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Rural Development

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Washington, DC 20250

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OFFICE OF THE SECRETARY

Magalie Roman Salas, Esquire
Office of the Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Dear Ms. Salas:

Enclosed are ex parte comments of the Rural Utilities Service in response to the Commission's action in CC Docket Nos. 96-45 and 96-262, (Seventh Report & Order and Thirteenth Order on Reconsideration in CC Docket No. 96-45, Fourth Report & Order in CC Docket No. 96-262 and companion Further Notice of Proposed Rulemaking, FCC 99-119 adopted May 27, 1999, on implementation and methodology issues for determining non-rural carrier's universal service support and interstate access charge reform). An original and copy are enclosed for each Docket.

Any questions regarding this filing may be directed to my office (202-720-9542).

Sincerely,

ANTHONY HAYNES
Rural Utilities Service

cc: Chairman Kennard
Commissioner Furchtgott-Roth
Commissioner Ness
Commissioner Powell
Commissioner Tristani

CCB: Keller, Zinman, King, Brown

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| In the Matter of | ) | |
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| Federal-State Joint Board on Universal Service | ) | CC Docket No. 96-45 |
| | ) | |
| | ) | |
| Access Charge Reform | ) | CC Docket No. 96-262 |

**Ex Parte Comments of the**
**<u>Rural Utilities Service</u>**

Original and One Copy filed with:
Office of the Secretary
Federal Communications Commission
445 12th Street, SW
Room TW-B204
Washington, DC 20554

The Rural Utilities Service (RUS, the Agency), a rural development agency of the United States Department of Agriculture actively supports and promotes the universal availability of a broad range of telecommunications and information services in rural America. The RUS appreciates the opportunity to offer comment to the Commission on the Seventh Report and Order and Thirteenth Order on Reconsideration in CC Docket No. 96-45 and the Fourth Report and Order in CC Docket 96-262 and Further Notice of Proposed Rulemaking (Report, Order, and Notice).

Our comments are intended to be helpful to the Commission in their efforts to develop the proper and most reasonable method for determining high-cost universal service support as part of the implementation of the Telecommunications Act of 1996 (Act of '96 or Act). Our Comments are in response to the paragraph numbers in the Report, Order, and Notice. These comments also offer the Commission an alternative use of the model which the RUS believes would more fully comply with the mandate of Section 254 of the Act. All previous RUS comments are available at our website: *www.rurdev.usda.gov/rus.*

**Paragraphs 11 and 30**

1. The "States Go First" policy may not ensure sufficiency.

The Second Federal-State Joint Board on Universal Service (Joint Board or Board) took a positive step when it altered its recommendation that the Commission set a fixed balance between federal (25%) and state (75%) universal service support. While abandoning a fixed percentage, the Board recommended and the Commission has adopted what can be described as a "states go first" policy. This policy is summarized succinctly in the following excerpt from paragraph eleven of the Report, Order, and Notice:

> ...That is, federal mechanisms will support areas with per-line costs in excess of this benchmark unless, as the Joint Board recommended, an objective indicator of state resources reveals that the state possesses the ability to achieve reasonable rate comparability in the state without federal support. We conclude, consistent with the Joint Board's recommendations, that states should not be required to alter their existing substantial universal service support mechanisms, such as intrastate rate averaging, to receive federal support, but that states' ability to provide for their own universal service needs should be evaluated based upon the assumption that each line within the state is capable of bearing an intrastate support burden equal to a fixed dollar assessment. The pool of revenue that could be raised from such an assessment is presumed to be available to the state for intrastate support efforts. We emphasize, however, that the use of a fixed per-line dollar value assessment to estimate states' abilities to support their universal service needs internally does not mandate the creation of state universal service funds for this purpose. Federal support will be available if this intrastate support is inadequate to enable reasonable comparability of rates.

The presumption of a "reasonable" state effort supplemented by the Federal mechanism inverts the Federal and State responsibilities set in the Act of '96. Section 254 of the Act makes clear that the Commission is required to implement a mechanism that is "specific, predictable and sufficient" to preserve and advance universal service. Under the Act, state responsibility is viewed as supplemental and must not burden the federal mechanism. We recognize the complicated jurisdictional issues involved, but the Commission must ensure sufficiency. A simple finding that "the state possesses the ability to achieve reasonable rate comparability" regardless of whether the state chooses to exercise its ability may not be enough to comply with the Act.

