STATE OF CALIFORNIA

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Ms. Magalie R. Salas
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20024

Via Federal Express

Re: **Ex Parte Comments: In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Low-Volume Long Distance Users, Federal-State Joint Board on Universal Service, CC Docket Nos. 96-262, 94-1, 99-249, 96-45**

Dear Ms. Salas:

In accordance with Section 1.1206(b)(1) of the FCC's Rules, the California Public Utilities Commission hereby submits for filing two copies of this presentation for inclusion in the public record in the above-referenced dockets.

On December 3, 1999, the Coalition for Affordable Local and Long Distance Services[1] (CALLS) and some of its individual members filed their reply comments in the Federal Communications Commission's (FCC) Notice of Proposed Rulemaking (NPRM) addressing the CALLS proposal. In their reply comments, these parties attempt to address the concerns and criticisms leveled by the People of the State of California and the California Public Utilities Commission (California) against the CALLS proposal. California takes this opportunity to respond to these reply comments.

As discussed herein, the CALLS proposal represents a major and inadvisable shift in the FCC's policies on universal service. Specifically, the CALLS proposal provides federal universal service support for an arbitrary amount of interstate access revenues that was negotiated by some industry members without the input, analysis or scrutiny of regulatory commissions or consumer groups. The CALLS proposal is structured to shield the resulting universal service funding and the interstate subscriber line charge (SLC) from price cap and competitive pressures. These components of the CALLS proposal ensure that interstate SLCs and universal service funding will be maintained at levels that are higher than needed, to the detriment of customers.

[1] CALLS members are AT&T, Bell Atlantic, BellSouth, GTE, Sprint and SBC.

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The FCC should carefully evaluate the benefits derived from the CALLS proposal relative to the burdens that it would place on end user customers. To the extent the FCC concludes that the CALLS proposal should be adopted, the FCC should, at a minimum, incorporate the modifications recommended herein by California.

I. THE CALLS PROPOSAL REPRESENTS A MAJOR AND INADVISABLE SHIFT IN THE FCC'S POLICIES ON UNIVERSAL SERVICE

In its first Report and Order on Universal Service, the FCC defined universal service to include the network access line and a limited amount of local usage and concluded that federal support should be limited to those services.[2] The FCC concluded that universal service support should be based on a reasonable measure of an incumbent local exchange carrier's (ILEC) forward-looking cost.[3] In deciding on a cost methodology, the FCC correctly reasoned that forward-looking costs best approximate the costs that would be incurred by an efficient carrier in the market, send the correct signals for entry, investment and innovation, and promote efficiency in the provisioning of universal service. The FCC also concluded that basing support on forward-looking cost would better implement the universal service requirements of the federal Telecommunications Act of 1996 and target support to those areas that need it most.[4] In rejecting a historical cost standard, the FCC concluded that federal universal service mechanisms are not intended to compensate ILECs for inefficient operation.[5] The CALLS proposal would alter these fundamental aspects of the FCC's policies on universal service. For the reasons set forth below, these aspects of the CALLS proposal should be rejected.

A. The CALLS Proposal Would Base Federal Universal Service Support on A Negotiated and Arbitrary Measure of ILECs' Historical Cost

The CALLS proposal would base federal universal service support on a negotiated and arbitrary measure of price cap ILECs' historical cost. Specifically, the CALLS proposal would relabel a negotiated and arbitrary portion of interstate access revenues as implicit universal service support and shift their recovery from traffic sensitive interstate access charges[6] to the federal universal service fund. CALLS' main defense for its approach to

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[2] Report and Order on Universal Service at ¶¶ 61-87 and 223.

[3] Report and Order on Universal Service at ¶¶ 224-226, 232-249, 252, 291; Seventh Report and Order on Universal Service at ¶ 11; Tenth Report and Order on Universal Service at ¶ 22.

[4] Report and Order on Universal Service at ¶¶ 224-226.

[5] Id. at 228.

[6] The particular rate elements are the common line, marketing and transport interconnection charge (CMT) rate elements and the interstate local switching charge.

measuring implicit support is that there is currently no means to create an alternative estimate of the amount of implicit universal service support to be made explicit. CALLS adds that it is better to observe the results of using its recommended $650 million universal service fund for the entire five year period during which the proposal is in effect before determining whether it should be revised.[7]

California urges the FCC to decline CALLS' invitation to replace its forward-looking universal service funding approach with this negotiated quantification of implicit universal service support. First, as the FCC is well aware, the burden is on CALLS to demonstrate that its proposal is appropriate for adoption on a nationwide basis to address such important issues as universal service, price cap regulation and access charge reform. Pointing to CALLS' perceived lack of alternatives is not sufficient basis for adoption of its proposal.

