

BEFORE THE
Federal Communications Commission
WASHINGTON, D.C. 20554

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

COMMENTS OF SBC COMMUNICATIONS INC.

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SBC Communications (SBC) hereby submits its Comments on the *Recommended Decision* of the Federal-State Joint Board that responds to universal service issues remanded to the Commission by the United States Court of Appeals for the Tenth Circuit.¹ The *Recommended Decision* does not define statutory universal service requirements adequately or establish the necessary inducements for state mechanisms to preserve and advance universal service, as required by the Tenth Circuit’s remand order. In order to satisfy the requirements of section 254, the Commission will have to implement a comprehensive universal service reform plan that goes far beyond the limited modifications proposed in the *Recommended Decision*.

I. INTRODUCTION AND SUMMARY

Congress recognized that the “patchwork quilt” of implicit subsidies that historically formed the foundation of the universal service system is not sustainable in a competitive market. Therefore, when Congress opened previously closed markets to competition in the Telecommunications Act of 1996, it also adopted section 254 to ensure the preservation and advancement of universal service in the new competitive environment. The plain language of section 254 demonstrates that Congress clearly intended for the Commission to undertake significant reform measures that would replace the legacy system of implicit subsidies with

¹ *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Recommended Decision, 17 FCC Rcd 20716 (2002) (*Recommended Decision*).

federal and state universal service mechanisms are “specific, predictable and sufficient.”² Once the Commission completes its overhaul of the universal service system, section 254 directs the Commission to assess the results by determining whether the amount of explicit universal service support is “sufficient” to maintain end user prices that are “reasonably comparable” and “affordable,”³ and to ensure the preservation and advancement of universal service.⁴

Seven years later, however, the Commission has not even begun to address meaningful universal service reform, let alone satisfy the statutory mandate of section 254. Instead of implementing universal service reform and then assessing the results according to the statutory requirements of section 254, the Commission has reverse-engineered a federal universal service funding mechanism that seeks to justify maintaining the status quo. Because the prices for almost all residential local telephone services continue to be set below cost and supported by a vast network of implicit subsidies, it is a meaningless exercise to analyze whether the amount of explicit federal universal service funding is “sufficient” or end user prices are “reasonably comparable.”

Given this lack of progress, it is not surprising that the issues remanded to the Commission by the Tenth Circuit are *extremely broad*. On remand, the Commission must (i) define the key statutory universal service requirements of section 254, (ii) explain how its universal service plan satisfies these statutory requirements, (iii) assume responsibility for ensuring that states take action to preserve and advance universal service, and (iv) explain how the federal universal service mechanism will interact with other universal service mechanisms to

² 47 U.S.C. §§ 254(b)(5), (e).

³ 47 U.S.C. §§ 254(b)(1), (3).

⁴ 47 U.S.C. § 254(b).

create a complete plan for supporting universal service.⁵ As SBC previously stated, in order to comply with the court's mandate and the requirements of section 254, the Commission must do much more than simply reaffirm its reverse-engineered 135% benchmark model and compare rural and urban prices that are the product of the legacy system of implicit subsidies.

The Commission's fairly narrow referral to the Joint Board stands in stark contrast to the Tenth Circuit's broad remand decision. Specifically, the Commission did not seek any information from the Joint Board about state pricing policies or universal service funding mechanisms. It did not ask the Joint Board to address interaction of the federal funding mechanism for non-rural carriers with other federal or state universal service programs.⁶ And, most importantly, the Commission did not ask the Joint Board to provide input on a comprehensive plan that ensures federal and state mechanisms exist to preserve and advance universal service. Therefore, as with the Commission's prior orders in this docket, the *Recommended Decision* operates from the same flawed premise that merely justifying the status quo is sufficient to satisfy the statutory requirements of section 254 and the Tenth Circuit's remand order. SBC respectfully disagrees.

There are two fundamental problems with the *Recommended Decision*. First, the *Recommended Decision* does not define statutory terms adequately or demonstrate that the federal universal service mechanism satisfies the statutory requirements of section 254. For example, instead of defining "reasonably comparable," the Joint Board examines the Commission's arbitrary 135% nationwide cost benchmark and attempts to justify the results. It

⁵ *Qwest v. FCC*, 258 F.3d 1191, 1201 (10th Cir. 2001).

⁶ See *Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Notice of Proposed Rulemaking and Order*, 17 FCC Rcd 2999, 3010-11, ¶¶ 25-26 (2002).

should not be surprising that a methodology designed to allocate support based on the difference between statewide average costs of non-rural carriers and the nationwide average of such costs will target support to the highest-cost states. But the statistical analysis that is used to justify the 135% benchmark still has no rational relationship to the reasonable comparability requirement of section 254. The supplemental review process proposed by the Joint Board does at least compare rural and urban rates, but the *Recommended Decision* falls far short of providing a definition of “reasonably comparable” or an explanation of why it is appropriate to use a 135% benchmark to compare urban and rural rates. With respect to the statutory term “affordable,” the Commission previously provided a definition of the term, but the Joint Board and the Commission have made no attempt to factor affordability into the federal universal service mechanism.

The Joint Board also recommends retaining the Commission’s narrow definition of “sufficiency” as the provision of enough universal service support to enable states to achieve reasonable comparability of rates.⁷ This definition ignores the fact that the amount of universal service support also must be sufficient to maintain affordable rates and preserve and advance universal service, as required by section 254. The federal funding mechanism is limited to achieving reasonable comparability, then the Commission must demonstrate that the other statutory requirements are being achieved by state universal service mechanisms. The Joint Board and the Commission, however, cannot simply limit their consideration to a single statutory requirement and ignore the others.