An alternative approach would be to peg federal support to a "national affordable rate" for a dialing scope and service quality comparable to that available in urban areas. Efforts to support rates below that level could be left to the states.

**Paragraphs 11,15, 70, 73, 74, and 77**

2. Study-area averaging can impede universal service and competition in areas served by non-rural carriers.

Without adjustment, study-area averaging could create a serious threat to universal service in the areas served by non-rural carriers and distort competitive markets. For such carriers who receive high cost support, they will lose it on a per-line basis not just when they lose a high cost customer to an eligible carrier, but when they lose any customer to any carrier, even when they lose their lowest cost customer to a non-eligible carrier. This is because, where there is support on a study-area averaged basis, every customer in the study-area is characterized as high cost.

The RUS appreciates the request for comment in paragraph 77 on how to make certain that carriers use the support only for the high cost facilities for which the support is intended. This is a concern that the RUS has raised repeatedly in previous comments to the Commission. We have argued that the mechanism needs to link support to investment in rural facilities and service provided. Study-area averaging threatens such a link. A well-managed business would likely use its high cost support to meet competition in its low cost areas. That company could also argue that it is not violating the Act's provision that support be used for high cost facilities and service because, where there is support on a study-area averaged basis, all of its loops are characterized as high cost. In part 6 of this filing, the RUS offers an alternative which would remedy this problem.

The RUS is very concerned about the comment in paragraph 74: "(m)oreover, it would eviscerate the concept of 'portable' support if the loss of customers to a competitor did not change the incumbent's support amounts." This statement is true only for the loss of a high cost customer. RUS believes that given a portable support system, a carrier should not lose high cost support when it loses a low cost customer. Similarly, a competitor with eligible carrier status should not gain only relatively low study-area averaged support when it "wins" a high cost customer.

3. Portability of support will distort markets if it is not close to sufficient or related to the cost of serving particular customers.

The idea that portability of support will attract a competitor is based on the assumption that investment will follow universal service support. This would probably be true if the support were sufficient, but investment will follow market choices and no business will invest in a high cost area if the per-line support bears no relation to the cost to serve.

a. Proposals for determining high cost support have not included market share adjustments to reflect the loss of customers to a competitor.

As important as what level of support should be portable to the competitor, is what support remains with the incumbent. Even after a customer is lost, significant fixed costs related to that customer remain with the incumbent. Those remaining costs will be spread among fewer customers. If portability of support means a loss of all support related to former customers, rates for the remaining customers could be affected in a way clearly unintended by Congress. Such a

"zero sum" system of portability could also distort markets. A competitor could enter a market not primarily to serve customers, but as part of a strategy to deprive a rival of support.

b. Current "parentage" rules should be changed.

The Commission's determination that portable support will be based on what would have been received by the incumbent of record as of May 8, 1997 poses serious competitive problems and acts as a barrier to rural investment and improvement of service in high cost areas of non-rural and rural companies. The RUS refers to this concept as "parentage."

Unadjusted, under a system of study-area averaging, the support available for any high cost loop will be determined not by the cost of that loop, or even by the cost of loops in the wire center, but by the average of all loops in the carrier's system. As a result, a high cost exchange will receive dramatically different levels of support depending on the nature of the parent carrier. This may artificially divert competition to rural carriers with smaller study-areas even though there is a more rational basis for competition in the non-rural carrier's territory. This is clearly at odds with the Commission's principle of competitive neutrality.

Perhaps the most serious result of study-area averaging and "parentage" would be the plight of rural customers in areas served by non-rural carriers where:

- The incumbent has no incentive or obligation to use federal support in the high cost areas either because it receives no support or because, on a study-area averaged basis, every area is characterized as high cost.

- No purchaser or competitor can enter the high cost area because the "parentage-derived" per-line support bears no relation to the cost of service in the high cost areas.

This double whammy means that universal service will suffer and competition will be thwarted in these areas. The Commission has a responsibility to preserve and extend universal service in all areas of the country. The parentage of the loop should not condemn some Americans to stagnating and declining service because of inadequate universal service support or act as an artificial impediment to competition or acquisition in the high cost areas of non-rural companies.

c. Study-area Averaging and Parentage at Work: Two Examples.

