

**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 GENERAL COMMUNICATION, INC.

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May 5, 2003

SUMMARY

The Joint Board seeks comment in three areas: (1) the Commission's rules for high cost universal service support in areas where a competitive eligible telecommunications carrier ("CETC") is providing service; (2) the Commission's rules regarding support for additional lines to a home or business; and (3) the process for designating ETCs.

The issues presented for comment in the *Public Notice* implicate the two fundamental goals of the Telecommunications Act of 1996 (the "1996 Act"), competition and universal service. These goals don't simply complement one another: one cannot be fully achieved without the other. Where market conditions support it, competition ensures that services are delivered to consumers in the most efficient manner and at the lowest price. Competition also provides an incentive for carriers to invest in network facilities used to provide high-quality, advanced telecommunications services. Universal service, working in tandem with competition, ensures that when unsubsidized retail rates for supported services are too high to keep those rates affordable and reasonably comparable between urban and rural areas, subsidies will bring those rates down to affordable and reasonably comparable levels. If constructed correctly, universal service support will neither preclude competitive entry where it is economically efficient, nor support entry where it is not. The real beneficiaries will be consumers, not competitors – just as the 1996 Act intended.

Unfortunately, that is not the way universal service has been implemented to date. Seven years after the enactment of the 1996 Act, the Commission's universal service policies for rural, insular and high cost areas remain a hodgepodge of mechanisms

lacking a coherent, unifying framework. Rather than harnessing competition to reduce the need for subsidies, or better targeting subsidies, the existing support mechanisms for areas served by rate-of-return incumbent local exchange carriers (“ILECs”), particularly in rural telephone company service areas, use subsidies to guarantee a portion of the ILEC revenue stream and to reduce ILEC business risks in the face of emerging competition. This is a *pro-ILEC* rather than *pro-consumer* approach to universal service.

High cost support mechanisms should harness competition to achieve universal service goals, and provide support only where necessary to achieve affordable and reasonably comparable rates. Any serious effort to reform the prevailing high cost support mechanisms along these lines must begin from a more principled foundation than preservation of ILEC revenue guarantees. General Communication Inc. (“GCI”) believes that five basic principles should guide reform of the current mechanisms:

Principle No. 1: Provide adequate, but not excessive, support. High cost support must be adequate to ensure that rates are affordable and reasonably comparable, but support should be the lowest amount necessary to achieve these objectives.

Principle No. 2: Deliver support to the service provider. High cost support should be paid to the service provider that pays the cost of facilities employed to deliver the service to the end user customer. High cost support should not be paid to all potential providers of service, regardless of whether they are actually providing the supported service to the end user customer.

Principle No. 3: Ensure equal opportunity for support. The support paid to the appropriate provider should be the same for all competitors, regardless of the facilities they employ, the manner in which they procure facilities, or the metric used to determine the per-line support level.

Principle No. 4: No double payments. If one carrier gets high cost support for providing a line to a household, another provider should not also get support for providing (or being able to provide) a line to the same household.

Principle No. 5: Let the market work as it would in the absence of subsidies. Other than permitting more consumers to purchase service, high cost support

should not alter the competitive signals that the market would send to ILECs and CETCs in the absence of support payments.

Following these principles, the Joint Board should not endorse the “cure-alls” suggested by various ILECs – all of which have the objective of reinstating or entrenching monopoly in rural, insular and high cost areas, regardless of whether competition is a better alternative. Most significantly, the Joint Board should not embrace proposals to provide different amounts of per-line high cost support to ILECs and CETCs. The market can only work to reveal and remove inefficiency and to promote innovation if all ETCs, whether incumbent or competitive, receive the same support, in accordance with Principles No. 3 and 5. Also consistent with Principles No. 3 and 5, there is no basis for distinguishing support for CETCs that provide supported service to customers using UNEs – for which those CETCs pay a cost-based rate – from support for service using other methods of entry other than resale.

Nor should the Joint Board embrace the status quo. Today, support flows to services that do not warrant support, such as multiple connections to a home or business, and to areas that do not need support to maintain affordable and reasonably comparable rates. Demands on the federal universal service fund (“USF”) have grown significantly over the past several years, as rate-of-return ILECs’ expectations for full recovery of their embedded costs plus a rate of return through USF have gone virtually unchecked, and support for multiple connections provided by all ETCs has increased sharply. To better target high cost support to areas and services that truly need it, GCI recommends that the Joint Board and the Commission take the following six steps to change the current high cost support mechanisms:

- 1. Recommendation No. 1: Eliminate duplicate high cost support payments to ILECs when a CETC serves the end user through a method other than resale.**
- 2. Recommendation No. 2: Cap per-line high cost support within a study area upon CETC entry.**
- 3. Recommendation No. 3: Reduce per-line high cost support when a market can be served at a lower cost.**
- 4. Recommendation No. 4: Limit high cost support to a single line to a home or business.**
- 5. Recommendation No. 5: Consolidate study areas within a state for high cost support purposes.**
- 6. Recommendation No. 6: Define the upper limit of “affordable” and “reasonably comparable” rates.**

If applied, these six recommended steps will, consistent with GCI’s five principles for high cost support, make certain that there is sufficient funding to provide universal service to *consumers* (*not* competitors) through a fund that is sized properly and support that is targeted correctly.

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GLOSSARY

<p>High Cost Loop Support (“HCLS”)</p>	<p>Assists rural local telephone companies with high local loop costs. Support offsets loop costs that would otherwise be recovered through intrastate rates. <i>See</i> 47 U.S.C. § 36.601 <i>et seq.</i> Total HCLS nationwide is subject to an indexed cap.</p>
<p>High Cost Model Support (“HCMS”)</p>	<p>Assists non-rural local telephone companies with high costs, based on FCC’s Hybrid Cost Proxy model of forward-looking costs. Support offsets loop costs that would otherwise be recovered through intrastate rates. <i>See</i> 47 C.F.R. § 54.309.</p>
<p>Interstate Access Support (“IAS”) – also known as “CALLS Support”</p>	<p>Provides per line support for all ETC loops in high cost zones of study areas served by ILECs regulated under price cap regulation. <i>See</i> 47 C.F.R. § 54.800. Total nationwide IAS is capped at \$650 million per year.</p>
<p>Interstate Common Line Support (“ICLS”) – also known as “MAG Support”</p>	<p>Provides support to offset a portion of the interstate common line revenue requirement of rate-of-return ILECs, with CETCs receiving per line support equivalent to the ILEC’s support per ILEC working loop. <i>See</i> 47 C.F.R. § 54.901.</p>
<p>Local Switching Support (“LSS”)</p>	<p>Assists local telephone companies serving study areas of 50,000 or fewer access lines. Support is provided to offset a portion of the local switching costs that would otherwise be recovered through intrastate rates. <i>See</i> 47 C.F.R. § 54.301.</p>
<p>Long Term Support (“LTS”)</p>	<p>Assists local telephone companies subject to rate-of-return regulation that participate in NECA’s Common Line Pool with loop costs allocated to the interstate jurisdiction. <i>See</i> 47 C.F.R. § 54.303. LTS for non-rural ILECs is transitioning to ICLS.</p>

I. INTRODUCTION

The issues presented for comment in the *Public Notice* implicate the two fundamental goals of the Telecommunications Act of 1996 (the “1996 Act”), competition and universal service. These goals don’t simply complement one another: one cannot be fully achieved without the other. Where market conditions support it, competition ensures that services are delivered to consumers in the most efficient manner and at the lowest price. Competition also provides an incentive for carriers to invest in network facilities used to provide high-quality, advanced telecommunications services. Universal service, working in tandem with competition, ensures that when unsubsidized retail rates for supported services are too high to keep those rates affordable and reasonably comparable between urban and rural areas, subsidies will bring those rates down to affordable and reasonably comparable levels. If constructed correctly, universal service support will neither preclude competitive entry where it is economically efficient, nor support entry where it is not. The real beneficiaries will be consumers, not competitors – just as the 1996 Act intended.