In addition, the *Recommended Decision* does not give any consideration to whether affordable and reasonably comparable rates are being achieved through implicit subsidies, which

⁷ *Recommended Decision*, ¶ 15.

is contrary to the statutory requirement that universal service support be “explicit,” as well as “specific, predictable and sufficient.” It is easy to claim that rates are affordable, if rates are kept below cost by regulatory fiat. And it is easy to claim that rural and urban rates are reasonably comparable, if states mandate the use of implicit subsidy mechanisms, such as rate averaging, value of service pricing or residual local service pricing. But the “sufficiency” and “reasonably comparable” requirements of section 254 must be satisfied by means of *explicit* universal service support mechanisms, not an outdated system of implicit subsidies.

Moreover, the *Recommended Decision* does nothing to establish a link between the support that is being provided and the rates that are being charged in rural and high-cost areas. The net result of basing federal universal service support on statewide average costs is to force non-rural carriers such as SBC to attempt to sustain universal service through rate averaging and implicit subsidies. It is not appropriate or reasonable for *any* carrier, whether rural or non-rural, to be forced to rely on statewide averaging as a mechanism for supporting universal service.

The Commission can give meaning to all of the statutory requirements of section 254 by implementing SBC’s proposed affordability approach to universal service reform. Under SBC’s proposal, the Commission would establish an affordability benchmark based on the median household income of a particular geographic area (*e.g.*, a county) and provide funding for geographic areas only where the forward-looking cost of providing service exceeds the affordability benchmark. The Commission also would establish a transition plan that allows residential local telephone prices to rise to levels that are self-supporting and affordable. This approach would generate explicit support that is “specific, predictable and sufficient” to ensure that consumers do not pay a “disproportionate amount of their income on telephone service,”

while also ensuring that the amount of such support is no larger than necessary.⁸ Use of a nationwide affordability benchmark that is applied to specific geographic areas also would provide a way for the Commission to ensure that rates in rural areas are “reasonably comparable” to rates in urban areas.

Second, the *Recommended Decision* does nothing to ensure that states have established the necessary *explicit* mechanisms for preserving and advancing universal service, as required by the Tenth Circuit. The Joint Board identifies the Commission’s role as being limited to providing support to high-cost states with statewide average costs well above the national average.⁹ While this approach to the federal universal service mechanism might be reasonable in theory, it relies heavily on the states to achieve the goals of universal service in their borders. Yet the Joint Board and the Commission do not even have any information that would allow them to analyze state universal service mechanisms.

The *Recommended Decision* will not induce state action to implement the statutory requirements of section 254. Indeed, the *Recommended Decision* tacitly endorses the use of implicit subsidies as a legitimate way for states to support universal service, even though implicit subsidy mechanisms are unsustainable and contrary to the requirements of section 254.¹⁰ The *Recommended Decision* also supports retention of the Commission’s 135% benchmark, which encourages states to maintain universal service through rate averaging and implicit subsidies by artificially limiting the amount of federal support and masking the high cost of providing local telephone service in many rural areas. The supplemental mechanism proposed by the Joint

⁸ *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, First Report and Order, 12 FCC Rcd 8776, ¶ 110 (1997) (*First Universal Service Order*).

⁹ *Id.*, ¶ 25.

Board may not result in any additional funding for high-cost states, and it certainly will not induce states to establish explicit universal service mechanisms within their borders.

The Commission can and should do much more to ensure that the universal service goals of section 254 are achieved. As SBC previously demonstrated, the Commission has broad authority to implement a comprehensive national plan for universal service reform. Section 254 significantly expands the Commission's authority over universal service issues and imposes many new requirements directly on the states. Consistent with this broad grant of authority, the Tenth Circuit held that the Commission has an obligation to ensure that states take the necessary action to achieve the universal service requirements of section 254. As with other provisions of the 1996 Act, the Commission has rulemaking authority to carry out the provisions of section 254 in a manner that preserves the states' authority over intrastate rates. Thus, the statutory definitions and support mechanisms developed by the Joint Board and the Commission must serve as the model for both federal and state universal service funds.

This proceeding provides an unprecedented opportunity for the Commission to eliminate the outdated system of implicit subsidies and implement significant reforms of federal and state universal service mechanisms. Replacing implicit subsidies with explicit universal service support that is "specific, predictable and sufficient" is essential to preserving universal service in a highly competitive market. In addition, the current system of below-cost prices for residential services creates a barrier to local competition, which is inconsistent with the pro-competitive goals of the 1996 Act. The implementation of universal service reform also will facilitate intercarrier compensation reform by laying the necessary groundwork for a bill and keep regime.

¹⁰ *Id.*, ¶ 24.

II. THE *RECOMMENDED DECISION* DOES NOT DEFINE STATUTORY TERMS ADEQUATELY OR RESPOND TO THE TENTH CIRCUIT’S REMAND ORDER

The *Recommended Decision* does not define statutory terms adequately or explain how the federal universal service mechanism satisfies the requirements of section 254, as required by the Tenth Circuit. In its remand order, the court held that the Commission’s definition of “reasonably comparable” as a “fair range” of rates was inadequate.¹¹ The court also found that the Commission could not substitute the reasonably comparable standard of section 254, which calls for reasonable comparability between rural and urban rates, with some other standard.¹² In addition, the Tenth Circuit held that the Commission had not defined what it means for federal universal service support to be “sufficient.” Instead, the Commission had asserted without explanation that its support mechanism would be sufficient.¹³ On remand, the court directed the Commission to define these key statutory terms more precisely and to then to assess whether its funding mechanism will be sufficient to satisfy the various statutory requirements of section 254.¹⁴

SBC believes that, in order to comply with the Tenth Circuit’s broad remand order, the Joint Board and the Commission must define all key statutory terms, including “reasonably comparable,” “affordable,” “explicit,” “specific and predictable,” “rural” and “urban.” The Joint Board and the Commission also must design and implement a comprehensive plan *at the federal and state level* that satisfies these statutory requirements. Only then will the Joint Board and the Commission be in a position to demonstrate that federal and state universal service mechanisms

¹¹ *Qwest v. FCC*, 258 F.3d at 1201.

