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

COMMENTS OF THE PEOPLE OF THE STATE OF CALIFORNIA AND THE CALIFORNIA PUBLIC UTILITIES COMMISSION ON THE RURAL TASK FORCE PROPOSAL FOR REFORMING RURAL UNIVERSAL SERVICE SUPPORT

The People of the State of California and the California Public Utilities Commission (California) hereby file these comments in response to the Notice of Proposed Rulemaking (NPRM), released January 12, 2001 by the Federal Communications Commission (FCC), seeking comment on the Recommended Decision of the Federal-State Joint Board on Universal Service regarding a proposal by the Rural Task Force (RTF) to reform universal service support for rural carriers.[1]

I. INTRODUCTION AND SUMMARY

The RTF proposes to modify the funding of universal service to rural carriers using a modified version of the current high-cost loop support mechanism, based on the carriers' embedded costs. Various upward adjustments to current limits on high-cost loop support for rural carriers would be allowed. These include a "safety valve" mechanism to provide additional support for "meaningful" investment in high-cost exchanges acquired by rural carriers, and a

[1] The RTF was created by the Joint Board to develop a recommendation for the establishment of a forward-looking economic cost mechanism for rural telephone carriers. The RTF's recommendation, submitted September 29, 2000 to the Joint Board, represents the consensus of individual Task Force members, and not necessarily the positions of organizations or companies to which the Task Force members belong. RTF Recommendation at 3 n. 3.

"safety net additive" which would provide further support in years in which rural carriers realize over 14 percent growth in telecommunications plant in service beyond a specified cap. The RTF also proposes to adjust the limits on high-cost loop support using a new annual Rural Growth Factor (RGF) index equal to the sum of the annual line growth rate for rural carriers and a general inflation factor. Current Long Term Support and Local Switching Support funding would continue unchanged. The RTF recommended additionally that implicit support in interstate access charges be replaced by a new High Cost Fund III, suggesting certain principles that would guide the transfer of implicit support to that fund. The RTF's recommended support mechanism would remain in effect for five years and would be re-evaluated by the Joint Board by 2002 to determine whether any modifications are needed at the end of this five-year period.

In comments filed November 2, 2000, California opposed the recommendations of the RTF as contrary to the principles that the FCC has adopted for funding universal service to non-rural carriers. As California explained, a methodology for funding universal service to high costs areas, both rural and non-rural, should be guided by the following principles: (1) it should use forward-looking costs to determine universal service support; (2) it should narrowly target areas of actual need; (3) it should produce a federal fund that is modestly sized; (4) and it should minimize the burden on those states that are net contributors to the fund.[2] These principles are consistent with the policies underlying the Telecommunications Act of 1996 (1996 Act), and apply with equal force to a methodology for funding universal service to high cost areas served by rural carriers. The RTF proposal, now adopted by the Federal-State Joint Board as a "good foundation" for implementing a rural universal service plan, thwarts these fundamental principles in several ways.

[2] *See also* Comments of California on Joint Board Second Recommended Decision, CC Docket No. 96-45, DA 98-2410 (December 23, 1998).

First, the proposal inappropriately relies on the continued use of embedded costs to determine the magnitude of universal service funding for rural carriers. In rejecting the use of forward-looking costs in determining universal service support, the RTF proposal never addresses the basic flaws in the existing universal service support system that relies on the use of embedded costs. The RTF proposal also does nothing to promote efficiency in the operation of rural carriers. Instead, the RTF merely assumes that a rural carrier's embedded costs are reasonable, believing that the results of a forward-looking cost model should match embedded costs. In particular, the RTF concludes that a mismatch between embedded costs and the results of the Synthesis Model means that the Synthesis Model is flawed. The RTF, however, gives no consideration to modifying or improving the FCC's Synthesis Model for rural carrier purposes prior to concluding that universal service support should be based on embedded costs.

Second, as with the CALLS and the MAG access charge reform proposals, the RTF proposal implicitly assumes that interstate access charges solely support universal service. However, as California has pointed out previously, above-cost access charges could include one or more of the following: misallocation of non-access costs, subsidization of below-cost services, recovery of embedded access costs in excess of forward-looking costs, excess contribution to an ILEC's shared and common costs, and/or excess profits. These components of access charges may overlap, e.g., embedded costs for access charges could help support cross-subsidization of other services. The RTF proposes principles for addressing implicit universal service support but does not provide for a detailed examination of the rates and costs of an ILEC's services, thereby making it impossible to identify and isolate all of the causes of above-cost access charges let alone assume that they support universal service.