Unfortunately, that is not the way universal service has been implemented to date. Seven years after the enactment of the 1996 Act, the Commission’s universal service policies for rural, insular and high cost areas remain a hodgepodge of mechanisms lacking a coherent, unifying framework. Rather than harnessing competition to reduce the need for subsidies, or better targeting subsidies, the existing support mechanisms for areas served by rate-of-return incumbent local exchange carriers (“ILECs”),³ particularly

³ The federal universal service fund has several components. These comments concern High Cost Fund support (“high cost support”) mechanisms for rate-of-return ILECs. “Rate-of-return ILEC” refers to ILECs that are subject to rate-of-return

in rural telephone company service areas, use subsidies to guarantee a portion of the ILEC revenue stream and to reduce ILEC business risks in the face of emerging competition. This is a *pro-ILEC* rather than *pro-consumer* approach to universal service.

High cost support mechanisms should harness competition to achieve universal service goals, and provide support only where necessary to achieve affordable and reasonably comparable rates. Any serious effort to reform the prevailing high cost support mechanisms along these lines must begin from a more principled foundation than preservation of ILEC revenue guarantees. GCI believes that five basic principles should guide reform of the current mechanisms:

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regulation for interstate revenues. Most, but not all, rate-of-return ILECs also meet the definition of “rural telephone company” in 47 U.S.C. § 153(37).

Following these principles, the Joint Board should not endorse the “cure-alls” suggested by various ILECs – all of which have the objective of reinstating or entrenching monopoly in rural, insular and high cost areas, regardless of whether competition is a better alternative. Most significantly, the Joint Board should not embrace proposals to provide different amounts of per-line high cost support to ILECs and CETCs. The market can only work to reveal and remove inefficiency and to promote innovation if all ETCs, whether incumbent or competitive, receive the same support, in accordance with Principles No. 3 and 5. Also consistent with Principles No. 3 and 5, there is no basis for distinguishing support for CETCs that provide supported service to customers using UNEs – for which those CETCs pay a cost-based rate – from support for service using other methods of entry other than resale.

Nor should the Joint Board embrace the status quo. Today, support flows to services that do not warrant support, such as multiple connections to a home or business, and to areas that do not need support to maintain affordable and reasonably comparable rates. Demands on the federal universal service fund (“USF”) have grown significantly over the past several years, as rate-of-return ILECs’ expectations for full recovery of their embedded costs plus a rate of return through USF have gone virtually unchecked, and support for multiple connections provided by all ETCs has increased sharply. To better target high cost support to areas and services that truly need it, GCI recommends that the

Joint Board and the Commission take the following six steps to change the current high cost support mechanisms:

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If applied, these six recommended steps will, consistent with GCI’s five principles for high cost support, ensure sufficient funding to provide universal service to *consumers* (*not* competitors) through a fund that is sized properly and support that is targeted correctly.

II. CETC ENTRY INTO RURAL AREAS BENEFITS CONSUMERS

A. GCI’s Entry Has Brought Better Product Packages, Better Customer Service and Innovation to Rural Markets.

GCI’s experience in Alaska demonstrates how competition and universal service can work together to benefit consumers, as well as how a discriminatory high cost support mechanism can deprive consumers of otherwise beneficial competition. GCI is a diversified telecommunications, information services, and cable television provider operating primarily in Alaska. GCI offers competitive local telephone service – along with long distance service, cable service, and high speed and dial-up Internet access – to

customers in Anchorage, Fairbanks and Juneau, competing with the Alaska Communications Systems (“ACS”),⁴ the incumbent LEC. GCI serves both the business and residential markets, and has been designated an ETC by the Regulatory Commission of Alaska (“RCA”). GCI competes head-to-head with ACS, offering services of the same or better quality. Rather than offering a limited range of products that merely complement ACS’ services (such as wireless service or high-speed Internet access), GCI provides its customers with a full range of services that fulfill all of their telecommunications needs. GCI’s entry thus provides consumers with the type of choice envisioned by the 1996 Act, and has delivered lower prices, better service packages and advanced services to both rural and non-rural markets.

Since 1997, when GCI entered the competitive local exchange business in Anchorage (Alaska’s lone non-rural market), consumers in Anchorage alone have saved in excess of \$19 million in local rates. In November 2001, when ACS persuaded the RCA to grant it both a retail rate and a UNE price increase in Anchorage, GCI held the line on its rates and gave consumers an alternative to the incumbent’s business-as-usual approach. Consumers, in turn, have voted with their pocketbooks, showing overwhelming support for competition: GCI now serves more than 40 percent of Anchorage residential and business customers combined.

GCI has more recently brought the benefits of competition to two rural study areas, Fairbanks, the second largest city in Alaska, and Juneau, the state capitol.

⁴ In GCI’s service areas, the ILECs are Alaska Communications Systems Group, Inc. and its operating subsidiaries, ACS of Alaska, Inc., ACS of Anchorage, Inc., ACS of Fairbanks, Inc., and ACS of the Northland, Inc. (collectively “ACS”). ACS is a rate-of-return ILEC. It also is designated as a rural telephone company pursuant to 47 U.S.C.

Although it is more difficult to quantify the reductions in rates in those markets because ACS was able to anticipate competition, consumers clearly believe GCI's alternative is beneficial: today, GCI has earned a 21 percent market share in Fairbanks and over 19 percent market share in Juneau.

GCI has been successful in obtaining significant local market share for a combination of reasons.⁵ It has been innovative in its customer service and service offerings, presenting customers with a package of local service plus custom-calling features at a price substantially below the price ACS had charged for the same set of services before competition. GCI pioneered night installations for businesses, which ACS had previously refused to perform. GCI also combines its local service offerings with other services desired by consumers, such as Internet access, for which its extensive network also provides cost advantages. GCI has built a modern, efficient local switching and transport network, and it has been able to take advantage of economies of scale and scope in its local telephone, long distance and cable television operations by installing and operating consolidated fiber optic transport facilities. GCI was the first company to offer digital subscriber services for businesses, as well as ISDN PRI's, in Fairbanks and Juneau. These all are benefits of competition, which allows the market's invisible hand to tailor services and innovation dynamically to best meet consumers' needs as they change over time.

§ 153(37) with respect to its Fairbanks and Juneau operations, but not its Anchorage operations.

⁵ GCI entered the market with high brand recognition and loyalty because it had previously brought long distance competition, and lower rates, to Alaska. GCI also provides quality cable television service in Alaska. Familiar with GCI, many customers were eager to escape the incumbent monopolist that had taken their patronage for granted for all too many years.

Unfortunately, GCI's experience also demonstrates the cost to consumers when *ex ante* regulation prohibits entry. Because of regulatory obstacles, GCI was delayed from bringing consumer benefits to the Fairbanks and Juneau markets, entering only after waging a costly legal battle to lift the rural exemptions in those communities. For four years, ACS held off entry with claims that Fairbanks and Juneau were "too small" to be served by two carriers. ACS was wrong. Not only did GCI enter those markets, but ACS' total local telephone revenue in Anchorage, Fairbanks and Juneau actually *grew* from \$222.3 million to \$222.6 million in 2002 after GCI had entered Fairbanks and Juneau.⁶ The only thing that *ex ante* regulatory barriers to entry accomplished was to make consumers worse off for four years.

