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April 10, 2003

NOTICE OF *EX PARTE* PRESENTATION

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 Twelfth Street, SW, Room TW B204
Washington, D.C. 20554

Re: <u>Federal-State Joint Board on Universal Service, CC Docket No. 96-45</u>

Dear Ms. Dortch:

On April 9, 2003, the undersigned, Indra Chalk and Robert Blau (BellSouth), on behalf of the United States Telecom Association (USTA), discussed the attached issues paper concerning the future of universal service with William Maher, Carol Mattey, Narda Jones and Eric Einhorn of the Wireline Competition Bureau. In accordance with FCC Rule 1.1206(b)(1),[1] this Notice of *Ex Parte* Presentation and a copy of the issues paper are being filed with you electronically for inclusion in the record of the above-referenced proceeding. Should you have questions, please contact me at (202) 326-7300.

Sincerely,

Lawrence E. Sarjeant

Lawrence E. Sarjeant
Vice President – Law
and General Counsel

Attachment

cc: William Maher
Carol Mattey
Narda Jones
Eric Einhorn

[1] 47 C.F.R. § 1.1206(b)(1).

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Universal Service at Risk

Charting a Stable, Sustainable Future

For more than a century, our nation's telecommunications network has helped define the fabric of American life. Like the electrification of the countryside, the nation's commitment to universal service -- seeing essential telecommunications reach every corner of the country – has played a major role in America's economic and social development. The ubiquitous presence of a telephone in virtually every American home stands as one of the nation's landmark achievements of the 20th century and a testament to the efficacy and value of the universal service program.

Universal service support exists to bring essential telecommunications service to parts of the country where the market alone cannot support its presence. By easing the extraordinary costs of reaching sparsely populated areas, universal service helps ensure that all Americans have affordable, reliable access to a dial tone and the security and opportunities it represents. With the nation's evolution from an industrial to an information economy and with the country's escalating security concerns, reliable access to essential telecommunications has never been more important. Yet the funding mechanism that ensures this broad access today is in peril—undercut by telecommunications policies that discourage investment, undermine the evolution of healthy telecommunications markets, lavish resources on companies that do not face the same obligations as incumbent wireline providers, and turn a blind eye to new platforms that now regularly compete for consumers' communications dollars, but that do not contribute their fair share to the universal service support funding mechanisms.

Fortunately, there is growing recognition of the value and vulnerability of universal service funding mechanisms. The Federal Communications Commission (FCC) recently adopted an interim funding mechanism that makes incremental progress. It also has proceedings underway to contemplate long-term solutions to perpetuate the program. This paper examines the trends that have placed federal universal service support in jeopardy today, as well as solutions to ensure the fair and fiscally sound continuation of this vital program.

The Core Challenge: A Costly, Unsustainable Status Quo

For most of their existence, universal service mechanisms have focused on mitigating the high costs associated with delivering vital telecommunications services and infrastructure to rural, insular and remote parts of the nation. With the Telecommunications Act of 1996 (1996 Act), however, Congress set universal service on a perilous path of 'mission creep.' Rather than a focused cost-recovery mechanism aimed at helping facilities-based infrastructure providers offset extraordinary costs toward the public benefit, universal service has become a costly and sprawling mechanism rooted in the well-intentioned, but overly simplistic philosophy that supporting competition for competition's sake must be even better. Unfortunately, this has been implemented without a thorough and fair evaluation of the public interest.

Seven years after the passage of the 1996 Act, this policy alteration—and how it was executed--has set off a chain reaction that now has called the entire program's sustainability into question. As a result of this alteration, the number of companies successfully gaining universal service support has exploded. In fact, if the trend continues unabated, experts predict the high-cost fund will, due to this factor alone, grow by $2 billion over the next four years.

Inflating the Balloon

The primary driver inflating the costs associated with Universal Service are provisions of the 1996 Act that open up support to multiple providers in the same service area that successfully secure status at the state level as Eligible Telecom Carriers (ETCs). For incumbents to gain universal service support, they must thoroughly document the costs of their telecom infrastructure, promise to deliver a specified list of services, and most importantly, continue to fulfill the regulatory, public safety, and national security expectations and obligations of state and federal officials. So while incumbent providers have access to a cost-recovery mechanism, non facilities-based providers are offered what amounts to a windfall. They get the money, regardless of whether they are truly fulfilling the obligation of being a critical infrastructure provider, and potentially the sole critical infrastructure provider, in a particular area. This perpetuates a fundamental disparity rampant throughout today's outdated system of wireline regulation: rewarding those who fail to assume the full obligations of a true carrier of last resort and punishing those that actually carry out the Fund's initial purpose of delivering the infrastructure that ensures reliable, affordable access to basic services in every community across the country.