¹² *Id.*

¹³ *Id.* at 1202.

provide support that is “sufficient” to advance and preserve universal service in the manner prescribed by section 254.

A. Problems with the *Recommended Decision*

Rather than providing definitions for statutory terms, the *Recommended Decision* focuses on rationalizing the status quo. For example, instead of defining “reasonably comparable,” the Joint Board examines the Commission’s arbitrary 135% nationwide cost benchmark and attempts to justify the results. Specifically, the Joint Board uses a cluster analysis to show that those states receiving non-rural carrier support under the 135% benchmark are states that have substantially higher costs than other states.¹⁵ It should not be surprising that a methodology designed to allocate support based on the difference between statewide average costs of non-rural carriers and the nationwide average of such costs will target support to the highest-cost states. But the statistical analysis that is used to justify the 135% benchmark still has no rational relationship to the reasonable comparability requirement of section 254. The Joint Board’s acknowledgement that state pricing structures vary widely from state to state, for reasons that include implicit subsidies remaining in local rates, is not an adequate basis for continuing to focus on statewide average cost comparability.¹⁶

The supplemental review process proposed by the Joint Board does at least compare rural and urban rates, but the *Recommended Decision* falls far short of providing a definition or an explanation of why it is appropriate to use a 135% benchmark to compare urban and rural rates. By failing to define “reasonably comparable,” the Joint Board avoids having to determine the

¹⁴ *Id.*

¹⁵ *Recommended Decision*, ¶ 36.

¹⁶ *See id.*, ¶ 19.

range of rate variations that will be deemed reasonable. As the Commission itself previously concluded, it would be “unreasonable to expect rate levels *not* to vary to reflect the varying costs of serving different areas.”¹⁷ Therefore, the Joint Board and the Commission must provide a definition of “reasonably comparable” in order to determine how much universal service support must be provided to offset the significant cost variations that exist between rural and urban areas.

With respect to the statutory term “affordable,” the Commission previously provided a definition of the term, but the Joint Board and the Commission have made no attempt to factor affordability into the federal universal service mechanism. The Commission’s definition recognizes that there is both an *absolute component* that takes into account an individual’s ability to pay for telephone service and a *relative component* that takes into account whether consumers are spending a disproportionate amount of their income on telephone service.¹⁸ As discussed further below, affordability is a critical statutory term because it establishes the demarcation point between costs that should be recovered from end users and costs that should be supported by universal service. Because affordability is currently not a consideration, the Commission has no way of knowing whether federal and state universal service mechanisms are providing a sufficient amount of universal service support or perhaps providing more support than is necessary to maintain affordable rates.

The Joint Board also recommends retaining the Commission’s narrow definition of “sufficiency” as the provision of enough universal service support to enable states to achieve

¹⁷ *Federal-State Joint Board on Universal Service; Access Charge Reform*, Seventh Report and Order and Thirteenth Order on Reconsideration in CC Docket No. 96-45 and Fourth Report and Order in CC Docket No. 96-262 and Further Notice of Proposed Rulemaking, 14 FCC Rcd 8078, at ¶ 30 (1999) (emphasis added).

¹⁸ *First Universal Service Order*, ¶ 110.

reasonable comparability of rates.¹⁹ This definition ignores the fact that the amount of universal service support also must be sufficient to maintain affordable rates and preserve and advance universal service, as required by section 254. If the federal funding mechanism is limited to achieving reasonable comparability, then the Commission must demonstrate that the other statutory requirements are being achieved by state universal service mechanisms. The Joint Board and the Commission, however, cannot simply limit their consideration to a single statutory requirement and ignore the others.

In addition, the *Recommended Decision* does not give any consideration to whether affordable and reasonably comparable rates are being achieved through implicit subsidies, which is contrary to the statutory requirement that universal service support be “specific, predictable and sufficient.” It is easy to claim that rates are affordable, if rates are kept below cost by regulatory fiat. And it is easy to claim that rural and urban rates are reasonably comparable, if states mandate the use of implicit subsidy mechanisms, such as rate averaging, value of service pricing or residual local service pricing. But the “sufficiency” and “reasonably comparable” requirements of section 254 must be satisfied by means of *explicit* universal service support mechanisms, not an outdated system of implicit subsidies. The Joint Board, however, merely acknowledges that states “tend to rely on implicit or explicit mechanisms to transfer support from low-cost lines to high-cost lines within a state” without any additional analysis.²⁰ Thus, as with the Commission’s prior decisions, the Joint Board appears to accept that implicit subsidies can continue unabated, notwithstanding the plain language of section 254.

¹⁹ *Recommended Decision*, ¶ 15.

²⁰ *Recommended Decision*, ¶ 24.

If anything, the record in this proceeding demonstrates that current universal service mechanisms are *not* providing sufficient explicit support to satisfy the requirements of section 254. The fact that the Commission's 135% benchmark produces a federal fund that is not significantly larger than the prior fund demonstrates that the Commission reverse-engineered the benchmark without taking any action to replace implicit subsidies with self-supporting end user prices and explicit universal service support.²¹ In fact, the Commission has actually exacerbated the problem by adding more than \$2 billion annually to the universal service system through the establishment of the schools and libraries fund. The Commission also has taken billions of dollars of implicit support out of the system without substituting adequate explicit universal service support mechanisms. These and other policy have decisions removed a significant portion of the revenues that carriers rely on to support the preservation and advancement of universal service. As a result, the universal service system is under more stress than ever without any action being taken to rationalize local prices and end the reliance on implicit subsidies.