The competitive benefits GCI has delivered to Alaska markets are permanent. GCI has entered these markets for the long haul, sinking more than \$40 million to date in local telephone service investment, including deployment of its own switches and fiber and ongoing deployment of a state-of-the-art IP cable telephony network.⁷ Indeed, GCI

⁶ Alaska Communications Systems Group, Inc., Form 10-K Filed for Year Ended December 31, 2002 at F-4. Although ACS reported a \$1.3 million loss in local telephone revenue for 1Q03 compared to 1Q02, it also announced: "We were also pleased to generate \$11.8 million in cash during the quarter and believe this is a testament to our aggressive restructuring, the efficiency [of] our local telephone operations, and our conservative cash management and capital spending program." Wes Carson, President of ACS, Transcript of Alaska Communications Systems First Quarter Earnings Release Conference Call, Apr. 24, 2003. *See also* "The Financial Condition of Alaska Communications Systems Group, Inc. Phase I Report," Snively King Majoros O'Connor & Lee, Inc., *attached to* Letter from Frederick W. Hitz, III, GCI, to William Maher, Wireline Competition Bureau, CC Docket Nos. 96-98, 98-147 and 01-338 (filed Jan. 23, 2003).

⁷ GCI provides local service using all of the methods available under the 1996 Act: some customers are served entirely with GCI's own facilities; some are served using a combination of UNEs and GCI's facilities; and some are served through total service resale. Whenever possible, GCI serves its customers using its own facilities. For customers served with UNEs, GCI generally leases only UNE loops from ACS, although

has proposed to share carrier-of-last-resort (“COLR”) requirements under state law in those areas where it provides service to at least 35 percent of lines in a study area through its own facilities or through UNEs.⁸

If GCI did not receive the same high cost support as its competitors in Fairbanks and Juneau, its entry into these markets would have been unfairly constrained. The absence of high cost support would have placed GCI at a substantial competitive disadvantage. UNE loop rates alone in both markets exceed the combined revenue from ACS’ retail rate and the federal Subscriber Line Charge (“SLC”).⁹ Moreover, GCI’s costs are not limited to the UNE loop, but also include the costs of collocation, plus GCI’s own multiplexing equipment, switch, and fiber transport facilities, marketing, operations and corporate expenses.¹⁰ If GCI did not have the opportunity to receive the same high cost support as ACS, GCI would have been subject to a substantial price squeeze, especially in the residential market, because, if GCI and ACS were equally

GCI does serve a small number of customers via the UNE Platform in cases where GCI cannot use UNE loops or where ACS does not process and provision orders for such loops quickly enough.

⁸ Comments of GCI, *Whether Interexchange Carriers Operating In the Anchorage Market Should be Allowed to Sell Interexchange and Local Services in a Bundle; Consideration of Revision to the Regulations Governing the Competitive Local Exchange Market in Alaska; Petition by GCI Communication Corp., d/b/a/ General Communication, Inc., and d/b/a/ GCI to Amend 3 AAC 53.290(g)*, Dockets No. R-02-12, R-02-6, R-02-7 (filed Jan. 31, 2003).

⁹ ACS’ residential retail rate in Fairbanks (including the federal SLC) is \$18.50 per month, but the UNE loop rate is \$19.19 per month. In Juneau, ACS’ residential retail rate (including the federal SLC) is \$15.42 per month, but the UNE loop rate is \$16.71.

¹⁰ In Fairbanks, for example, GCI estimates that its own loop costs are approximately \$32 per month, including the UNE loop rate paid to ACS. This does not include non-monetary costs such as the goodwill lost when ACS delays processing GCI orders or installs equipment that interferes with GCI service. Declaration of Frederick W. Hitz, III, at ¶ 10 (attached as Exhibit A to these Comments).

efficient, ACS could still offer service to consumers at a lower rate than GCI, solely because ACS would have received greater high cost support.¹¹

Alaska's competitive experience following GCI's entry into the local telecommunications market demonstrates that the Commission was correct when it concluded that "designation of qualified ETCs promotes competition and benefits consumers by increasing customer choice, innovative services, and new technologies."¹² GCI's successful entry in Fairbanks and Juneau proves that competition and universal service – the twin goals of the 1996 Act – are not in conflict, but are complementary. In sum, GCI's experience illustrates that the Joint Board and the Commission must take care to ensure that high cost support mechanisms are competitively neutral, so that the dynamic benefits of competition are available to *all* Americans.

¹¹ In Juneau, GCI receives \$4.37 in high cost support per residential and single-line business connection. GCI receives a lesser amount for each multi-line business connection. In Fairbanks, GCI receives \$6.91 in high cost support per residential connection in Zone 1 (a low-cost zone), and \$12.17 in high cost support per residential and single-line business connection in Zone 2 (a high cost zone). GCI receives less support for each multi-line business connection. Although, as discussed further in Section V, GCI receives support on a per-line basis, ACS receives high cost support based on the total embedded cost of serving its study area. GCI's per line support is based on the high cost support ACS would receive for serving that study area, divided by ACS' projected working loops. In both Fairbanks and Juneau, a portion of the high cost support is provided to subsidize switching costs, rather than loop costs, through the Local Switching Support mechanism.

¹² *In the Matter of Federal State Joint Board on Universal Service; RCC Holdings, Inc. Petition for Designation as an Eligible Telecommunications Carrier Throughout Its Licensed Service Area in the State of Alabama*, Memorandum Opinion and Order, 17 FCC Rcd 23532, 23540 (¶ 23) (Comm. Carr. Bur. 2002) ("RCC Order"); see also *In the Matter of Federal-State Joint Board on Universal Service; Western Wireless Corporation Petition for Designation as an Eligible Telecommunications Carrier for the Pine Ridge Reservation in South Dakota*, Memorandum Opinion and Order, 16 FCC Rcd 18133, 18137 (¶ 12) (2001) ("Western Wireless Pine Ridge Order").

B. GCI's Broadband Deployment Demonstrates that Subsidies Are Not Always Necessary Simply Because ILECs Have Been Subsidized Historically.

GCI's experience in the voice market shows how competition and universal service work together. GCI's experience delivering advanced telecommunications services throughout Alaska demonstrates that an ILEC's past receipt of subsidies does not always mean that subsidies are necessary to ensure that comparable services are available in rural areas at affordable and reasonably comparable rates. GCI provides advanced telecommunications services in a market that is one-fifth the size of the contiguous United States and has fewer miles of road than the State of New Hampshire. Nevertheless, in terms of Internet access, Alaska is the second most "wired" state in the country,¹³ and Alaskans use the Internet more than any other state on a per-capita basis.¹⁴ These broadband penetration rates are based in large part on GCI's deployment of advanced telecommunications services throughout Alaska. Importantly, GCI has accomplished its deployment of advanced telecommunications services *without* the high cost support for broadband services sought by ILECs.

¹³ U.S. Department of Commerce, Economics and Statistics Administration and National Telecommunications and Information Administration, "Falling Through the Net: Toward Digital Inclusion," Table 1-B, Percent of Households with Internet Access, By State: 2000 (Oct. 2000) at 22. This report evaluates the number of American households and individuals that have a personal computer and an Internet connection.

¹⁴ U.S. Department of Commerce, Economics and Statistics Administration and National Telecommunications and Information Administration, "A Nation Online: How Americans Are Expanding their Use of the Internet," Table 1-1, Internet Use by Percent of State Population (Feb. 2002) at 8.