Second, as explained in California's comments in this proceeding, and as previously recognized by the FCC,[8] the exact composition of interstate access revenues has become increasingly blurred with the implementation of federal price cap regulation. In addition to recovering the forward-looking economic cost of providing access services, interstate access revenues may recover embedded access costs, subsidies to below-cost services, misallocated non-access costs (e.g., marketing costs), excess contribution to an ILEC's shared and common costs, and/or excess profits. Absent a detailed examination of the rates and costs of an ILEC's services, it would not be possible to identify and isolate all of the causes of above-cost access charges, let alone assume, as CALLS would have the FCC do, that the entirety of those revenues support an ILEC's cost of providing universal service. Such action would inevitably result in a federal universal service fund that is larger than needed. The FCC should also reject CALLS' approach to "measuring" the magnitude of implicit subsidies because it would establish the troublesome precedent of relabeling revenues as implicit universal service subsidies and shifting them for recovery from end users and the universal service fund as changes in technology continue to reduce the forward-looking cost of interstate access services.

In defending CALLS' approach to measuring implicit subsidies in interstate access rates, GTE reasons that any contribution recovered through the federal price cap mechanism is

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[7] CALLS Reply Comments at 12-13.

[8] In its Access Charge Reform Order, the FCC recognized that universal service costs included in interstate access are intermingled with other costs, including the forward-looking economic costs and the historical costs of interstate access services. The FCC recognized that it would not be able to quantify these universal service costs until such time as its forward-looking economic cost model for non-rural ILECs had been completed. First Report and Order, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing and End User Common Line Charges (CC Dockets 96-262, 94-1, 91-213 and 95-72), adopted May 7, 1997 ("Access Charge Reform Order") at footnote 16.

reasonable, by definition, and could therefore be recovered through a federal universal service mechanism.[9] California could not disagree more. A significant portion of the revenues generated under an ILEC's price cap mechanism recovers the cost of providing a wide array of services that are unrelated to universal service. While it may be reasonable for the ILEC's own customers to compensate the ILEC for the cost of providing these services, it would not be reasonable to recover those costs from all telecommunications subscribers on a nationwide basis by placing them in a universal service fund.

B. The CALLS Proposal Would Extend Universal Service Support to Interstate Long Distance Services

CALLS argues that the federal universal service mechanism must ensure the affordability of interstate access charges in rural and high cost areas.[10] The FCC should evaluate carefully this aspect of the CALLS proposal. CALLS' recommendation to utilize federal funding to ensure the affordability of interstate access charges would unilaterally extend federal universal service funding to services that are outside the FCC's definition of universal service. As explained above, the FCC has defined universal service to include the network access line and a limited amount of local usage. Loop costs are a significant component of network access line costs. A portion of these loop costs is allocated to the interstate jurisdiction and recovered, in part, from the interstate SLC. As a result, there may be some merit in utilizing the federal universal service fund to ensure the affordability of that rate element. However, the CALLS proposal virtually ensures that its measure of implicit subsidies recovers costs in addition to loop costs. As a result, using the federal fund to recover those "implicit subsidies" once CALLS' contemplated SLC caps have been reached would extend support to services outside the FCC's definition of universal service.

II. THE CALLS PROPOSAL WOULD SHIELD INTERSTATE SLCs AND UNIVERSAL SERVICE FUNDING FROM PRICE CAP PRESSURE

In its reply comments, CALLS disagrees with California's recommendation to target X factor reductions to the universal service fund and CALLS' version of the interstate SLC once target traffic-sensitive interstate access rates are reached. CALLS argues that the CALLS proposal will result in significant price reductions and that continuing mandated price cap reductions once target rates are reached may stifle competition.[11]

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[9] GTE Reply Comments at 27 and 28.

[10] CALLS Comments at 3.

[11] CALLS Reply Comments at 50-51.

California disagrees. The CALLS proposal achieves its "target" traffic-sensitive rates primarily by shifting revenue recovery from those rate elements to the interstate SLC and the federal universal service mechanism. Coupled with the proposal's elimination of mandated price cap reductions once the "target" rates are reached, this shifting of revenue ensures that the CALLS proposal will in fact lead to relatively small price reductions and that ILEC exposure to potential revenue losses will be limited. It will also ensure that revenues reallocated to the interstate SLC and the universal service fund are shielded from any downward pressure as a result of the federal price cap mechanism.