Third, the RTF proposal fails to eliminate the National Exchange Carrier Association (NECA) pooling system despite the fact that the pools violate the universal service funding requirements set forth in Section 254 of the 1996 Act.

Fourth, the RTF proposes to increase federal universal service support by weakening the caps on federal High Cost Loop funding and corporate operations expenses and by including "safety net additive" and "safety valve" provisions with no analysis as to whether such changes are in fact needed, whether they bear any relation to universal service, and whether they are cost-based. In particular, the proposed "safety net" provisions could stimulate excessive and/or inefficient investment by rural carriers to maximize their universal service receipts and thereby unduly burden net contributors to the federal universal service fund. Similarly, the RTF fails to explain why it is appropriate to use federal universal service funds, as opposed to other mechanisms (e.g., ratemaking or insurance coverage) to support meaningful investment in newly acquired exchanges and to recover the costs of catastrophic events.

In addition, RTF provides no evidence to support its contention that the cap on universal service funding has had an adverse impact on rural LECs' investment in advanced services. To be sure, given that advanced services are not part of the definition of universal service, it is not clear that investment in advanced services is even a universal service issue.

All of these changes result in a doubling of the amount of federal universal service support to rural LECs from about $1.5 billion to about $3 billion by modifying the caps and limitations on universal service funding which currently exist. California ratepayers alone would likely be required to contribute an additional $150 million annually upon implementation of the RTF proposal.[3] These increased funding requirements do not include additional support under

[3] This computation is based on the fact that California's net contributions to federal universal service funds amount to approximately 10 percent of those funds.

the proposed uncapped High Cost Fund III that would take the place of any implicit universal service support removed from interstate access charges, nor additional support permitted under the "safety valve" mechanism.

Additionally, the proposal fails to show which study areas of rural carriers will be funded, whether such funding is narrowly targeted to study areas of actual need, or whether such funding is necessary to ensure reasonably comparable rates among the states. 47 U.S.C. § 254(b)(3). Without this fundamental showing, no determination can be made whether the proposed funding mechanism is at all consistent with the policy to preserve and advance universal service under Section 254 of the 1996 Act.

II. USE OF MODIFIED EMBEDDED COSTS TO DETERMINE UNIVERSAL SERVICE SUPPORT

Based on the differences between rural and urban LEC characteristics and the differences between rural LECs' embedded costs and the forward-looking cost results produced for them by the FCC's Synthesis Model (the model used to determine universal service support for non-rural carriers), the RTF rules out use of forward-looking costs to determine federal universal service support to rural carriers. Instead, the RTF recommends use of a Modified Embedded Cost mechanism to size the High Loop Cost universal service funding for rural carriers. This mechanism would utilize a rural carrier's embedded costs (i.e., actual investments and expenses) in the year 2000, with annual increases in universal service funding thereafter. The RTF reasons that support based on embedded cost will encourage infrastructure investments necessary for providing access to advanced services.

The RTF's decision to use embedded cost as the benchmark for evaluating the reasonableness of the Synthesis Model's forward-looking cost results is problematic. This is because it fails to consider whether those embedded costs were reasonably incurred and can be reduced over time. Moreover, the RTF proposal fails to consider any modifications or

improvements to the FCC's Synthesis Model prior to concluding that universal service support should be based on embedded costs. While the Synthesis Model may not adequately capture the operating characteristics and circumstances of rural LECs, this current flaw cannot reasonably support a conclusion that the Synthesis Model cannot be modified to address its shortcomings.

The RTF proposal further fails to provide any evidence that basing universal service support on embedded costs will encourage prudent investment in the facilities used to provide universal service when compared with forward-looking costs. In fact, in recommending use of embedded cost based support, the RTF appears to be most interested in promoting investment in advanced services and access to advanced information services, neither of which is currently included within the definition of universal service.

III. IMPLICIT SUBSIDIES IN ACCESS CHARGES

The RTF states that current interstate access charges may contain some amount of implicit universal service support, but RTF members disagree on how much or how to compute that amount. The RTF does not recommend any particular treatment of implicit support but proposes principles in accordance with which this implicit support may be made explicit. According to the RTF proposal, when the FCC addresses interstate access charges for rural carriers, it should identify the appropriate unit prices of interstate access. However, the RTF does not recommend any particular method for arriving at appropriate interstate access prices.

Under the RTF proposal, the difference between current interstate access revenues and the re-priced interstate revenues would be replaced by an un-capped High Cost Fund III that is funded by all interstate telecommunications carriers. This aspect of the proposal is flawed. As noted previously, access charges for rural carriers may be excessive for several reasons. California cautions that any excessive revenues currently being recovered through access charges

may not all subsidize universal service. At a minimum there should be a showing that any excess revenues currently recovered from access charges do, in fact, support universal service.