GCI offers broadband cable modem service to approximately 90 percent of Alaskan homes.¹⁵ In more remote areas, GCI offers high-speed Internet service using a broadband platform integrating digital subscriber lines (“DSL”), satellite, and fixed wireless technologies. Using this platform, GCI now offers high-speed wireless Internet services at affordable prices to 12 villages, and serves five more villages using DSL.¹⁶ Subscribers receive 265K downstream/64K upstream for \$49.99 per month, a price on par with that paid for comparable service by urban consumers in the lower 48 states. For example, GCI provides broadband service to Akutan, a village located on Akutan Island in the eastern Aleutians with a population of 713. *Over fifty percent of the households in Akutan subscribe to GCI’s high-speed Internet offering.* GCI intends to extend similar high-speed Internet service to every village and community where it has a point of presence by the end of 2004.¹⁷

Again, GCI’s broadband deployment has been and will be made available without high cost support, and with no regulatory assurance that GCI will earn a return on its investment. At the same time, GCI has *not* been forced to compete against an ILEC whose broadband offerings were directly subsidized by high cost support.¹⁸ And GCI was not frozen out of the broadband market by *ex ante* entry barriers such as ETC

¹⁵ Demand for GCI’s cable modem services grew dramatically after GCI deployed its own fiber optic cable to the lower 48 states in 1999, providing Alaskans with a critical communications link to the rest of the nation.

¹⁶ These DSL-based services are offered in conjunction with the local exchange carrier serving the village.

¹⁷ In addition, GCI provides high-speed Internet service to 285 rural schools, five regional health organizations and 70 clinics throughout Alaska.

¹⁸ ILECs do receive support for high cost loops. ILECs also are eligible for low-interest Rural Utility Service loans to further broadband deployment in rural areas.

designation and rural exemption proceedings. GCI was therefore able to enter the broadband market more quickly than it could the voice market in some areas.

The competitive playing field in the broadband market would have been very different, however, had the Commission provided high cost support for advanced telecommunications services, as some have urged.¹⁹ GCI would have been ineligible to receive such support in areas where it has not been designated an ETC. This would have forced GCI to compete against an ILEC receiving high cost support as a designated ETC, and would have placed GCI at a significant price disadvantage – potentially deterring it from entering the broadband services market at all.

The Alaska experience shows that the provision of high cost support can distort market entry to favor subsidized ILECs and deter subsidy-free entry by innovative and efficient carriers such as GCI. That surely was not what Congress had in mind when it enacted Section 254 of the Communications Act of 1934 (“Act” or “Communications Act”).

¹⁹ Almost one year ago, the Joint Board provided the Commission with a recommendation regarding “whether any services should be added to or removed from the definition of services supported by universal service.” *See In the Matter of Federal-State Joint Board on Universal Service*, Recommended Decision, CC Docket 96-45 (rel. July 10, 2002). The Joint Board declined to find that high-speed or advanced services should be added to the definition of the supported services pursuant to 47 U.S.C. § 254(c), stating, “because market forces continue to encourage the deployment of advanced and high-speed services, we do not believe that it would be in the public interest to substantially increase the support burden by expanding the definition of universal service to include these services.” *Id.* at ¶ 15. GCI agrees.

III. ERECTING ENTRY BARRIERS THROUGH UNIVERSAL SERVICE PREEMPTS THE MARKET’S PROCESS FOR DISCOVERING EFFICIENT ENTRY AND ROBS CONSUMERS OF COMPETITIVE BENEFITS.

The Joint Board seeks comment on the standards for ETC designation under the Communications Act. GCI believes that, in its decisions to date, the Commission has generally articulated appropriate standards for ETC designation. In particular, the Commission has been leery of ILEC assertions that a market is “too small” to support more than one entrant. As GCI’s experience attempting to enter Fairbanks and Juneau shows, ILECs are quick to claim that a market is “too small” or a “natural monopoly,” but are short on the facts. However, the Commission has consistently and correctly “reject[ed] the general argument that rural areas . . . are not capable of sustaining competition for universal service support” when it has been asked to designate carriers as ETCs in such areas.²⁰

There is no question that lack of access to high cost support to carriers otherwise meeting all the requirements for CETC designation constitutes a formidable barrier to entry. In determining that certain state ETC designation practices violate Section 253’s prohibition against state-created barriers to entry,²¹ the Commission recognized that, “[a] new entrant faces a substantial barrier to entry if the [ILEC] is receiving universal service support that is not available to the new entrant for serving customers in high cost areas,” and concluded:

²⁰ *Western Wireless Pine Ridge Order*, 16 FCC Rcd at 18138 (¶ 15); *see also RCC Order* 17 FCC Rcd at 23540 (¶ 26).

²¹ 47 U.S.C. § 253 (providing that no “state or local statute or regulation” may “prohibit . . . the ability of any entity to provide any interstate or intrastate telecommunications service”).

No competitor would ever reasonably be expected to enter a high-cost market and compete against an incumbent carrier that is receiving support without first knowing whether it is also eligible to receive such support. We believe that it is unreasonable to expect an unsupported carrier to enter a high-cost market and provide a service that its competitor already provides at a substantially supported price.²²

The Commission was, and remains, correct.

The Commission has also concluded that Section 253 limits state commissions' exercise of their statutory responsibility to determine whether designation of an additional ETC in an area served by a rural telephone company is in the public interest. Rejecting ILEC claims that Section 214(e)(2) grants state commissions unfettered power to condition, or even to deny, ETC designation for any reason, the Commission concluded:

[A]lthough Congress granted to state commissions, under section 214(e)(2), the primary authority to make ETC designations, we do not agree that this authority is without any limitation. While state commissions clearly have the authority to deny requests for ETC designation without running afoul of section 253, the denials must be based on the application of competitively neutral criteria that are not so onerous as to effectively preclude a prospective entrant from providing service. We believe that this is consistent with sections 214(e), 253, and 254, as well as the decision of the United States Court of Appeals for the Fifth Circuit in *Texas Office of Public Utility Counsel v. FCC*.²³

State commissions must therefore exercise their discretionary authority to designate additional ETCs in areas served by rural telephone companies on a “competitively neutral basis and consistent with Section 254.”²⁴

²² *In the Matter of Federal-State Joint Board on Universal Service; Western Wireless Corporation Petition for Preemption of an Order of the South Dakota Public Utilities Commission*, Declaratory Ruling, 15 FCC Rcd 15168, 15172-73 (¶¶ 12-13) (2000) (“*South Dakota Preemption Order*”).

²³ *Id.* at 15175 (¶ 18) (citations omitted).

²⁴ 47 U.S.C. § 253(b).

These guidelines are already in place through Commission orders, and should not (and, consistent with the plain meaning of Section 253, cannot) be modified. The Joint Board should resist ILEC pleas to ignore Section 253's commands.

A. Requests to Return to De Jure Monopolies in Rural Telephone Company Serving Areas Incorrectly Assume that ILECs Are Organized and Operated in the Most Efficient Manner and Have Been Perfectly Regulated.

Rural ILECs will undoubtedly argue in this proceeding, as they have previously, that the most efficient way to provide supported services in rural, insular and high cost areas is to provide high cost support to a single network and to regulate that network to ensure that it provides universal service at affordable rates. This argument necessarily assumes not only that the provision of universal service in these areas is a natural monopoly, but also that the ILEC itself is organized in the most efficient form, that it provides service in the most efficient manner, and that it has been perfectly regulated so that no excessive costs are embedded in its rate base. Each of these assumptions is questionable at best. To the extent that any of these assumptions is untrue, however, competitively neutral high cost support can allow other carriers to “provide competitive alternatives in rural, insular, and high cost areas and thereby benefit rural consumers.”²⁵ By contrast, restoring monopolies to rural telephone company serving areas would be contrary to the very purpose of the 1996 Act, which discards the traditional rate-of-return paradigm and ushers in a new era of competition.