This expensive mission creep undermines the political viability and economic sustainability of the entire program. With far more companies participating at a price tag in the billions of dollars, taxpayers and legislators see diminishing returns on their rising investments because the benefits of support for multiple carriers in each service area rarely outweigh the explosion in costs.

There also is a strong argument to be made that this subsidy-heavy approach undermines the evolution of healthy, sustainable markets in rural America, as well as the rollout of leading-edge services. The way rural markets develop, typically one business determines that there is adequate 'critical mass' to support their business. Then, over time, the opportunity and the community grow to the point where others are attracted into the area and competition ensues. In the case of telecom, universal service support has skewed the economics of what attracts companies to higher cost areas. A mechanism that lures multiple providers and subsidizes inferior service undermines this natural evolution, all but ensuring long-term dependence on government subsidies and weakening the growth of a sustainable market and the investment that typically accompanies it.

Cherry-picking Further Punishes True Carriers of Last Resort

Another challenge to the current USF structure is the effort in some states to reduce the size of USF service areas in places served by rural telephone companies. This is yet another attempt to use universal service to promote competition rather than simply access to affordable, essential services. For example, CenturyTel is fighting such an effort in Colorado. States' segmentation of service areas to a granular level encourages competitors to selectively enter areas with higher revenue customers, leaving incumbents (which have carrier of last resort obligations for the broader service area as a whole) with the least profitable customers of all.

Funding competition that cannot be supported by normal marketplace economics, and handing out vast amounts of resources to companies without the obligations and expectations that accompany service provided by the incumbent LEC, clearly call into question the future viability of the program. In fact, the purse strings are perceived to have become so loose in recent years that organizations that target government waste are starting to zero in on high-cost USF support, making it imperative that the Fund be operated in a more responsible and restrained manner in the future, in order to ensure that its important core work continues.

Spreading the Burden Fairly

The current universal service approach has undermined the program's initial purpose--delivering to remote communities the economic opportunities and security of a dial tone. However, like U.S. telecom policy in general, the universal service program is behind the times in making another crucial acknowledgement: In the 21st Century telecom marketplace, voice telephony is no longer the sole domain of incumbent local exchange carriers.

Consider these core facts:

- Today, one in five Americans use their cell phone as their home phone; half of all Americans, according to Forrester Research, will follow suit in five years' time;

- The cable industry is adding 100,000 new voice customers every month; and Cox Cable today is the 12th largest phone company in the nation;

- Internet-based telephony is beginning to go mainstream; in fact, the U.S. Department of Commerce is in the process of transferring its entire telephone system to Internet-based telephony.

- Even in the traditional wireline market, 93% of households have at least two local providers serving them.

Given that the 21st Century telecommunications marketplace has diversified, so too must the pool of contributors to universal service. This is the only path to ensuring a platform neutral approach in which all participants in the marketplace contribute, so no set of companies is put at a disadvantage.

The Current Mechanism is Not Sustainable

The current mechanism used to collect federal universal service support as established in Section 254 of the Telecommunications Act of 1996 is not sustainable. Congress, when it passed the 1996 Act, had multiple goals. First and foremost, however, it wanted to promote local telephone competition, even in rural areas where the provision of service is extremely costly and without universal service support would be prohibitively expensive to the consumer. Density, or more appropriately, the lack of density, is the costly rural problem—there are more telephones in a typical Manhattan office building than there are in the entire service area of many rural telephone providers. Nonetheless, Congress specifically provided for the possibility of multiple non facilities-based recipients of federal universal service support—this was in furtherance of its primary policy goal of local telephone competition in all areas, including rural ones. In other words, universal service support would, pursuant to the 1996 Act, be used to facilitate the entry of new local telephone providers even in areas served by rural telephone companies — this then is the "mission creep". Section 214 of the Communications Act of 1934 was amended by the 1996 Act to authorize multiple "eligible telecommunications carriers" (ETCs) to be the recipients of universal service support in rural areas, with state commission approval. The funding source for this universal service support is "telecommunications carriers that provide interstate telecommunications service." Consequently, the states have no reservations about authorizing additional ETCs, given that they have no responsibility for raising the universal service support funds that will be distributed in their states. Only the FCC has this fundraising duty, and the courts have instructed the FCC that only interstate revenues may serve as the basis for assessing federal universal service support contributions.