Let's examine the effects of study-area averaging and the parentage provision using some actual Universal Service Fund payment amounts. In Georgia, the Regional Bell Operating Company received $1.62 of support per line in 1997. (We will assume that this level of support will be maintained under the "hold harmless" proposal because under the cost model, they would likely get less. For example, current runs of the HCPM using a $30 benchmark would result in no support.) We will imagine a hypothetical rural exchange of 500 subscribers served by a non-rural carrier. This exchange is quite rural, relatively high cost, and historically has benefited somewhat from rate averaging and other support from within the large company. On the other hand, as is true of many rural exchanges served by non-rural companies that have received little or no universal service funding, the level of service lags that found in the more densely populated

areas.

If the incumbent decides to sell this exchange to reduce the internal drain on its urban and suburban revenues, or if a competitor seeks to enter to improve the quality of service, the prospective carrier has to consider the limited universal service support that is available under the prospective universal service mechanisms. An annual payment of $1.62 per line for a rural exchange is trivial. To put this in perspective, the average cost per line of RUS-financed carriers in Georgia is $2899 (based on the 1997 RUS Annual Statistical Report). Rural carriers serving high cost areas in Georgia collected high cost universal service support ranging from $9.21 to $222.09 per line in 1997, with 12 of the 35 independents collecting over $100 per subscriber. At $100 per subscriber, an independent would collect over $50,000 in high cost support for this exchange, compared to the incumbent's current collection of 500 times $1.62 = $810.

The situation is similar from state to state. The per-line support in areas served by Bell Operating Companies is either zero or significantly smaller than if the area were served by a rural carrier. In New Mexico, the Bell Operating Company received $1.07 of support per line in 1997 whereas rural carriers collected from $221 to $1,414 per line.

This bond of parentage coupled with study-area averaging means that rural exchanges of the Bell Operating Companies and other non-rural carriers represent a very poor value to a prospective buyer and are even less attractive to a new entrant. Hence, because of the parentage affect, the only carrier that can afford to maintain and improve service in this exchange is the incumbent who has no incentive to do so. No other eligible telecommunications carrier, whether a purchaser or an over-builder, can afford to offer service.

At a minimum, the "parentage" limitations on service areas once served by non-rural carriers and subsequently acquired by rural carriers should be lifted. Such action will facilitate new investment in these rural high cost areas.

**Paragraph 80**

4. Current line-item charges for universal service are misleading.

As the RUS stated in its comments on truth in billing (dated 11/27/98), the move to establish new line items for universal service by some carriers is misleading to consumers, and whatever the intention, tends to create a public backlash against the concept of universal service. A uniform system of rates which clearly displays the monthly, useage and percentage charges and any premiums or discounts will enhance consumer understanding of service offerings and facilitate competitive markets. In that truth-in-billing filing, the RUS provided a sample rate disclosure which could be incorporated into customer bills and advertising as well as disclosed at the time of subscription.

**Paragraphs 77 & 101 - 116**

5. Choosing the correct area over which costs should be averaged will help solve the problem of ensuring that support is used for the purposes intended under Section 254.

In paragraph 77, the Commission seeks comment on how to ensure that support is used in a manner consistent with Section 254, specifically, that it is used for the provision, maintenance, and upgrading of facilities for which the support is intended. In paragraphs 101-110, the Commission seeks comment on the area over which cost should be aggregated.

The RUS believes that these issues are inseparable. In previous comments to the Commission, the RUS has repeatedly emphasized the need to link support to performance. In other words, universal service support for rural areas should go towards the building of rural facilities and providing of service. Averaging over the large study-area of a non-rural carrier breaks the link between support and investment. For the carrier who receives support, on average, every loop is a high cost loop. As a result, the support can be invested in any loop.

Wire Center averaging is better than study-area averaging but it does not solve the problem inherent in these types of averages. Whether the area is a state or a wire-center, the characteristics of the area are not uniform. A state has areas of extremely low and extremely high cost loops. A wire center tends to be a bit more uniform but for rural exchanges, there is still a tremendous difference between the low cost and high cost lines. The problem is that in a study-area or wirecenter, the average cost is not a typical cost for a high cost customer.

The RUS has long held that the level of aggregation should be as granular as practical, on a per-line basis, if possible. Identifying which lines are high cost is the first step in ensuring that support goes to the lines for which it is intended. It also reduces the opportunity for arbitrage and gaming of the support mechanism. The RUS offers an alternative approach which we describe as "cluster averaging."