The *Recommended Decision* also cites a GAO Report that found no statistical differences in residential local telephone rates between urban and rural areas, even though the estimated cost of providing local telephone service is almost 200% higher in rural areas than urban areas shows that there is no relation between costs and current rates.²² The GAO Report's findings provide compelling evidence that the federal universal service mechanism is having little effect in replacing implicit subsidies with a sufficient amount of explicit universal service support. There is also extensive evidence that has *not* been considered by the Commission or the Joint Board that illustrates the extent to which states continue to rely on below-cost pricing structures and

²¹ See *id.*, ¶ 30.

²² See *id.*, ¶ 15.

implicit subsidies. As SBC previously noted, many states have capped ILEC residential local prices without regard to the actual costs of providing service. In SBC's region, two states have not changed residential local prices in *five* years and two states have not changed residential local prices in *ten* years. Of those states that have changed prices recently, three states increased residential local prices, but six states *decreased* residential local prices. Attachment A hereto is a chart showing the highest price of residential local service in each state in SBC's region, as well as the date the price was last changed.

Some states have set averaged residential local prices according to the number of people in the local calling area, which produces the *lowest* prices in the *highest-cost*, lowest-density areas. In Texas, for example, the most sparsely populated rural calling areas pay the lowest monthly price of only \$8.15, whereas the most densely populated urban areas pay a monthly price of \$11.05. The situation is similar in Missouri, where the monthly price in the most sparsely populated rural area is only \$7.42 and the price in the most densely populated urban areas is \$12.41. The result is that regulated prices for ILEC residential local services often bear no relation to the costs of providing the service. Further, these prices often are the product of traditional intrastate ratemaking rules that rely upon residual pricing principles. This residual pricing methodology requires prices for discretionary services, such as vertical services, toll and switched access, as well as prices for some business services, to be set at artificially high levels so that residential local prices can be set below cost and still allow for overall cost recovery.²³

A number of states, including four states in SBC's region, have not even established explicit universal service funds. In those states that have established universal service funds,

²³ *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Ninth Report and Order and Eighteenth Order on Reconsideration, 14 FCC Rcd 20432, ¶ 15 (1999) (*Ninth Universal Service Order*).

contributions to the state funding mechanisms are driven by measures of intrastate activities, such as intrastate minutes of use and intrastate revenues. Despite the fact that SBC is one of the primary contributors to these state funding mechanisms, there are a number of states where SBC does not receive any support from the state fund. Thus, there is no factual basis for concluding that the Commission's existing mechanism provides a sufficient amount of explicit support to preserve and advance universal service.

The supplemental rate review process proposed in the *Recommended Decision* does nothing to establish a link between the support that is being provided and the rates that are being charged in rural and high-cost areas. The end result is still a federal universal service support mechanism based on statewide average costs, which effectively forces non-rural carriers such as SBC to attempt to sustain universal service through rate averaging and implicit subsidies. Once again, the *Recommended Decision* accepts this result, provided that it is confined to non-rural carriers. The Joint Board concludes that statewide averaging is appropriate in the non-rural mechanism, but it also cautions that such averaging "may not be appropriate for the high-cost mechanism providing support to rural carriers."²⁴ There is no statutory basis for such a distinction. The purpose of the universal service mechanism is to provide support that is sufficient to maintain affordable prices in rural and high-cost areas, not to allocate support differently based on arbitrary categories of carriers. It is not appropriate or reasonable for *any* carrier, whether rural or non-rural, to be forced to rely on statewide averaging as a mechanism for supporting universal service.

²⁴ *Recommended Decision*, ¶ 11.

B. SBC's Proposed Affordability Benchmark Approach

The Commission can give meaning to all of the statutory requirements of section 254 by implementing SBC's proposed affordability approach to universal service reform. Under SBC's proposal, the Commission would establish an affordability benchmark based on the median household income of a particular geographic area (*e.g.*, a county). In establishing an affordability benchmark, the Commission should compare local telephone service expenses to other categories of household expenses. For example, assuming that the Commission were to establish 3% as an affordability benchmark for local telephone service, Bureau of Labor Statistics data shows that this level of expense is less than the average household spends on energy expenses (3.2%), gasoline and motor oil (3.1%) and food away from home (5.1%). It is slightly more than the average household spends on television (including cable television service), radios and sound equipment (1.5%) and miscellaneous household equipment (1.8%).²⁵ The benefit of this type of comparison is that it shows not only the relative magnitude of local telephone service expenses, but also the relation of such expenses to purely discretionary expenses, such as television. By conducting an analysis of typical household expenses, the Commission would be able to establish a reasonable affordability standard upon which to base the universal service funding mechanism.

Once the Commission establishes an affordability benchmark, it should establish a universal service mechanism that provides funding in geographic areas where the forward-looking cost of providing service exceeds the affordability benchmark. The combined amount of explicit federal and state universal service support would give carriers enough funding to pay for the difference between the affordability benchmark in a geographic area and the forward-looking

²⁵ See Attachment B.

cost of providing service in that same area. While support could be raised in both the federal and state jurisdictions, there would have to be an integrated universal service mechanism that determines the *total* amount of universal service support that is needed for the entire nation.

SBC's proposal to establish an affordability benchmark for a particular geographic area, such as a county, would result in federal and state universal service mechanisms that produce more targeted results than the use of statewide average costs and a nationwide average cost benchmark. Identifying median household income for a smaller geographic area in order to determine whether household expenditures for universal service are affordable resolves the issues caused by averaging data over large geographic areas, which has the effect of hiding those rural and high-cost areas that may require support. This feature of SBC's proposal will ensure that support is available and thus sufficient to maintain affordable prices in those rural and high-cost areas that need assistance.