²⁵ *In the Matter of Federal-State Joint Board on Universal Service, Report and Order*, 12 FCC Rcd 8776, 8803 (¶50) (1997) (“*Universal Service First Report & Order*”).

The assumption that ILECs have organized themselves in the most optimal form belies any reasonable expectation. As Nobel Laureate Fredrich Hayek explained:

Every organization is based on given knowledge; organization means commitment to a particular aim and to particular methods, but even [an] organization designed to increase knowledge will be effective only insofar as the knowledge and beliefs on which its design rests are true.²⁶

Like all other forms of human organization, ILECs are no less fallible than the individuals that comprise them, and inefficient operational structures have often been retained to preserve subsidy flows.

Moreover, rate-of-return regulation – the type of regulation applied to the vast majority of ILECs serving rural, insular and high cost areas – makes it particularly unlikely that ILECs provide service in the most efficient manner and that excessive costs do not enter the ratebase. As the Commission recognized when it adopted price caps first for AT&T and then for the large ILECs, “rather than encourage socially beneficial behavior by the regulated firm, rate of return [regulation] actually discourages it.”²⁷ The Commission explained:

The distorted incentives created by rate of return regulation are easily illustrated. In a competitive environment, where prices are dictated by the market, a company’s unit costs and profits generally are related inversely. If one goes up, the other goes down. Rate of return regulation stands this relationship on its head. Although carriers subject to such regulation are limited to earning a particular *percentage* return on investment during a fixed period, a carrier seeking to increase its dollar earnings often can do so merely by increasing its *aggregate* investment. In other words, under a rate of return regime, profits (i.e., dollar earnings) can go up when investment goes up. This creates a powerful incentive for carriers to ‘pad’ their costs, regardless of whether additional investment is necessary or efficient. And, because a carrier’s operating expenses generally are

²⁶ F.A. Hayek, *The Constitution of Liberty* 37 (1960) (“Hayek”).

²⁷ *In the Matter of Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873, 2889 (¶ 29) (1989) (“*AT&T Price Cap Order*”).

recovered from ratepayers on a dollar-for-dollar basis, and do not affect shareholder profits, management has little incentive to conserve on such expenses. This creates an additional incentive to operate inefficiently.²⁸

In addition to creating incentives for inefficiency (and thus making it less likely that rate-of-return ILECs operate efficiently), rate-of-return regulation rarely works well, let alone perfectly. As the Commission concluded:

Administering rate of return regulation in order to counteract [the incentives to pad costs] is a difficult and complex process, even when done correctly and well. This is so primarily for two reasons. First, such regulation is built on the premise that a regulator can determine accurately what costs are necessary to deliver service. In practice, however, a regulator may have difficulty obtaining accurate cost information as the carrier itself is the source of nearly all information about its costs. Furthermore, no regulator has the resources to review in detail the thousands of individual business judgments a carrier makes before it decides, for example, to install a new switching system.

The second inherent difficulty associated with administering rate of return regulation relates to its requirement that determinations be made about how to allocate a carrier's costs among services that often are provided jointly or in common. Such determinations tend to become more economically problematic as they become more detailed. The history of this Commission's experience in this area over the past several decades reflects the difficulty of implementing cost allocation systems²⁹

Rate-of-return regulation operated then as it operates now, and there is nothing about it and its impact on ILEC operations that makes the Commission's observations any less true today.³⁰

²⁸ *Id.* at 2889 (¶ 30); *see also In the Matter of Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786 (¶ 30) (1990) (“*LEC Price Cap Order*”) (“Unfortunately, a regulatory system that simply corrects for a tendency to pad investments or expenses is not a system that can also drive LECs to become more efficient and productive. But incentive regulation, by limiting the amount carriers can charge for their services and continually exerting downward pressure on those price ceilings, can.”).

²⁹ *AT&T Price Cap Order* at 2889-90 (¶¶ 31-32).

³⁰ Recent evidence also suggests that incentive regulation, without competition, is not sufficient to foster substantial cost reductions in the U.S. telecommunications

Economists have long recognized the deficiencies of regulation (especially rate-of-return regulation) and the superiority of competition. As Alfred Kahn noted more than thirty years ago:

Regulated monopoly is a very imperfect instrument for doing the world's work. It suffers from the evils of monopoly itself – the danger of exploitation, aggressively or by inertia, the absence of pervasive external restraints and stimuli to aggressive, efficient and innovative performance. Regulation itself tends inherently to be protective of monopoly, passive, negative, and unimaginative. . . . Regulation is ill-equipped to treat the more important aspects of performance – efficiency, service innovation, risk taking, and probing the elasticity of demand. Herein lies the great attraction of competition: it supplies the direct spur and the market test of performance.³¹

Furthermore, as Clair Wilcox wrote:

Regulation, at best, is a pallid substitute for competition. It cannot prescribe quality, force efficiency, or require innovation, because such action would invade the sphere of management. But when it leaves these matters to the discretion of industry, it denies consumers the protection that competition would afford.³²

As these economists emphasize, a monopolist operating under rate-of-return regulation is particularly unlikely to provide service in the socially optimal manner, because rate-of-return regulation dulls incentives to innovate. GCI was innovative when it entered its markets because it distinguished its offerings from those of ACS. ACS, which could have introduced improvements in service packages, pricing and customer service at any time, was forced to respond. GCI's experience is consistent with the

industry. However, cost reductions do occur when incentive regulation is combined with competition. See Chunrong Ai and David E. M. Sappington, "The Impact of State Incentive Regulation on the U.S. Telecommunications Industry," 22 J. Reg. Econ. 133-159 (Sept. 2002).

³¹ Alfred E. Kahn, 2 *The Economics of Regulation: Principles and Institutions* 325-326 ("Kahn").

³² Clair Wilcox, *Public Policies Toward Business* 476 (3d ed. 1966) ("Wilcox").

historical lack of innovation in other monopoly local markets nationwide. As noted by one court,

The American economic system proceeds on the basis of the assumption – closely related to the assumption underlying our political system – that competition is far more likely to lead to the production of more and better products and their distribution to consumers at affordable prices than a market dominated by a monopoly, whether governmental or corporate. In fact, . . . more new and innovative telephone products have appeared on the shelves of this country’s retailers in the four years since divestiture than in the preceding twenty.³³

Finally, it is important to recognize that ILEC organization has not been the by-product of free and open market transactions; rather, it has been significantly influenced by regulatory history. For example, independent ILECs³⁴ exist in part because AT&T committed to the federal government in the Kingsbury Commitment that it would not further acquire or expand into the territories of these carriers.³⁵ Later, price-cap regulation and the structure of the federal universal service high cost support mechanisms, including the 1996 Act’s distinction between “rural telephone companies” and other telephone companies, created incentives for independent ILECs to avoid rationalizing their structure and consolidating where appropriate.

³³ *United States v. Western Electric Co.*, 714 F.Supp. 1, 8 (D.C. Cir. 1998); *see also*, e.g., *In re: Application of EchoStar Communications Corp., General Motors Corp., and Hughes Electronics Corp., (Transferors) and EchoStar Communications Corp (Transferee)*, Hearing Designation Order, 17 FCC Rcd 20559, 20626 (¶ 177) (finding that the proposed merger of EchoStar and DirecTV “might well reduce [the merged company’s] incentive to improve services and quality,” particularly in areas where there was no competition from cable operators).

³⁴ Many independent ILECs are rural telephone companies under 47 U.S.C. § 153(37). The vast majority of independent ILECs are subject to rate-of-return regulation at the state and federal levels.

