therefore, SBC has argued that an area smaller than the study area must be used to determine support. MCI WorldCom contends that calculating costs based upon a study area rather than on a geographic cost zone creates several dangers, including understatement of the necessary size of the fund and lack of guidance as to how to distribute the fund when competitive local exchange carriers ("CLECs") are providing service.[32]

With regard to MCI WorldCom's concern about distribution of support, BellSouth has argued that high-cost support should be calculated on a study area basis; and, once support is so determined, it can be distributed on a wire center basis, thereby enabling support to be associated with high-cost wire centers.[33] Bell Atlantic has argued that state costs should be aggregated at no less than study area levels to avoid "significant increases in the high cost fund," and it rejects proposals to de-average to the wire center level.[34] Ad Hoc concurs with the positions of BellSouth and Bell Atlantic in this regard.

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31 *SBC Comments* at p. 4.

32 Comments of MCI WorldCom, to the *Second Recommended Decision*, in CC Dkt. No. 96-45, at p. ii (December 23, 1998.) MCI WorldCom explains that basing support on the current study areas would continue "to keep much of the subsidy hidden in the ILEC's existing rate structure," thereby preventing the Commission from assessing the size of the implicit subsidies, resulting in understatement of the size of the subsidy. *Id.* Further, according to MCI WorldCom, distribution of funds among ILECs and CLECs serving the same study area would be complicated by the failure to distinguish between high-cost and low-cost areas within the study area. *Id* Finally, MCI WorldCom asserts that the Joint Board's recommendation regarding study areas could be misinterpreted as implying that the funds are intended for the ILEC or that a CLEC must serve an entire study to receive a subsidy, a concern that Ad Hoc believes to be unfounded. *Id.*

33 *BellSouth Comments* at 8-9.

34 *Bell Atlantic Comments* at 5.

VI. The USTA Proposal Is Competitively Neutral but Economically Irrational

The United States Telephone Association's ("USTA's") plan for reforming universal service would replace the current CCLC and PICC in favor of "deaveraged, portable per-line support payments."[35] GTE and SBC support USTA's proposal.[36]

USTA asserts that "its plan would not harm any group of customers," and that "customers in every category of use would experience a slight reduction in rates."[37] But the study supporting USTA's plan does not examine any impact upon business customers specifically;[38] therefore, at the very least, USTA's claim lacks an evidentiary foundation.

More to the point, however, even if USTA's plan may be competitively neutral, it still is economically irrational and fundamentally at odds with nearly two decades of Commission policy because it would recover non-traffic-sensitive ("NTS") costs through what amounts to a usage-sensitive surcharge. The Commission rejected this approach in its first Access Charge Order in 1984,[39] and it has been working steadfastly to shift NTS cost recovery to fixed end-user based charges, such as the SLC and the PICC. USTA would thus turn back the clock and undermine the overarching Commission goal

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[35] Affidavit of Dennis Weller ("Weller Affidavit"), submitted with Comments of the United States Telephone Association, to the *Second Recommended Decision* in CC Dkt. No. 96-45, at p. 2 (December 23, 1998) [hereinafter *USTA Comments*].

[36] *SBC Comments* at p. 3. *GTE Comments* at p. 4.

[37] *USTA Comments* at p. 3.

[38] Weller Affidavit, *supra,* note 32, at p. 3.

[39] *MTS and WATS Market Structure*, CC Dkt. No. 78-72, FCC 82-579, *Third Report and Order* (Phase I), 93 FCC 2d 241 (1983).

of efficient, economically sound pricing shaped by effective competition, not regulated monopoly power.

Institution of a revenue-based surcharge would chill demand for network usage and would inefficiently decrease consumption and innovative uses of modern telecommunications services. Coupled with an inherently excessive level of funding to begin with -- due to the failure to recognize "affordability" in setting support requirements -- USTA's plan would impose inefficient and unnecessary burdens across a broad range of telecommunications consumers and providers while failing to assure that high-cost support is provided in the most efficient manner.

The support of USTA, and some of its ILEC members, for a revenue-based universal service surcharge is hardly surprising, in that it is self-serving. Industry revenues are growing at a far faster rate than end-user access lines; hence, a funding scheme tied to revenues will, all else being equal, produce year-after-year increases in aggregate funding levels that would exceed those arising under an end-user-based charging scheme. This problem could, of course, be overcome entirely by a true-up mechanism in which the surcharge rate were reduced annually to reflect disproportionate increases in aggregate revenues; but even such a true-up would not overcome the inherent inefficiency of USTA's proposal, which should be rejected.

VII. Carriers Should Not Be Permitted to Amend Unilaterally the Terms of Existing Long-Term Customer Contracts to Recover Their Universal Service Contributions.