**The RUS wishes it to be known that the "cluster average" approach which follows is not an endorsement or validation of the Hybrid Cost Proxy Model (HCPM). It is also not a suggestion that the cost estimates it produces should or should not automatically be the basis for universal service support. The HCPM still needs improvement. We have commented frequently to the Commission on problem areas such as customer location, plant layout, and verification. Those comments still stand. Indeed, as the Commission acknowledges in paragraph 53, the model has yet to be verified. In a companion filing (CC Dockets 96-45 and 97-160), the RUS details several concerns about the current accuracy of the HCPM. However, using "cluster averaging" to disaggregate actual cost, or other appropriately determined level of forward-looking cost, could dramatically improve the non-rural carrier universal service support system.**

6. Cluster Averages - A New Approach.

The RUS has held in previous comments that the cost models should disaggregate to the

individual loop. This has been objected to on the grounds of modeling difficulty and complexity. In response to that criticism, we suggested as early as 1997 that the level of analysis need not be constant, that high cost areas could be examined in greater detail than low cost areas. After all, it is much more important to identify high cost loops and their variation in cost than to identify low cost loops since they will not receive support.

The RUS believes it has found a better area over which costs should be averaged. In each of these areas, the average cost is close to the typical cost. This is a unit of disaggregation where the resolution increases as the population density falls thus providing a more precise identification of the highest cost loops. Best of all, if the HCPM can be improved to a level where it can be verified in practice, the tool for identifying this area is already part of the plant layout of the model.

The HCPM builds plant from existing wire centers. Every customer is served either directly from a central office or from a digital subscriber carrier system. In either case, the copper loop that serves the customer is limited to 18,000 feet. Through an iterative process, the model groups the customers into clusters so that they can be served with minimum cost plant. As the model moves into increasingly rural areas, the cluster counts (number of lines in each cluster) decline.

Since the maximum size of a cluster is over 20 square miles, a five customer cluster is very rural and a one customer cluster is as rural as it gets. Thus cluster count is an excellent proxy for subscribers per 20 square miles in low density areas. As would be expected, model projected costs go up as cluster count declines, but since clusters tend to be much more uniform than wire centers, the average per-line cost within the cluster is a typical cost for its area.

7. Cluster analysis better identifies and ranks high cost lines.

In areas where the model works well and the customer location information is good, cluster analysis more precisely identifies the high cost lines than does a wire center or study area analysis. At the present state of model development, it also does a reasonable job of ranking the relative cost of loops. If the model can be improved sufficiently, it may be able to assign proportional cost rankings to customer clusters, or ultimately, it might be able to accurately predict the forward-looking cost of every cluster.

This is a unique analytical tool not available in any other form because historically, plant records have not been established to segregate the high cost areas. Perhaps, the most important part of cluster analysis for universal service purposes is that high cost areas can be identified, ranked, and mapped. Precise identification is the first and crucial step in establishing a successful mechanism, one that could verifiably put the support into the areas for which it is intended.

Support should be linked to performance and follow the construction of forward-looking plant in high cost areas. By using the HCPM's cluster costs as a disaggregating tool of a company's incurred forward looking costs (after implementation of the new universal support system), the Act's mandate that support should only be used for its intended purpose can be met and the link between investment and support preserved. If the model were used in this fashion, the effects of model error and model refinement would be mitigated. Also, predictability of support would be

enhanced because it would be based not just on the model, but on actual investment.

**Summary**

Absent adjustment or other supplemental source of support, the combination of study-area averaging and tying support to the incumbent of record as of May 8, 1997 could hurt universal service in the areas served by non-rural carriers. At a minimum, the per line cap or "parentage" principle should be eliminated when a non-rural carrier sells or transfers an exchange to another carrier. Such action will at least provide a pathway to improved infrastructure in the current high cost areas of non-rural carriers.

Cluster averaging is superior to study-area or wire center averaging as a means of identifying high cost areas and cluster analysis could be applied to actual costs, incurred forward-looking costs, or other appropriate level of support, to disaggregate universal service support.

The RUS has been pleased to provide the Commission staff data and technical advice on model development and alternatives and offers to assist the Commission in any way possible to fulfill the vision of the Telecommunications Act of 1996.

Dated: August 20, 1999

CHRISTOPHER A. McLEAN
Deputy Administrator
Rural Utilities Service