³⁵ Peter Huber, Michael K. Kellogg & John Thorne, *Federal Telecommunications Law* § 1.3.2 (2d ed. 1999); Milton L. Mueller, Jr., *Universal Service: Competition, Interconnection, and Monopoly in the Making of the American Telephone System* 129-135 (1997).

The Fairbanks, Alaska market perfectly illustrates the fallacy of assuming that existing ILEC study area boundaries reflect optimal industrial organization. In the greater Fairbanks region, ACS serves the market through three different ILEC subsidiaries operating in three different study areas.³⁶ Downtown Fairbanks is in one study area. Two neighboring areas, Fort Wainwright and Eielson Air Force Base, are part of another study area (ACS of Alaska) that includes Juneau, which is in a different region of the state, 600 miles away. Another part of the greater Fairbanks region, the North Pole area, is in a third study area (ACS of the Northland) that encompasses more remote, non-contiguous Alaska villages. ACS, however, is serving, or has proposed to serve, all of these areas as a single network with a host/remote arrangement served from a switch in downtown Fairbanks, while nonetheless retaining the same three separate telephone company service areas. This provides *prima facie* evidence of the economic and technological irrationality of these study area boundaries.

The current organization of many ILECs serving rural, insular and high cost areas is thus in no sense “natural” – it is a unique outgrowth of the regulatory environment. The Commission thus has little factual basis on which to assume that ILECs subject to rate-of-return regulation operate efficiently such that competitive entry is not rational or would be without effect. The evidence points to the contrary.

³⁶ ACS acquired Anchorage Telephone Utility, the non-rural municipally-owned ILEC serving the Anchorage market (now ACS of Anchorage, Inc.); Telephone Utilities of Alaska, Inc., the ILEC in Juneau (now ACS of Alaska, Inc.); PTI Communications, Inc., the ILEC in downtown Fairbanks (now ACS of Fairbanks, Inc.); and Telephone Utilities of the Northland, Inc., the ILEC serving the suburbs of Fairbanks and other, smaller areas of the state (now ACS of the Northland, Inc.).

B. Basic Economics Teaches that the Market, Not Government, Will Best Determine Optimal Entry.

As the Commission has long recognized, competition is the most desirable and workable remedy to the inefficient organization and operation of many ILECs and the related imperfections created by rate-of-return regulation. As Hayek taught,

[i]f any facts contradict the beliefs on which the structure of the organization is based, this will become evident only in its failure and suppression by a different type of organization. Organization is therefore likely to be beneficial and effective so long as it is voluntary and is imbedded in a free sphere and will either have to adjust itself to circumstances not taken into account in its conception or fail.³⁷

Rate-of-return ILECs seek to shield themselves from the test of different organizations (competitive local exchange carriers (“CLECs”)) by seeking imbalanced regulatory policies to limit or block competitive entry altogether.

The wonder of a market with basically free entry and exit is that it is self-correcting. If an ILEC operates inefficiently because of the history and inadequacy of regulation, or because of its own marketplace choices, a competitor can enter the market.

[Competition will] weed out the inefficient and concentrate production in the efficient; it will determine, by the objective test of market survival, who should be permitted to produce; it will force producers to be progressive and to offer customers the services they want and for which they are willing to pay; it will assure the allocation of labor and other inputs into the lines of production in which they will make the maximum contribution to total output.³⁸

This is exactly what GCI’s entry has done in Anchorage, Fairbanks and Juneau, even with substantial regulatory delays to entry.

³⁷ Hayek at 37.

³⁸ Kahn at 18.

Alternatively, if too many carriers enter, or if a market is simply incapable of sustaining multiple carriers, one or more carriers will ultimately exit, either through bankruptcy, merger or withdrawal. The Commission has, over the last three years, seen the market winnow the ranks of CLECs that were overly ambitious. As one Wall Street analyst recently put it, “in the summer of 1996 a lot of entrepreneurs had the same idea – to become the next MCI – while thinking they were the only one with the idea . . . [i]t turns out that you can’t have 200 different companies each getting 20% of the market.”³⁹ So long as universal service mechanisms are designed properly, the same self-correction can and will result in rural, insular and high cost areas, making additional and discriminatory government intervention unnecessary. Universal service policies should neither block competitive entry nor make possible otherwise unsustainable competition.

In any event, government has little chance of accurately predicting which markets will actually sustain competition and which will not. As stated by Justice Breyer, “[t]he defects and difficulties inherent in the system make regulation a crude weapon of government intervention – a blunderbuss, not a rifle.”⁴⁰ In the first instance, government will not have better information for making this determination than it has for engaging in rate-of-return regulation, which the Commission has already recognized is limited and flawed because it relies on information supplied by the ILEC itself.⁴¹ Even if government also has the information supplied by the prospective entrant, this too only constitutes one party’s best guess. Furthermore, there is no way that government, or even

³⁹ Blair Levin, Managing Director, Legg Mason, “Regulation and Platforms for Economic Growth,” presented at the 7th Annual Florida Communications Policy Symposium (Apr. 3, 2003).

⁴⁰ Stephen Breyer, *Regulation and Its Reform* 185 (1st ed. 1982).

⁴¹ See text accompanying n.29, *supra*.

a prospective entrant, can successfully predict all the potential benefits generated by competitive entry, including innovations that will occur as the new entrant and the incumbent are locked in competitive battle. (Indeed, even if a new entrant could predict the innovations and consumer benefits it would offer, it would not serve the public interest to require it to disclose all of its superior knowledge, skill and foresight publicly so that the incumbent could harvest the benefits.)

Moreover, when government prevents entry, it creates an asymmetric bias against the consumer. If the government *permits* entry to occur, and entry turns out to have been unwise, then, as the CLEC industry has amply demonstrated, the market itself will correct such unwise entry. However, if the government *prevents* entry, there can be no marketplace test to determine whether the government was correct or whether it misjudged the market (and the ILEC organization). For instance, if the RCA had not finally rejected ACS' arguments that Fairbanks and Juneau were too small to sustain competitive entry, real marketplace experience could not refute ACS' claim today.

At bottom, the Joint Board and the Commission must realize that "the single most widely accepted rule for the governance of regulated industries is to regulate them in such a way as to produce the same results as would be produced by effective competition, if it were feasible."⁴²

C. *Ex Ante* Market Barriers Slow Entry and Rob Consumers of Competitive Benefits.

As GCI's experience in Alaska shows, *ex ante* market barriers will slow competitive entry into rural, insular and high cost areas and thereby rob consumers of the

⁴² Kahn at 17.

benefits created by competition. GCI's entry into the Fairbanks and Juneau markets was stalled for four years because of such legal obstacles. Thus, for four years, Fairbanks and Juneau consumers were deprived of a choice that Anchorage consumers enjoyed, simply because these consumers allegedly lived in markets that were "too small" to support more than one carrier. Marketplace reality demonstrates that Fairbanks and Juneau are not, in fact, too small. Once given the chance, Fairbanks and Juneau consumers supported competitive entry with their pocketbooks, just like their urban counterparts in Anchorage.

As economist George Stigler warned: "every industry or occupation that has enough political power to utilize the state will seek to control entry."⁴³ The history of the Commission's policymaking is, of course, replete with examples of such behavior. For example, one commentator noted that a "witches' brew of conventional wisdom, procedural rights, vague standards, and industry 'gamesmanship'" resulted in a series of Commission decisions that history and consumers have not judged kindly:

- In terminal equipment, the Commission made it illegal to attach a harmless plastic mouthpiece to a telephone (the Hush-A-Phone case).
- In broadcasting, the Commission largely outlawed cable television for twenty years on the grounds that it might bankrupt struggling UHF stations. UHF never became popular, but the Commission held inviolable a block of spectrum that could have been used for other needs. Ironically, when cable finally got on its feet, it helped UHF stations by overcoming their inferior picture quality compared to VHF stations.
- In long distance, the Commission took almost six years to license MCI's initial line, between Chicago and St. Louis. Another decade passed before the courts ruled, over the Commission's objection, that MCI could use its system to provide ordinary long distance service, which it had been capable of all along.