AT&T has proposed that carriers be given flexibility in designing rate structures to recover their universal service contributions, and that they be allowed to recover

more than their own universal service assessments from customers.[40] While some flexibility may be appropriate, the Commission should not give carriers the unilateral right to abrogate their long-term service arrangements with customers to increase rates or add a fee to recover their universal service contributions. Although the Commission's Report and Order in this proceeding indicated that carriers should be allowed to amend their customer contracts unilaterally to recover their universal service contributions,[41] such wide latitude continues to be unsound policy and to be legally unsupportable, for the reasons Ad Hoc has explained in earlier submissions in this docket.[42]

A policy which would allow carriers unilaterally to revise the terms of their customer contracts by raising their rates to reflect their universal service contributions runs flatly contrary to longstanding principles of state contract law. Even where a party faces unforeseen added burden or expense in performing its obligations under a contract -- which is not the case with respect to universal service contributions -- that party may not rescind its contractual obligations absent extremely harsh consequences.

The Commission's decision in the Report and Order[43] to allow carriers to reform their customers' contracts was based on the assumption that the carriers did not foresee the new universal service contribution requirements, which have increased the

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[40] *See, e.g.,* Comments of AT&T Corp. in CC Dkt. No. 96-45 (filed December 23, 1998) at pp. iii, 9-10.

[41] *Report and Order*, *supra*, note 28, at ¶ 851.

[42] On July 17, 1997, the Ad Hoc Committee filed a Petition for Partial Reconsideration and Clarification of the Commission's earlier decision allowing such abrogation. The Petition is pending.

[43] *Supra*, note 28.

carriers' costs of providing service.[44] But, even if this assumption is correct—and it is not—it is not a valid basis for allowing carriers to reform their customer contracts unilaterally to raise their rates.

State contract law does not authorize carriers or other parties to contracts to unilaterally rescind or reform their contractual obligations simply because a governmental order may render contract performance less profitable. New York State contract law, for example,[45] maintains that an individual party "may not abrogate a contract unilaterally merely by showing it would be financially disadvantageous to perform it."[46] This general rule has been consistently applied where the government renders performance of a contract less profitable.[47] If a governmental action is

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[44] The Commission asserted that it "create[d] an expense or cost of doing business that was not anticipated at the time contracts were signed." *Report and Order*, *supra,* note 27, at ¶ 851.

[45] The Ad Hoc Committee has focused on one state to illustrate its argument. Because of the long history and high level of commercial activity in New York, we have analyzed the soundness of the Commission's abrogation conclusion under New York State law. Other states, however, follow the general rule that applies in New York. *See, e.g., Cutter Laboratories, Inc. v. Twining,* 34 Cal.Rptr. 317, 324 (Dist. Ct. App. 1963); *Standard Iron Works v. Globe Jewelry & Loan, Inc.,* 167 C.A.2d 108, 118; 330 P.2d 271 (Dist. Ct. App. 1958); *Rose v. Long*, 128 C.A.2d 824, 827; 275 P.2d 925 (Dist. Ct. App. 1954); *Consolidated Laboratories Inc. v. Shandon Scientific Co.,* 413 F.2d 208, 212 (7th Cir. 1969) (applying Illinois law); *Valtrol Inc. v. General Contractors Corp.,* 884 F.2d 149, 153-154 (4th Cir. 1989) (applying Texas law); *Measday v. Kwik Kopy Corp.,* 713 F.2d 118, 126 (5th Cir. 1983) (applying Texas law).

[46] *A.W. Fiur Co. v. Ataka and Co.,* 422 N.Y.S.2d 419, 423 (A.D. 1979); *see also 407 E. 61st Garage, Inc. v. Savoy 5th Ave. Corp.,* 23 N.Y.2d 275, 282 (1968); *Rockwell v. Knights Templars & Masonic Mut. Aid Assn.,* 119 N.Y.S. 515, 518-519 (A.D. 1909) ("[i]t is repugnant to the idea of a contract that one of the parties may, at his election, from time to time change the amounts which he is to receive from the other party. . . . The fact that a contract proves unprofitable...is no reason why the courts can permit the party who has made such an unwise contract to change its terms at will and make for itself a more profitable contract.").

[47] *Coastal Power Production Co. v. New York State Public Service Commission,* 551 N.Y.S.2d 354, 356 (A.D. 1990) ("'[t]he fact that a contract becomes increasingly difficult and expensive to perform because of a law enacted after its execution does not excuse performance'") (quoting 22 NYJur2d, Contracts, § 355). *See Sullivan County Harness Racing Assn. v. City of Schenectady Off-Track Betting Commission,* 351 N.Y.S.2d 56, 60 (Sup. Ct. 1973) ("performance is *never* excused by changes in the law,

foreseeable at the time parties assume their contractual obligations, then unilateral abrogation by either party will be impermissible, even if one of the contracting parties becomes bankrupt as a result of being required to perform its obligations.[48] If something -- including a governmental order -- is unforeseeable at the time parties enter into a contract, performance will be "excused only in extreme circumstances,"[49] i.e., the order renders performance of the contract impossible or illegal.[50]

The effects of the *Universal Service* Report and Order were foreseeable; therefore, under New York State contract law, carriers would not be excused from their contractual obligations to customers, even if performance of those obligations would drive the carriers into bankruptcy. But, even assuming, arguendo, that carriers' universal service contribution obligations were unforeseeable, the modest financial impact of those obligations on the carriers would not amount to an "extreme circumstance" warranting contract reformation under New York law.