SBC's proposed approach to universal service does not aim to fully reimburse carriers for their actual costs and eliminate all implicit subsidies. In particular, carriers would not receive support equal to their actual costs in geographic areas where such costs exceed either the forward-looking economic cost of providing service or the affordability benchmark. Nevertheless, SBC believes this conservative approach is reasonable, provided that carriers are able to recover their costs from revenue sources, such as vertical services, that are inseparable from the residential local service provided to the customer.

The Commission also should establish a transition plan that allows residential local telephone prices to rise to levels that are self-supporting and affordable. Instead of attempting to identify the amount of explicit support needed to replace implicit subsidies from various sources such as toll charges, interstate and intrastate switched access charges, vertical services, business

services and averaged prices, the Commission should focus on rationalizing residential local service prices. Specifically, the Commission should immediately initiate a proceeding to establish inducements or agreements for states to establish residential pricing structures that would allow prices for residential local service to rise to levels that are self-supporting. This could be accomplished a number of different ways. SBC believes the best approach would be for the Commission to establish general universal service pricing standards that satisfy the requirements of section 254 and set a deadline for the states to put in place specific pricing structures that are consistent with these standards. A similar process has been used to implement the local competition requirements of the 1996 Act.

It should not be difficult to establish a “just and reasonable” standard for residential local prices. By incorporating a “just and reasonable” price standard as a universal service requirement in section 254(b), Congress merely incorporated the existing requirement of section 201(b) that prices for interstate services must be just and reasonable. The Commission has extensive experience ensuring that tariff terms and conditions — including prices — are just and reasonable under section 201(b). As SBC indicated in its *Inter-carrier Compensation* comments, all carriers should be allowed to charge market-based prices that are self-supporting. The Commission’s pricing standards also should be flexible enough so that all carriers have the ability to respond to market forces by implementing calling and pricing plans that meet the needs of customers. States would continue to have the authority to regulate prices for intrastate services, provided that their pricing structures are consistent with the Act and the Commission’s implementing regulations.

III. THE *RECOMMENDED DECISION* DOES NOT PROVIDE ADEQUATE INDUCEMENTS FOR STATE UNIVERSAL SERVICE MECHANISMS

The Tenth Circuit held that the Commission has an obligation to ensure that states take the necessary action to achieve the universal service requirements of section 254. As the court noted, the Commission’s federal universal service mechanism will result in reasonably comparable rates only if states implement their own universal service mechanisms.²⁶ The Commission, however, did nothing to ensure that these mechanisms exist.²⁷ The court held that the Commission “may not simply assume that the states will act on their own to preserve and advance universal service” — it remains obligated to “undertake the responsibility to ensure that the states act.”²⁸ On remand, the Tenth Circuit directed the Commission to “develop mechanisms to induce adequate state action” to achieve the statutory goals of universal service.²⁹

The *Recommended Decision* does nothing to ensure that states have established the necessary explicit mechanisms for preserving and advancing universal service, as required by the Tenth Circuit. The Joint Board identifies the Commission’s role as being limited to providing support to high-cost states with statewide average costs well above the national average.³⁰ While this approach to the federal universal service mechanism might be reasonable in theory, it relies heavily on the states to achieve the goals of universal service in their borders. Yet the Joint

²⁶ *Qwest v. FCC*, 258 F.3d at 1203.

²⁷ *Id.*

²⁸ *Id.* at 1204.

²⁹ *Id.*

³⁰ *Recommended Decision*, ¶ 25.

Board and the Commission do not even have any information that would allow them to analyze state universal service mechanisms.

The *Recommended Decision* will not induce state action to implement the requirements of section 254. Indeed, the *Recommended Decision* tacitly endorses the use of implicit subsidies as a legitimate way for states to support universal service, even though implicit subsidy mechanisms are unsustainable and contrary to the requirements of section 254.³¹ The *Recommended Decision* also supports retention of the Commission's 135% benchmark, which encourages states to maintain universal service through rate averaging and implicit subsidies by artificially limiting the amount of federal support and masking the high cost of providing local telephone service in many rural areas. The supplemental mechanism proposed by the Joint Board may not result in any additional funding for high-cost states, and it certainly will not induce states to establish universal service mechanisms within their borders.

The Commission can and should do much more. As SBC previously demonstrated, the Commission has the authority, but also the obligation, to end reliance on implicit subsidies and implement meaningful universal service reform. Such a plan is meaningless unless it rationalizes local service prices and removes implicit subsidies from intrastate services. Although universal service support comes from both federal and state mechanisms, ultimately all of this support is being used for a single service — residential local telephone service. Thus, both the Commission and the states must assume responsibility for implementing universal service reform.

The Tenth Circuit's decision stands for the proposition that the Commission has an obligation to ensure that states take the necessary action to achieve the requirements of Section

³¹ *Id.*, ¶ 24.

254. The court’s holding reflects the Commission’s expanded responsibility for universal service as a result of the 1996 Act. Indeed, just as sections 251 and 252 significantly expand the Commission’s authority over intrastate services to facilitate the introduction of competition in the local market, section 254 significantly expands the Commission’s authority to provide universal service support for local services. There are numerous examples of this delegation in section 254. For example, section 254(a)(2) directs the Commission, with input from the Joint Board, to conduct a proceeding to implement a federal universal service mechanism. In addition, section 254(c) directs the Commission to maintain an evolving definition of universal service that takes into account advances in telecommunications and information technology and services, and section 254(d) requires the Commission to establish a mechanism for collecting universal service contributions from providers of interstate telecommunications services providers (and providers of interstate telecommunications if the Commission determines it is in the public interest). The Commission also has the responsibility under section 254(h)(2) for establishing rules to enhance the availability of advanced services for schools, health care facilities and libraries.