CALLS also argues that there is no evidence to indicate that competition will fail to drive further price reductions so that the need for price cap reductions is eliminated.[12] Based on experience in its own state, California believes that the need for mandatory price cap reductions will continue for a significant period of time, until price-constraining competition is sufficiently developed to protect end users. As explained in Section III below, the CALLS proposal does not provide sufficient safeguards to ensure that interstate access charges and universal service funding will be adequately exposed to competition. To the extent competition forces ILECs to reduce rates below levels that would be allowed by federal price caps, price caps would not be controlling. However, to the extent competition is not sufficiently developed, mandated price cap reductions would provide an invaluable safeguard to end users.

CALLS adds that California's recommendation to continue use of the X factor once target rates are reached is unsustainable because it does not propose an ending point to X factor reductions which, CALLS argues, cannot go on forever.[13] However, the FCC routinely reviews the X factor and is fully capable of modifying or eliminating the X factor if it determines that productivity gains have tapered off to the point that current X factor levels are no longer warranted.

Finally, in defending CALLS' approach to negotiating away federal price cap reductions, GTE argues that no party has provided evidence that the target rate levels proposed by CALLS are unreasonable.[14] While GTE would shift the evidentiary burden, CALLS and its members bear the responsibility of justifying the proposal. However, CALLS has provided no evidence that productivity gains have slowed such that elimination of the X factor is reasonable. As a result, GTE's attempt to shift the evidentiary burden away from CALLS should be rejected.

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[12] Id.

[13] Id.

[14] GTE Reply Comments at 43.

For the reasons set forth above, California urges the FCC to consider with caution CALLS' proposal to negotiate away the price cap mechanism's productivity factor. Further, if the FCC adopts a version of the CALLS proposal, it may wish to reduce ILECs' recovery from the new universal service fund by an amount at least proportionate to the Price Cap Index reductions for the CMT basket once target traffic-sensitive access rates are reached and traffic-sensitive CMT rate elements are eliminated.

III. CALLS' PROPOSAL WOULD SHIELD INTERSTATE SLCs FROM COMPETITIVE PRESSURE

In its comments, California explains that the CALLS proposal would shield SLC revenues from competition because an ILEC would be able to maintain SLC rates at or near their cap in a zone with little competition in order to provide lower SLC rates in more competitive zones. To address this concern, California recommends that SLC deaveraging be restricted whereby the percentage differences in SLC rate levels across zones would be capped at the percentage differences in the rates for the price cap ILEC's deaveraged unbundled network elements (loop plus port) in those zones.

CALLS disagrees with California's conclusion that the CALLS proposal would shield SLC revenues from competition and argues that the CALLS proposal will promote competition and therefore make California's concern unlikely.[15] While consolidating the Primary Interexchange Carrier Charge (PICC) and SLC charges into a single rate element may promote competition, CALLS overestimates the extent to which this consolidation will impact competition in less competitive areas for a number of reasons. CALLS inappropriately assumes that charging SLCs and PICCs separately is the main, if not the sole, barrier to competitive entry into less competitive local exchange markets. However, there are a number of more difficult barriers to overcome, including inadequate provisioning of unbundled network elements as well as inadequate operation support systems which render entry, at best, difficult.[16] Even if these intractable barriers to entry were overcome, reliance on competition to control ILECs' ability to shield SLC revenues from competition would only be successful if such competition occurs across all SLC zones. Otherwise, the ILEC would continue to have an opportunity to shield SLC revenues from competition until competition flourishes in all UNE/SLC zones.

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[15] CALLS Reply Comments at 31. See, also GTE Reply Comments at 22 and Bell Atlantic Reply Comments at 8.

[16] See, California Comments (May 29, 1999) and Reply Comments (June 10, 1999) in Second Further Notice of Proposed Rulemaking, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98 (rel. April 16, 1999).

In the absence of competition, CALLS argues that its proposal's limit of SLC deaveraging to no more than four zones should address California's concerns regarding this matter.[17] However, this provision of the CALLS' proposal fails to ensure that SLC variances among the four UNE/SLC zones will be reasonable. In fact, the CALLS proposal places no ceiling on an ILEC's ability, through voluntary reductions of SLC rates in more competitive zones, to develop significantly higher SLC rate levels in less competitive zones than in zones facing a greater degree of competition.

CALLS also argues that its proposal places limits on the variation among SLCs in different zones because of adjustments to the SLCs for lower cost zones.[18] California interprets this portion of CALLS' comments to refer to the proposal's requirement that lower cost zones have SLCs that are no higher than those assessed in higher cost zones. This aspect of the CALLS proposal does nothing to address California's concerns, however. This is because competition is more likely to occur in lower cost areas. As a result, those are precisely the areas that will see the voluntary SLC rate decreases while the higher cost, less competitive zones will see the SLC rate increases.