⁴³ G. Stigler, "The Theory of Economic Regulation," *reprinted in* P. Peretz (ed.), *The Politics of America Economic Policy Making* 63-64.

- In mobile services, the Commission did not allow cellular service until twelve years after it was proved technically feasible.⁴⁴

In all of these cases, the Commission erected regulatory barriers to competitive entry, and in each case consumers were the poorer for it. The Joint Board and the Commission should be wary of allowing state commissions to use universal service for anti-consumer purposes.

To the extent that a state commission's real objective in erecting *ex ante* entry barriers is to ensure that implicit revenue flows can reduce monthly service rates, particularly for residential customers, the 1996 Act provides other mechanisms – most notably in Section 254 itself – to achieve the policy goals of affordability and reasonable comparability of rates. With a properly constructed high cost support mechanism, society can achieve these goals without the great costs in reduced innovation, reduced pressure to lower operating costs, and reduced incentives to improve service quality and product offerings that accompany *ex ante* entry prohibition.

IV. THE JOINT BOARD AND COMMISSION SHOULD BASE UNIVERSAL SERVICE SUPPORT IN COMPETITIVE AREAS ON A PRINCIPLED, COMPETITIVELY NEUTRAL APPROACH.

To ensure that competition can occur where it is economically feasible, and to ensure that competition and universal service support can work hand-in-glove to deliver affordable and reasonably comparable service at the lowest total cost for society, the Joint Board and the Commission should adopt a principled approach to high cost support. Such an approach would not supplant the need for the Joint Board and the Commission to define carefully and precisely the services that will be supported and the methodology for

⁴⁴ See John W. Berresford, "The Future of the FCC: Promote Competition, Then Relax," 50 Admin. L. Rev. 731, 735 (Fall 1998).

determining whether the goal for “affordable” and “reasonably comparable” rates has been met. Assuming these have been defined, however, GCI believes that high cost support mechanisms should be implemented to follow five competitively neutral principles, which, though briefly outlined below, are discussed more extensively in the subsequent sections.

A. *Principle No. 1: Provide adequate, but not excessive, support. High cost support must be adequate to ensure that rates are affordable and reasonably comparable, but support should be the lowest amount necessary to achieve these objectives.*

The Commission is required to base its universal service program on all the principles in Section 254(b).⁴⁵ Thus, among other requirements, the fund must guarantee that “[q]uality services should be available at just, reasonable and *affordable* rates.”⁴⁶ The Commission also must ensure that reasonably comparable services are available at reasonably comparable rates between urban and rural service areas.⁴⁷ These are the cornerstone objectives of universal service policy, objectives that GCI supports without exception.

Affordability and comparability, however, are not the Commission’s only concerns. The Fifth Circuit has recognized that excessive subsidization can itself violate the principle of affordability by increasing the prices charged for services in order to fund

⁴⁵ See *Qwest v. FCC*, 258 F.3d 1191, 1200 (10th Cir. 2001) (“*Qwest*”). The Commission adopted the additional principle that federal support mechanisms be competitively neutral. See *Universal Service First Report & Order*, 12 FCC Rcd at 8801 (¶¶ 46-48).

⁴⁶ 47 U.S.C. § 254(b)(1) (emphasis added).

⁴⁷ See 47 U.S.C. § 254(b)(3).

the subsidy.⁴⁸ As the court recognized, excessive support can itself make unaffordable the resulting rates assessed upon the consumers that are net payers of support.⁴⁹

GCI's experience providing advanced services without high cost support illustrates why subsidies must not exceed the minimum necessary amount, and, where possible, should be avoided. High cost support, even under the most competitively neutral design, will always distort the marketplace to some extent because only ETCs can receive support. If substantial high cost support is provided when such support is not necessary to achieve Section 254's objectives, the support mechanisms themselves create barriers to entry and efficient competition, as they would have for GCI's entry into advanced services. While some competitive inequality between ETCs and non-ETCs stems from the statutory requirement that ETC designation be a prerequisite for high cost support, inequality can be reduced by limiting support to the minimum amount necessary to accomplish the 1996 Act's goals of affordable and reasonably comparable rates for supported services.

B. *Principle No. 2: Deliver support to the service provider. High cost support should be paid to the service provider that pays the cost of facilities employed to deliver the service to the end user customer. High cost support should not be paid to all potential providers of service, regardless of whether they are actually providing the supported service to the end user customer.*

As the Commission concluded in the *Universal Service First Report & Order*, “universal service support should be provided to the carrier that incurs the costs of

⁴⁸ See *Alenco v. FCC*, 201 F.3d 608, 620 (5th Cir. 2000) (“*Alenco*”).

⁴⁹ See *id.*

providing service to a customer.”⁵⁰ When an ILEC and a CETC both serve a particular study area,⁵¹ the carrier providing service to the end user pays the cost of the facilities used to provide the supported services. This is clearest when a CETC uses its own facilities (and no ILEC UNEs) to serve the customer, such as through the provision of cable telephony or wireless service. As discussed further in Section VI, however, this still holds true when a CETC provides supported services using UNEs: the CETC pays the full forward-looking cost of the underlying facilities, including the cost of the UNE loop.⁵² Thus, when a CETC serves a customer in a rural, insular or high cost area using self-deployed facilities *or* UNEs (or a combination of the two), it incurs the cost of providing service to that customer and should receive support. By the same token, when an ILEC provides service using its own facilities, it should receive high cost support for that line.

C. *Principle No. 3: Ensure equal opportunity for support. The support paid to the appropriate provider should be the same for all competitors, regardless of the facilities they employ, the manner in which they procure facilities, or the metric used to determine the per-line support level.*

All carriers should have an equal opportunity for support, regardless of the facilities employed, or the manner in which facilities are procured. A carrier that self-provisions facilities to serve a customer incurs the cost of doing so. Similarly, facilities-based CETCs incur costs to serve a customer whether they self-provision, purchase

⁵⁰ *Universal Service First Report & Order*, 12 FCC Rcd at 8867 (¶ 162) (emphasis added).

⁵¹ This is not the case where a CETC provides service using telecommunications services for resale pursuant to Section 251(c)(4).

⁵² See Section VI, *infra*.

UNEs, or employ some combination of the two. The sole issue to be determined is whether (not how) the technology and/or facilities satisfy the basic service requirements. Any other outcome would violate the principle of competitive neutrality.⁵³

- D. *Principle No. 4: No double payments. If one carrier gets high cost support for providing a line to a household, another provider should not also get support for providing (or being able to provide) a line to the same household.***

This principle is the converse of Principle No. 2: support for providing service to the end user should only be paid once, and then only to the carrier providing the service. Under this principle, no market participant should be paid for simply being “ready to serve” customers. Instead, the carrier must *actually provide* the supported services. As discussed in Section V, *infra*, however, the current method of calculating high cost support for rate-of-return ILECs violates this principle and results in double-payment, because ILECs retain support for lines they lose to competitors.⁵⁴

- E. *Principle No. 5: Let the market work as it would in the absence of subsidies. Other than permitting more consumers to purchase service, high cost support should not alter the competitive signals that the market would send to ILECs and CETCs in the absence of support payments.***

The Commission’s high cost support mechanisms should not alter the competitive signals that the market would send to ILECs and CETCs in the absence of support payments. This should be a bedrock principle of the Commission’s universal service

⁵³ *Universal Service First Report and Order*, 12 FCC Rcd at 8801 (¶¶ 46-48).