At the same time, the court’s holding reflects the fact that Congress plainly contemplated a partnership between the Commission and the states to support universal service.³² The court itself noted numerous examples illustrating Congress’ intent: (i) section 254(b)(5) provides that “there should be specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service;” (ii) section 254(f) provides that “[e]very telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, in a manner determined by the State to the preservation and

³² *Qwest v. FCC*, 258 F.3d at 1203.

advancement of universal service; and (iii) section 254(k) provides that both the Commission and the states must “ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.” In addition to these statutory provisions, section 254(f) provides that a state is prohibited from adopting regulations that are inconsistent with the Commission’s rules to preserve and advance universal service, and section 254(i) provides that “the Commission and the States should ensure that universal service is available at rates that are just, reasonable and affordable.”

SBC believes the only way to make sense of this statutory scheme is to assume that Congress intended to establish a dual-jurisdiction regime similar to the one established in sections 251 and 252. Therefore, the Supreme Court’s analysis of the jurisdictional balance struck by sections 251 and 252 is instructive. In reviewing the Commission’s rules implementing sections 251 and 252, the Supreme Court confirmed the Commission’s jurisdiction to adopt rules governing matters to which the 1996 Act applies.³³ It held that Section 201(b) provides the Commission with rulemaking authority to carry out the “provisions of this Act,” which includes the provisions of Sections 251 and 252 added by the 1996 Act.³⁴ The Supreme Court concluded that the Commission’s prescription of a pricing methodology through rulemaking does not prevent the states from establishing rates, because it is the states that “determine the concrete result in particular circumstances.”³⁵ The argument for applying the Supreme Court’s reasoning to the universal service provisions of the 1996 Act is bolstered by the

³³ *AT&T Corp. v. Iowa Util. Bd.*, 525 U.S. 366, 385 (1999).

³⁴ *Id.* at 377-78 (*citing* 47 U.S.C. § 201(b)).

³⁵ *Id.*, at 384.

fact that section 254(f) and 252(c) both require that state actions must be consistent with the Commission's regulations.

Clearly, the Commission must do more than just establish a limited amount of federal universal service support without any knowledge, let alone assurance, of what states are doing to promote universal service. The elimination of implicit subsidies and implementation of residential pricing reform are essential components of meaningful universal service reform. Anything less would not "preserve and advance universal service," as required by Section 254(f), and would maintain unlawful implicit subsidies. As previously discussed, both Congress and the Commission have recognized that implicit subsidies are not sustainable in a competitive environment and that regulators cannot continue to rely on implicit subsidies as a source of universal service support. Accordingly, the Commission has the authority to institute comprehensive universal service reform and to establish inducements for states to reform residential local prices and end reliance on implicit subsidies from various sources (*e.g.*, toll services, intrastate switched access, business services, and statewide average prices) by a date certain.

IV. COMPREHENSIVE UNIVERSAL SERVICE REFORM THAT ELIMINATES IMPLICIT SUBSIDIES IS URGENTLY NEEDED AS A POLICY MATTER

There are compelling public policy reasons for the Commission to move expeditiously to implement significant universal service reform that eliminates implicit subsidies. The Commission has recognized the competitive distortions that are created by the combination of implicit subsidies and below-cost residential local prices:

[E]fforts to sustain implicit universal service support in a competitive environment could encourage business decisions contrary to the purpose of high-cost support For example, competitors may be more likely to target high-revenue business customers in low-cost urban areas where incumbent LECs are charging rates significantly above costs, while foregoing opportunities to serve lower-revenue residential customers in high-cost

rural areas where incumbent LECs are charging artificially low rates because of implicit support flows.³⁶

Instead of tackling this difficult and politically sensitive issue, however, the Joint Board and the Commission have assigned the highest priority to avoiding an increase in the amount of federal universal service support.³⁷ This effectively amounts to a policy decision that the Joint Board and the Commission will not take any action to reduce, let alone eliminate, the reliance on implicit subsidies as the primary source of universal service support. The Joint Board and the Commission also have declined to establish effective inducements for states to replace intrastate implicit universal service support with a combination of self-supporting residential local service prices and explicit universal service support where it is needed to maintain affordable prices. The statutory goals of universal service will never be realized until implicit subsidies are eliminated and prices for residential local service are self-supporting.

It is inevitable that, in a competitive market, ILECs that are dependent on switched access prices and business service prices as sources of implicit subsidies will lose customers to competitors that do not need to subsidize below-cost services.³⁸ This situation is not sustainable. As ILECs lose low-cost, high-revenue customers to competitors or reduce their prices to stem such losses, the implicit support for residential services necessarily disappears.³⁹ It is precisely

³⁶ *Ninth Universal Service Order*, ¶ 16.

³⁷ *Federal-State Joint Board on Universal Service; Access Charge Reform*, Seventh Report and Order and Thirteenth Order on Reconsideration in CC Docket No. 96-45 and Fourth Report and Order in CC Docket No. 96-262 and Further Notice of Proposed Rulemaking, 14 FCC Rcd 8078, at ¶¶ 16, 69 (1999).