This statutory combination of universal service support as a local telephone competition facilitation device, coupled with the limitation on universal service support contributions to only narrowly based interstate revenues, places extreme pressure on these federal universal support mechanisms. In and of themselves, these two factors alone will render the existing federal mechanisms unsustainable, in that demands for universal service support funds are increasing far more rapidly than interstate revenues are growing. Over the next five years, USTA estimates that demands for universal service support will increase substantially, from $7.4 billion to $11.9 billion, while the interstate service revenue funding base remains flat at best.

In addition to these two factors, however, there are other developments in the telecommunications marketplace that make the current federal universal service support mechanism truly unsustainable. First, for decades, states have established a host of implicit subsidy mechanisms and telecommunications rate determinations that need federal universal service support in order to be maintained. Devices of this sort can exist in the non-competitive telecommunications environment that existed when they were originally established, but that era has passed. Rates in high cost areas must be rebalanced. Second, popular flat rate, all-distance pricing plans for voice services are rendering distinctions between interstate and all other telecommunications services meaningless and thus unworkable as a basis for collecting universal service support funds going forward. Third, voice over are Internet protocol services (VOIP) thus far have been considered by the FCC to be information services and not telecommunications services. This means that revenues from these VOIP services cannot be assessed universal service contributions. These VOIP services, often provided by cable modem and Internet service providers, will skew demand in favor of these services, making it increasingly costly, if not impractical, for traditional telecommunications service providers to continue funding universal service support even at existing levels.

Universal Service Reform—What Should Be Done?

Support Recipients Must Have an Equality of Obligations

The policy of using universal service support as a means to promote competition has proven to be an expensive failure. This artificial approach simply adds to the cost of the universal service program. States should make reasoned public interest findings before designating additional ETCs, with full consideration of an equality of obligations on carriers and equality of expectations of all of the consumers in the subject service area. A recipient should be required to serve an entire high cost area – not just the least costly part, as is often the case today.

Broader Support Base

The FCC should be given the authority to impose a support fee on a broader base of telecommunications products and services. By broadening the base for universal service support to all telecommunications products and services, both technological and competitive neutrality will be achieved. The receipts from these fees must be targeted exclusively to universal service support purposes in a manner similar to the specifically targeted and Congressionally mandated assessments for highways and airports.

Rate Rebalancing

Rates for telecommunications services should be comparable throughout a given state. Considerable universal service support is now being utilized to maintain telecommunications service rates in some areas of states at rate levels that are much lower than those existing for equivalent service in other areas of such states. To lessen this demand, rate rebalancing should occur.

Telephone rates have for decades been based in many instances on political and social considerations that could be justified and effective in a non-competitive, monopoly environment. Conversely, a competitive environment, where all telecommunications products and services are legally open to competition, should require state regulators to adjust these rates in a manner that reflects this new competitive marketplace reality. This rate rebalancing should be accomplished without the necessity of extensive and expensive rate cases. When accomplished on a revenue neutral basis, the remedy should not require extensive regulatory intervention.

Support Should Be Based Upon Actual Costs

Because of the ever increasing demand for universal service funds due to the requirement to fund multiple ETCs from a declining interstate revenue base, for larger ILECs, the FCC has employed a cost recovery methodology that does not permit the recovery of the actual costs incurred by such carriers in high cost areas. Universal service support is needed in high cost areas to keep telephone rates comparable to rates in other parts of the country and thus, widely affordable. Consequently, actual cost recovery is a necessary component of any universal service reform plan.

Conclusion

Our universal service support structure needs to go back to the core concepts that were in place prior to the passage of the 1996 Act, but in a manner consistent with today's converged marketplace. Everyone should pay into the fund on technology neutral principles; eligibility for ETC status should be based on sound economic and public interest fundamentals; support should be based on actual costs; states should not continue to expect that designation of additional ETCs is a license to increase the burden on interstate ratepayers; and, rationalizing the system of support cannot happen if rate rebalancing does not occur. Under these concepts, incumbent LECs and their customers will have a more equitable climate, while interexchange carriers will receive significant relief as a result of continued declines in the access charge regime. The funding burden can be relieved on everyone as the base of who contributes is broadened. This will promote investment in rural areas because there will be a reliable source of universal service funding that keeps rates affordable, that gets comparable services out to these parts of the country, that encourages providers to invest in facilities and provide advanced services and intrastate calling should be much cheaper and providers will have more opportunity to creatively bundle their services.