IV. CONTINUATION OF THE NECA POOLING MECHANISM

The RTF proposal fails to eliminate the NECA pooling system despite the fact that the pools violate the universal service funding requirements set forth in Section 254 of the 1996 Act. The NECA pools are an implicit form of universal service support and are funded solely by LECs, contrary to Section 254. As an integral part of universal service reform for rural LECs, the FCC should take steps to eliminate the NECA pooling system, as needed to comply with the universal service funding requirements of the 1996 Act.

V. INCREASES IN UNIVERSAL SERVICE FUNDING

Under the RTF proposal, federal universal service support to rural LECs would be doubled without even beginning to address the issue of implicit universal service support in access charges. Specifically, the RTF proposal would loosen the cap on High Cost Loop funding, include a "safety net" provision for growth, loosen the cap on corporate operations expenses, include a "safety valve mechanism" for mergers and acquisitions, and provide for new funding of the costs of catastrophic events. The RTF has failed to provide adequate justification for any of these provisions.

A. High Cost Loop Funding

Under the RTF proposal, the existing cap on High Cost Loop funding, based on historical costs indexed by the growth in access lines, would be removed and the portion of High Cost Loop funding for rural carriers would be separated from the non-rural carriers' portion of the funding mechanism. The rural portion of High Cost Loop funding would initially be recomputed as if the indexed funding cap and the corporate operations expense limitation had not been in effect for support for the calendar year 2000. This re-basing has been estimated to result in an

increase in the rural portion of High Cost Loop funding of approximately $118.5 million, consisting of $83.9 million due to removal of the indexed funding cap and $34.6 million due to removal of the cap on corporate operations expenses.

For 2001 and future years, High Cost Loop funding for rural LECs would be calculated using the existing methods with certain specified modifications. The national average loop cost would be set at $240.00, which approximates the actual average for year 2000 support (based on 1998 data). Support for a rural LEC's study area would be calculated based on the rural LEC's actual costs, with modifications (discussed below) to the current cap on corporate operations expenses. A new indexed cap on the rural LECs' portion of High Cost Loop funding would be imposed, with annual maximum growth derived using a Rural Growth Factor (RGF), calculated as the sum of the annual percentage change in the Gross Domestic Product-Chained Price Index (GDPPI) and the percentage change in loop count for rural carriers. In any year when the cap is reached, "safety net additive" provisions (discussed below) would be computed with additional funding possible.

The RTF's proposal to loosen the existing caps for the rural LECs' portion of High Cost Loop funding (i.e., the overall funding cap and the cap on individual companies' corporate operations expenses) is not accompanied by any cost studies or other evidence indicating that these modifications are needed. Nor has any evidence been presented that suggests that these restrictions have adversely affected investment or that their modification would promote prudent investment by rural LECs.

The RTF would automatically increase the amount of rural High Cost Loop funding each year based on inflation and growth in access lines, with no consideration of whether the growing amount of universal service support is needed. There is no reason to believe, and the RTF has produced no evidence to conclude, that rural LECs' costs will reasonably increase in proportion

to inflation and the number of access lines served, with no productivity gains, or that High Cost Loop funding should increase by such amounts. Instead, the automatic increase in available funding provides no incentive for rural LECs to become more efficient.

B. Safety Net Additive for Growth in Plant

Under the RTF Proposal, a "safety net additive" would be included for growth in plant. This additive would be calculated for each study area where the growth in telecommunications plant in service (TPIS) per line is 14 percent[4] greater than the study area TPIS per line in the prior year. The safety net additive would equal 50 percent of the difference between the capped High Cost Loop funding for the study area and the uncapped amount for the study area. The safety net additive would be paid for each qualifying study area for a minimum of four succeeding years regardless of whether the study area meets the 14 percent criterion in those years.

The RTF provides no evidence to support a finding that such increases in support are necessary or appropriate. Further, extending the safety net additive support for four years, regardless of whether the 14 percent growth in investment occurs during those years, is inappropriate and would likely result in a windfall to rural LECs as it would likely overcompensate LECs for the investment undertaken during the four year period.

This provision would also encourage rural LECs to undertake lumpy investment every four years whereby large investment is undertaken in year one and minimal investments are undertaken in the three subsequent years.

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[4] The 14 percent factor was chosen as an estimate of twice the average RGF in recent years.