The Commission's own precedent does not permit a carrier to unilaterally abrogate a service contract to raise the rates provided under contract unless highly

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particularly when the law was in existence when the contract was made and the changes were foreseeable") (emphasis added). *See also Reetz, Inc. v. Stackler,* 201 N.Y.S.2d 54, 57 (Sup. Ct. 1960).

48 *A&S Transportation Co. v. County of Nassau,* 546 N.Y.S.2d 109, 111 (A.D. 1989) ("when a governmental action is foreseeable, a contractor may not invoke "impossibility" to excuse performance"). *Stasyszyn v. Sutton East Associates,*555 N.Y.S.2d 297, 299 (A.D. 1990) ("the law is well-established that economic inability to perform contractual obligations, even to the extent of insolvency or bankruptcy, is simply not a valid basis for excusing compliance"). *See also 407 E. 61st Garage, Inc. v. Savoy 5th Ave. Corp.,* 23 N.Y.2d 275, 281-82 (1968).

49 *Kel Kim Corp. v. Central Markets Inc.,* 524 N.Y.S.2d 384, 385 (N.Y. 1987); *see also J.J. Casone Bakery, Inc. v. Edison Co. of New York,* 638 N.Y.S.2d 898 (Sup. Ct. 1996).

50 *See Flaster v. Seaboard Garage Corp.,* 61 N.Y.S.2d 152, 155 (Sup. Ct. 1946); *Doherty v. Monroe Eckstein Brewing Co,* 187 N.Y.S. 633, 635 (Sup. Ct. 1921).

unusual and unforeseeable circumstances warrant reformation, and only if the carrier demonstrates "substantial cause" for increasing its rates.[51]

Moreover, any Commission concerns about unanticipated cost increases in providing telecommunications services should have been tempered by consideration of unanticipated cost decreases resulting from the *Access Charge Reform*[52] and *Price Caps*[53] Orders and the effect of those Orders on long distance carriers' cost of service. These proceedings will have an effect on some carriers' costs at least as profound as this proceeding. The net financial impact of the *Access Reform* and *Price Caps* Orders may be a decrease in costs for carriers providing service to some large users, which would offset any modest cost increase dictated in this proceeding.

In conclusion, the Commission may not, and should not, permit carriers unilaterally to abrogate the terms of their customer contracts to recover their universal service contributions. If the Commission permits carriers to modify the terms of existing customer contracts to enable them to recover their universal service contributions, then it should also allow customers to terminate their service agreements without termination liability (*i.e.*, to take a "fresh look").

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[51] *Tariff Filing Requirements for Nondominant Common Carriers*, Order, 10 FCC Rcd 13653 at ¶¶ 12-16 & n.35 (1995); *RCA American Communications, Revisions to Tariff FCC Nos. 1 and 2*, Memorandum Opinion and Order, 84 FCC 2d 353, 358 (1981); 86 FCC 2d 1197, 1201(1981); 2 FCC Rcd 2363 (1987) (collectively, "*RCA Americom* Orders"), *aff'd sub nom. Showtime Networks, Inc., v. FCC*, 932 F.2d 1 (D.C. Cir. 1991); *see AT&T Communications Contract Tariff No. 360*, Order Designating Issues for Investigation, 10 FCC Rcd 11031 at 11032-35 (1995).

[52] *Access Charge Reform, First Report and Order*, CC Dkt. No. 96-262, FCC 97-158 (rel. May 16, 1997).

[53] *Price Cap Performance Review for Local Exchange Carriers, Fourth Report and Order*, CC Dkt. No. 94-1 (rel. May 21, 1997).

CONCLUSION

In view of the foregoing the Commission should reject the Joint Board's recommendations. Ad Hoc understands that the approach it has recommended may not be popular with some carriers, some regulators and some elected officials. It is however economically sound, good public policy and consistent with the requirements of the Telecommunications Act of 1996.

Respectfully submitted,

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January 14, 1999

200.03/USF/COM REP 1-13-98 KD rev 1-12 Final Draft

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CERTIFICATE OF SERVICE{PRIVATE }

I, Anthony J. Mangino, hereby certify that on this the 14th day of January, 1999, true and correct copies of the foregoing "Erratum to Reply Comments of the Ad Hoc Telecommunications Users Committee" in CC Dkt. No. 96-45 were served by hand delivery, on the persons on the attached service list.

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