CALLS also disagrees with California's recommended restrictions on SLC deaveraging. CALLS argues that California's recommendation to restrict SLC deaveraging is unnecessary and would result in greater variation among SLCs than the CALLS proposal.[19] California disagrees. As explained above, the CALLS proposal does not contain sufficient safeguards to ensure that the variance among SLC rate levels in the four UNE/SLC zones remains reasonable. As a result, California's recommended restrictions are necessary. Further, California disagrees with CALLS' conclusion that our recommended restrictions would lead to greater variances among the SLCs than the CALLS proposal. This is because, while California's recommendation limits the amount of variation among SLCs in the different zones, the CALLS proposal does not. Specifically, California's proposal places a cap on the ILEC's ability to increase those variations by requiring that voluntary reductions in zones facing competition be accompanied by reductions in other zones facing little or no competition. However, with the possibility for voluntary reductions permitted under the CALLS proposal, an ILEC could develop SLCs with significantly larger variances than those allowed under California's recommendation.

For these reasons, the FCC should, at a minimum, restrict both voluntary and involuntary SLC deaveraging under the CALLS proposal so that the percentage differences in SLC rate

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[17] CALLS Reply Comments at 35.

[18] CALLS Reply Comments at 35.

[19] Id.

levels across zones are capped at the percentage differences in the rates for the price cap ILEC's deaveraged unbundled network elements (loop plus port) in those zones.

IV. CALLS' PROPOSAL WILL NOT ELIMINATE VIGOROUS LITIGATION OVER THE COMPLEX ISSUES OF UNIVERSAL SERVICE, PRICE CAP REGULATION AND ACCESS CHARGE REFORM

CALLS urges the FCC to adopt its proposal in toto on the basis that it will eliminate the impending vigorous litigation over price cap issues in particular for the foreseeable future. California urges the FCC to reject this hollow promise. The idea that adoption of the CALLS proposal will put an end to litigation over crucial and controversial issues such as universal service, price cap regulation and access charge reform issues is an illusion that should not seriously be considered by the FCC.

In fact, in order for CALLS' promise of a halt to litigation to materialize, two equally disturbing conditions would have to occur. First, the CALLS proposal would have to be perpetually renewed following implementation. Any attempt by the FCC to alter or eliminate the CALLS proposal after its implementation could drive the CALLS members to mount the vigorous litigation that the CALLS proposal alleges to be capable of eliminating. This appears particularly likely given some of the CALLS' members' apparent conviction that they are entitled to the revenues that are arbitrarily relabeled as universal service under the CALLS proposal.[20] The CALLS proposal's silence about a transition mechanism from the CALLS proposal to an alternative mechanism at the end of the five year term also adds to the likelihood of continued vigorous litigation before the FCC over price cap regulation, universal service and access charge issues.

The second condition that would have to occur to suspend litigation is that all parties opposing or concerned by the CALLS proposal--including telecommunications carriers, consumer groups and state regulatory commissions--would have to cease representing their interests and concerns before the FCC and the courts regarding the CALLS proposal and its shortcomings for the life of the CALLS proposal. California does not believe that all of those parties would waive their rights so that CALLS' promise would materialize.

[20] See, GTE Reply Comments at 27 and 28.

V. CONCLUSION

For the reasons set forth herein, California urges the FCC to:

- Reject CALLS' attempt to alter the FCC's policies of basing universal service support on forward-looking cost;
- Reject CALLS' attempt to expand the FCC's definition of universal service;
- Reject CALLS' proposal to shift up to 25% of local switching revenues to the interstate SLC and federal universal service mechanism;
- Consider with caution CALLS' proposal to negotiate away the price cap mechanism's productivity factors;
- Consider reducing ILECs' recovery from the new universal service fund (if adopted) by an amount at least proportionate to the Price Cap Index reductions for the CMT basket once target traffic-sensitive access rates are reached and traffic-sensitive CMT rate elements are eliminated;
- At a minimum, restrict both voluntary and involuntary SLC deaveraging under the CALLS proposal so that the percentage differences in SLC rate levels across zones are capped at the percentage differences in the rates for the price cap ILEC's deaveraged unbundled network elements (loop plus port) in those zones; and
- Refrain from considering CALLS' hollow arguments that its proposal will end vigorous litigation over universal service, price cap regulation and access charge reform issues.

Respectfully submitted,

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ESL:ngs

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