C. Modifications to Cap on Corporate Operations Expenses

The RTF recommends modifications to the FCC's cap on corporate operations expenses.[5] The new cap for a rural LEC study area would be the higher of (i) the study area's existing cap grown annually by the RGF, and (ii) the study area's uncapped corporate operations expense per line in 2000 grown annually by the RGF. The RTF explains that the purpose for its proposal is to provide an option other than the waiver process for companies that have corporate operations expenses above the current limitation. The RTF adds that while an existing waiver process is available, it is very expensive for a small rural carrier like Interior Telephone in Alaska, and gives petitioners only a one-year waiver. The RTF further adds that the waiver process can be economically infeasible for some rural carriers.

The loosening of the corporation operations expense cap proposed by the RTF is unneeded, would unnecessarily increase rural LECs' claim for High Cost Loop support, and should not be adopted. The FCC adopted a cap on universal service funding for a carrier's corporate operations expenses because such costs are not directly related to the provision of subscriber loops and may result instead from managerial priorities and discretionary spending.[6] The RTF provides no evidence to support a finding that the proposed automatic annual increases in the cap on corporate operations expenses based on inflation and growth in access lines are needed to promote universal service. There is no reason to expect that rural LECs' corporate operations expenses needed to provide subscriber loops should increase in proportion to inflation and the number of access lines served, with no productivity gains. Both the automatic increases in the cap on corporate operations expense and the ability to base a rural LEC's cap on that

[5] According to the FCC's rules, for study areas with 6,000 or fewer working loops the maximum corporate operations expense allowed per working loop is $31.188 - (.0023 x the number of working loops), or, $25,000 divided by the number of working loops, whichever is greater. For study areas with more than 6,000 but fewer than 18,006 working loops, the amount per working loop is 3.588 + (82,827.60 divided by the number of working loops). For study areas with 18,006 or more working loops, the amount per working loop is $8.188.

[6] First Report and Order, CC Docket 96-45, at ¶ 283.

carrier's own historical corporate operations expenses provide no incentive for rural LECs to limit corporate operations expenses or to become more efficient.

In contrast, the existing waiver process requires the petitioner to make a concrete showing that exceptional circumstances exist and that relief from the current limit on corporate operations expense is warranted.[7] California agrees with the stringent requirements of the current waiver process. However, in order to reduce the cost of the waiver process, California supports a change to the waiver process that would allow a multi-year waiver if a petitioner supports the need for a waiver for more than one year.

D. Safety Valve Mechanism for Merger and Acquisition Cap

The RTF includes a "safety valve" mechanism that modifies the current merger and acquisition cap on universal service funding.[8] According to the safety valve mechanism, support for acquired lines or exchanges would be increased, for five years, if the acquiring rural LECs make "meaningful investments" in those lines or exchanges. The additional universal service support under this safety valve mechanism is not included in the indexed High Cost Loop funding cap. The RTF acknowledges that the safety valve mechanism should be capped at some appropriate level, but provides no evidence to support a finding that any increases in support through the safety valve mechanism are necessary or that they will be used to promote universal service as opposed to other goals.

The RTF defines "meaningful investments" simply as an increase in the cost of serving acquired lines compared to the cost of serving those lines prior to the acquisition. The RTF proposal would fund 50 percent of that difference. However, the RTF does not provide for a

[7] Id., at ¶ 285.

[8] Currently, the FCC rules limit universal service support for an acquiring company to the support received by the selling company.

mechanism to verify that the increase in cost is, in fact, due to investment as opposed to a loss of economies of scale as a rural carrier acquires lines previously served by a non-rural carrier. Clearly, loss in economies of scale cannot be considered "meaningful investment."

In addition, rural LECs may wish to upgrade facilities in newly acquired exchanges in order to provide advanced services which, while desirable to many customers, are not part of the definition of universal service and whose costs are not appropriately recoverable from a universal service fund.

Further, even if a rural LEC's increased costs are due to meaningful investment related to the promotion of universal service, it may be inappropriate to extend safety valve support for a five year period. The extension of funding beyond the duration of the investment would represent a windfall to the rural LEC. As an additional concern, the safety valve mechanism inappropriately creates an incentive for an acquiring rural LEC to make unneeded investments upon acquisition, due to the window of opportunity to receive 50 percent funding.

The RTF argues that the safety valve mechanism is justified because customers in high cost rural exchanges should not be "doomed" to poor service because they live in exchanges that have been involved in sale/transfer transactions where the previous owner had limited access to universal service support funds. In making this assertion, the RTF appears to assume that the prior owners have allowed service to degrade and that new investment is carried out in order to bring service up to par. However, carriers are not required to provide evidence to support such an assumption in order to receive funding under the safety valve mechanism.