³⁸ *Id.*

³⁹ *Ninth Universal Service Order*, ¶ 16. Each customer that an ILEC loses to a competitor results in the loss of implicit subsidy revenues from interstate and intrastate switched access charges, common line charges, toll services and vertical features.

for this reason that Congress established a requirement that federal and state universal service mechanisms must be “specific, predictable and sufficient.”⁴⁰ The Commission does not have the authority to ignore or second-guess Congress’ determination that universal service support should be explicit, rather than implicit. In fact, the Fifth Circuit held that “the plain language of Section 254(e) does not permit the FCC to maintain implicit subsidies,”⁴¹ and it determined that the Commission could not even *allow* carriers to recover universal service costs through access charges because such recovery constitutes an unlawful implicit subsidy.⁴²

Further, carriers that are forced to generate their own implicit subsidies bear the entire funding burden of supporting universal service, which is contrary to the requirements of sections 254(d) and (f) that all carriers that provide interstate and intrastate telecommunications services contribute in an equitable and nondiscriminatory manner. For these reasons, the only type of funding mechanism that can satisfy the requirements of section 254 is one that provides explicit universal service support. Thus, the elimination of implicit subsidies is a statutory imperative, as well as an important policy goal.

It also is inevitable, as the Commission has recognized, that subsidies distort business decisions by competitors, driving them to target high-revenue business customers in low-cost areas and to ignore residential customers in higher-cost areas where ILECs are charging below-cost prices.⁴³ The D.C. Circuit recognized the competitive distortion that results from state

⁴⁰ 47 U.S.C. § 254(b)(5).

⁴¹ *Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393, 425 (5th Cir. 1999), *cert. granted sub nom. GTE Serv. Corp. v. FCC*, 530 U.S. 1213 (2000), *cert. dismissed* 531 U.S. 975 (2000).

⁴² *Comsat Corp. v. FCC*, 250 F.3d 931, 938-39 (5th Cir. 2001).

⁴³ *Ninth Universal Service Order*, at ¶ 16.

pricing structures in its decision reviewing the Commission's unbundling rules. Specifically, the court stated:

One reason for such market-specific variations in competitive impairment is the cross-subsidization often ordered by state regulatory commissions, typically in the name of universal service. This usually brings about undercharges for some subscribers (usually rural and/or residential) and overcharges for others (usually urban and/or business).⁴⁴

The court concluded that competitors will probably not be attracted to markets where customers are charged below-cost prices and that "given ILECs' regulatory hobblings," any competition in these markets will be "wholly artificial."⁴⁵

The message of the D.C. Circuit's holding is clear. The current system of implicit subsidies is acting as a barrier to local competition and sustainable facilities-based competition will never fully develop in residential local markets until prices are rationalized. Instead of attempting to manufacture competition by driving down wholesale prices to artificially low levels, the Commission should focus on the demand side by allowing local residential prices to rise to levels that will attract competition. Universal service reform is a critical component of local competition policy because universal service mechanisms must ensure that prices remain affordable in high-cost areas.

Moreover, as SBC explained in the *Intercarrier Compensation* proceeding, the Commission cannot replace interstate and intrastate switched access charges with a bill and keep regime without first tackling the issues of end user pricing and universal service reform. Access charges are critical to recovering the costs of local service attributable to interexchange traffic. If those costs are not recovered through carrier access charges, then they must be recovered

⁴⁴ *USTA v. FCC*, 290 F.3d 415, 422 (D.C. Cir. 2002), *pet. for cert. filed*, No. 02-858 (Dec. 6, 2002).

⁴⁵ *Id.*

through appropriate end user charges. The Commission *cannot* eliminate switched access charges without first *ensuring* that there are federal and state end user recovery mechanisms in place.

V. CONCLUSION

For these reasons, the Commission should conduct a further proceeding that develops a more extensive record on state pricing structures and the implicit subsidies that are being used to support below-cost residential local telephone rates. In order to respond to the Tenth Circuit's remand decision, the Commission must define key statutory terms and establish a federal universal service mechanism that comports with the statutory requirements of section 254. The Commission also must work with state commissions to ensure that states have established the necessary mechanisms for preserving and advancing universal service. By implementing comprehensive universal service reform based on an affordability benchmark approach, the Commission will be removing barriers to local competition and laying the groundwork for intercarrier compensation reform.

Respectfully Submitted,

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Attachment A:

**Residential Rates in
SBC's 13-State Region**

SBC Local Residential and Business Service

Residential Service

State	Local Residential Service Rate	Measured Rate	Last Date Rate Changed	Rate Prior to Change	Rate Increase or Decrease	Reason/Rationale for Change
Ohio ¹	\$14.25	N/A	1/9/00	\$14.40	Decrease	State Price Cap Adjustment
Arkansas	\$16.60	N/A	3/1/02	\$16.31	Increase	State Price Cap Adjustment
Michigan	\$14.31	N/A	3/28/01	\$13.96	Increase	Annual Inflation Adjustment per State Legislation
Illinois ²	\$13.45	\$9.00 + \$0.05/call	4/1/02	\$9.00 + \$0.015/min	Decrease	State Price Cap Adjustment
Kansas	\$17.00	N/A	10/1/02	\$17.25	Decrease	State Price Cap Adjustment
Connecticut	\$14.53	N/A	7/1/94	\$14.27	Increase	State Price Cap Adjustment
Oklahoma	\$14.34	N/A	1/29/86		Increase	
Indiana	\$11.51	N/A	1/1/02	\$12.17	Decrease	OI 2000
Wisconsin ³	\$11.82	\$6.57 + \$0.04/call	12/14/02	\$6.28+ \$0.05/call	Decrease	State Price Cap Adjustment
Missouri	\$12.41	N/A	12/1/02	\$12.30	Increase	State Price Cap Adjustment
Texas	\$11.05	N/A	3/15/85		Increase	
Nevada	\$10.75	N/A	1/1/97	\$10.00	Increase	Rate Rebalancing
California ⁴	\$10.69	N/A	11/1/99	\$11.22	Decrease	State Price Cap Adjustment

- *Tariff sheets obtained through TelView.com.*
- *Residential and Business rates are based on the highest basic line charge and average monthly usage.*
- **Intrastate Switched Access Rates** are rates paid by a long distance company to a local telephone company for using the local network to reach both customers involved in a long distance call. **Measured Service** is local telephone service on a usage-sensitive basis rather than a flat monthly rate.