The RTF asserts that the current cap on universal service funding discourages rural LECs from making new investments to upgrade the networks of newly acquired lines or exchanges, and that the safety valve mechanism helps to ensure that universal service support provides incentives for new investment in rural America. However, the RTF provides no evidence to

support its suggestion that the High Cost Loop and merger and acquisition caps have hindered investment in rural America. Instead, the ability of acquiring rural LECs to obtain increased universal service funding through the safety valve mechanism would encourage them to buy (and price cap LECs to sell) rural exchanges at a premium. The universal service support system should not artificially inflate the price on sale/transfer transactions. It is infeasible to detect an increase in selling price due to increased universal service funding. Even if such increase were detected, it is unlikely that the FCC or any other regulatory agency could intervene to reduce the selling price.

The RTF proposes that sold/transferred exchanges acquired by an entity would be designated as a new study area within the state. As a result, the sold/transferred exchanges would meet the definition of a "rural telephone company" under the 1996 Act and receive universal service support separately from other properties in the state owned by the same rural LEC. This provision is inappropriate. Federal universal service support should be based on an entire study area because that would reflect the overall economies of scale and scope of the carrier. Subdividing a carrier's study area into segments will lose the averaging effect of combining high and low cost areas and thereby increase federal funding to the detriment of consumers and contributor states.

Finally, while the RTF reassures the FCC that the sum of the sale/transfer safety valve expense adjustments would not exceed five percent of the indexed High Cost Loop funding cap for rural carriers, it should be remembered that even five percent of a fund of nearly $1 billion is still a major increase in universal service support, which has not been justified.

VI. GEOGRAPHIC DISAGGREGATION OF UNIVERSAL SERVICE SUPPORT

Under the RTF proposal, universal service support could be geographically disaggregated to the wire center level, with further disaggregation to two cost zones per wire center also

allowed. A rural carrier could request regulatory approval of its disaggregation plan, but also would have discretion to self-certify a method for geographic disaggregation without any regulatory oversight. California believes that disaggregation of universal service support should not be discretionary. Instead, it should be consistent with the degree of unbundled network element (UNE) deaveraging in order not to discourage competition in some rural zones while artificially stimulating competition in others due to universal service support windfalls.

VII. MODIFICATION TO UNIVERSAL SERVICE SUPPORT IN AREAS WITH COMPETITION

In the event a competitive LEC is designated as an eligible telecommunications carrier eligible for universal service funding, the RTF introduces a new form of support which would compensate both the incumbent rural LEC and the competitive LEC for the cost of catastrophic events (e.g., hurricanes, floods, etc) that directly affect the ability of the carrier to deliver universal service. It is unclear to California why a new form of additional universal service support is needed upon competitive LEC entry. This additional funding may double recovery costs for catastrophic events since areas that are declared natural disaster areas obtain other federal funding.

VIII. REVIEW OF UNIVERSAL SERVICE DEFINITION

The RTF recommends that the list of supported services should evolve to include access to information services at a rate that is reasonably comparable to that provided in urban areas. It supports universal service funding for investments to provide access to advanced services, since such investments will also provide access to information services.

Before determining whether federal universal service funding is appropriate for investments to provide access to advanced and information services, the FCC should determine whether customers in rural areas lack access to the Internet and, if so, whether the lack of access is due to the absence of quality facilities allowing such access or to other factors, such as the

location of Internet Service Providers (ISPs) outside the local calling area. Until such basic determinations are made, it is premature to assume that universal service funding is necessary to support advanced services. The FCC also should consider carefully the degree to which funding of investments in advanced services and access to information services will significantly increase the size of the universal service fund, and whether such expansion would be consistent with the purpose of universal service funding and the requirements for urban/rural rate and service comparability in Section 254 of the 1996 Act.

IX. CONCLUSION

For the reasons set forth herein, California recommends that the FCC reject the recommendations of the RTF as contrary to the basic principles that the FCC has adopted for funding universal service to non-rural carriers. California recommends, instead, that the FCC take steps to base universal service funding for rural carriers on forward-looking costs and to recover all universal service funding in a competitively neutral manner. If the FCC concludes, nevertheless, that the general approach taken by the RTF has merit, California urges that the FCC adopt the modifications to the RTF proposal recommended herein.

Respectfully Submitted,

PETER ARTH, JR.
LIONEL B. WILSON
ELLEN S. LEVINE
JONADY HOM SUN

/s/ JONADY HOM SUN
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Jonady Hom Sun

Attorneys for the People of the
State of California and the
California Public Utilities Commission

505 Van Ness Avenue
San Francisco, CA 94102
Phone: (415) 703-1470
Fax: (415) 703-2262

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