¹ Rate includes TouchTone.

² Rate based on average monthly usage of 108 calls.

³ Measured rate based on average monthly usage of 150 minutes.

⁴ Does not include the non-optional EAS surcharge of \$7.03.

⁵ Measured rate based on average monthly usage of 225 minutes.

⁶ Rate based on average monthly usage of 295 minutes.

Attachment B:

**Selected Expenditures from
Bureau of Labor Statistics
Consumer Expenditures Report**

Average Annual Household Expenditures

Household Expenditures	United States		Northeast		Midwest		South		West		Urban		Rural	
<i>Housing</i>	32.1%	\$ 13,319	30.4%	\$ 13,505	29.4%	\$ 11,961	27.5%	\$ 10,855	32.4%	\$ 13,972	30.1%	\$ 12,828	25.7%	\$ 8,775
<i>Food at Home</i>	7.3%	\$ 3,021	7.2%	\$ 3,202	7.2%	\$ 2,933	7.2%	\$ 2,823	7.6%	\$ 3,269	7.2%	\$ 3,054	8.2%	\$ 2,797
<i>Food Away from Home</i>	5.1%	\$ 2,137	4.9%	\$ 2,175	5.7%	\$ 2,322	4.8%	\$ 1,901	5.3%	\$ 2,285	5.2%	\$ 2,200	5.0%	\$ 1,703
<i>Residential Energy</i>	3.2%	\$ 1,315	3.4%	\$ 1,500	3.3%	\$ 1,337	3.5%	\$ 1,395	2.3%	\$ 1,011	3.0%	\$ 1,297	4.2%	\$ 1,445
<i>Gasoline and Motor Oil</i>	3.1%	\$ 1,291	2.5%	\$ 1,094	3.3%	\$ 1,352	3.3%	\$ 1,290	3.2%	\$ 1,400	3.0%	\$ 1,260	4.4%	\$ 1,507
<i>Gifts of Goods and Services</i>	2.6%	\$ 1,083	2.5%	\$ 1,096	3.2%	\$ 1,291	2.3%	\$ 908	2.6%	\$ 1,131	2.6%	\$ 1,120	2.4%	\$ 827
Telephone	2.1%	\$ 877	1.9%	\$ 856	2.2%	\$ 884	2.3%	\$ 891	2.0%	\$ 864	2.1%	\$ 889	2.3%	\$ 790
<i>Miscellaneous Household Equipment</i>	1.8%	\$ 731	1.6%	\$ 702	1.9%	\$ 782	1.6%	\$ 630	2.0%	\$ 865	1.8%	\$ 752	1.7%	\$ 588
<i>Television, Radios, and Sound Equipment</i>	1.5%	\$ 622	1.4%	\$ 627	1.6%	\$ 665	1.5%	\$ 574	1.5%	\$ 648	1.5%	\$ 626	1.7%	\$ 593
<i>Medical Services</i>	1.4%	\$ 568	1.1%	\$ 504	1.4%	\$ 575	1.4%	\$ 533	1.6%	\$ 669	1.3%	\$ 570	1.6%	\$ 550
<i>Entertainment Fees and Admissions</i>	1.2%	\$ 515	1.3%	\$ 577	1.4%	\$ 566	1.0%	\$ 395	1.4%	\$ 595	1.3%	\$ 548	0.8%	\$ 282
<i>Other Entertainment Supplies and Equipment</i>	0.9%	\$ 393	0.9%	\$ 395	1.1%	\$ 449	0.8%	\$ 335	1.0%	\$ 423	0.9%	\$ 370	1.6%	\$ 555
<i>Alcoholic Beverages</i>	0.9%	\$ 372	0.9%	\$ 390	1.0%	\$ 388	0.8%	\$ 304	1.0%	\$ 449	0.9%	\$ 390	0.7%	\$ 247
<i>Pets, Toys, and Playground Equipment</i>	0.8%	\$ 334	0.7%	\$ 316	0.9%	\$ 360	0.8%	\$ 313	0.8%	\$ 355	0.8%	\$ 328	1.1%	\$ 372
<i>Tobacco Products and Smoking Supplies</i>	0.8%	\$ 319	0.7%	\$ 326	0.9%	\$ 360	0.8%	\$ 334	0.6%	\$ 245	0.7%	\$ 310	1.1%	\$ 378
<i>Water and Other Public Services</i>	0.7%	\$ 296	0.5%	\$ 214	0.7%	\$ 291	0.8%	\$ 311	0.8%	\$ 351	0.7%	\$ 308	0.6%	\$ 218
Number of Households	109,367		20,994		25,717		38,245		24,410		95,627		13,740	
Income After Taxes (2000)	41,532		44,456		40,711		39,468		43,088		42,570		34,171	
Description of Regional Classifications			Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York,		Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North		Alabama, Arkansas, Delaware, District of Columbia, Florida, Georgia, Kentucky,		Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, New Mexico,		All persons living in Metropolitan Statistical Areas (MSAs) and in urbanized areas and urban places of 2,500 or more persons outside of MSAs. Urban, defined in this survey, includes the rural populations within an MSA.		All persons living outside a Metropolitan Statistical Area (MSA) and within an area with a population of less than 2,500 persons.	

Data Sources: Bureau of Labor Statistics
<http://www.bls.gov/cex/2000/Standard/tenracar.pdf>
<http://www.bls.gov/cex/2000/Standard/region.pdf>