⁵⁴ To be competitively neutral, the Joint Board and Commission could elect to provide support to all ETC networks that are “ready to serve” customers. However, such an approach would truly “subsidize competition,” and is not necessary to meet Section 254’s goals.

system, and is inherent in the Joint Board and Commission's prior holdings that high cost support mechanisms must be competitively neutral. Except for expanding consumer demand by lowering rates for the supported services, support should not provide CETCs with added incentive to enter markets that they would not otherwise enter in the absence of support. At the same time, support payments should allow ILECs to shield themselves from competition.

V. RURAL, RATE-OF-RETURN ILEC REVENUE GUARANTEES DISTORT TODAY'S HIGH COST SUPPORT MECHANISMS.

The Public Notice seeks comment on the methodologies for calculating high cost support for ETCs in competitive study areas.⁵⁵ The current method for calculating CETC support, however, is the victim of the Commission's flawed approach to determining ILEC support. With one exception, each of the mechanisms providing high cost support to CETCs in areas served by rate-of-return ILECs also provides ILECs with revenue guarantees.⁵⁶ These revenue guarantees are inconsistent with the five universal service principles laid out above: they inflate high cost support above the levels needed to ensure that rates remain affordable and reasonably comparable; they result in double support by paying ILECs even when they no longer provide supported services; and they distort the

⁵⁵ See *Public Notice* at ¶ 15.

⁵⁶ Intrastate high cost loop support for non-rural ILECs – both those subject to price-cap regulation and rate-of-return regulation – is based on a forward-looking cost model that does not guarantee ILECs a specific rate of return. More specifically, the forward-looking support mechanism provides support for 76 percent of statewide average costs above a nationwide average cost benchmark of 135 percent. See 47 C.F.R. § 54.309; see also *In the Matter of Joint Board on Universal Service*, Ninth Report & Order and Eighteenth Order on Reconsideration, 14 FCC Rcd 20432 (1999), *remanded sub nom Qwest v. FCC*, 258 F.3d at 1191. GCI's ILEC competitor, ACS, is a non-rural LEC in Anchorage, but it does not receive model-based federal high cost support; accordingly,

competitive signals that the market would send to ILECs and CLECs in the absence of support.

Nowhere does the 1996 Act require market-distorting ILEC revenue guarantees as a component of universal service. As the Fifth Circuit stated:

The Act does *not* guarantee all local telephone service providers a sufficient return on investment; quite the contrary, it is intended to introduce competition into the market. Competition necessarily brings the risk that some telephone service providers will be unable to compete.⁵⁷

Indeed, as the Court noted, revenue guarantees misplace the fundamental purpose of Section 254, which is to ensure that there is “sufficient funding of *customers*, not *providers*.”⁵⁸

A. Existing High Cost Support Mechanisms Create Anti-Competitive Revenue Guarantees For Rural, Rate-of-Return ILECs.

Four types of high cost support are available to rural ILECs subject to rate-of-return regulation: Interstate common line support (“ICLS”), High cost loop support (“HCLS”), Long-term support (“LTS”), and Local switching support (“LSS”). Because each of these mechanisms calculates ILEC support based on an ILEC’s reported regulatory costs for its entire study area, each of these mechanisms guarantees that ILECs will not lose high cost support even when they lose supported lines to competitors. Such a policy invites ILECs to be insensitive to the needs of their customers, since they are insulated from the full competitive pressures of the marketplace.

GCI does not address herein the model-based high cost loop support mechanism for non-rural ILECs.

⁵⁷ *Alenco*, 201 F.3d at 619 (emphasis in original).

⁵⁸ *Id.* (emphasis added).

HCLS ostensibly lowers intrastate rates of rural ILECs by shifting some loop costs from the intrastate jurisdiction into the interstate jurisdiction.⁵⁹ These costs are then recovered through the HCLS mechanism, rather than through interstate rate elements. The amount of loop costs that can be shifted to the interstate jurisdiction is limited by a nationwide cap, which grows annually by a Rural Growth Factor that combines the rate of inflation with the growth rate of lines in rural telephone company study areas.⁶⁰ Unlike high cost model support for non-rural ILECs, HCLS for ILECs is not calculated on a per-line basis, but as a lump sum per month that equals the costs shifted to the interstate jurisdiction.

LSS provides high cost support for local switching costs incurred by carriers serving study areas of 50,000 lines or less, all of which meet the Act's definition of a rural telephone company.⁶¹ This support covers switching costs that would otherwise be

⁵⁹ Specifically, an ILEC with fewer than 200,000 working loops can shift to the interstate jurisdiction up to 65 percent of the portion of its unseparated loop costs greater than 115 percent but less than or equal to 150 percent of the national average unseparated loop cost, and 75 percent of the portion of its unseparated loop costs greater than 150 percent. See *In the Matter of Federal-State Joint Board on Universal Service; Multi-Association Group ("MAG") Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, Fourteenth Report and Order, Twenty-Second Order on Reconsideration, and Further Notice of Proposed Rulemaking in CC Docket No. 96-45, and Report and Order in CC Docket No. 00-256, 16 FCC Rcd 11244, 11251-11252 (¶ 13, n.19) (2001) ("*Rural Task Force Order*"). In effect, this means that the interstate jurisdiction bears all rural carrier loop costs exceeding 150 per cent of the nationwide average loop cost. The *Rural Task Force Order* froze the nationwide average loop cost at \$240 per year, or \$20 per month. *Id.* at 11268 (¶ 55). A small number of non-rural ILECs still receive HCLS, pursuant to the "hold harmless" provisions in 47 C.F.R. § 54.311. This support for non-rural ILECs is being phased out.

⁶⁰ See *id.* 16 FCC Rcd at 11262 (¶ 35). In some instances, an ILEC can receive support above the cap through a "safety net additive," for example, when Telecommunications Plant in Service, on a per loop basis, grows by more than 14 percent over a one year period. See 47 C.F.R. § 36.605.

⁶¹ See 47 C.F.R. § 54.301.

recovered through intrastate rates. LSS is the successor to the Dial Equipment Minutes weighting mechanism, a high cost support mechanism that pre-dated the 1996 Act.⁶² LSS is also calculated and distributed to rural, rate-of-return ILECs as a lump-sum per month, as opposed to a per-line basis.

While HCLS and LSS provide support for costs that would otherwise be recovered in intrastate rates, ICLS and LTS together support a portion of the interstate-allocated common line costs of rate-of-return ILECs.⁶³ These mechanisms defray the interstate allocated loop costs (along with some other non-traffic sensitive costs) to the extent that recovery of those costs would otherwise result in an interstate subscriber line charge greater than \$6.50 per line per month for residential and single line business connections and \$9.20 per line per month for multiline businesses.⁶⁴ Like the other forms

⁶² See *Universal Service First Report & Order*, 12 FCC Rcd at 8892 (¶ 212).

⁶³ For non-rural ILECs, LTS is being transitioned into ICLS by the “hold harmless” mechanism, 47 C.F.R. § 54.311. The FCC has also sought comment regarding whether LTS should be consolidated with ICLS for rural carriers. See *In the Matter of Multi-Association Group (“MAG”) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers; Federal-State Joint Board on Universal Service, Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate of Return Regulation; Prescribing the Authorized Rate of Return From Interstate Service of Local Exchange Carriers*, Second Report and Order and Further Notice of Proposed Rulemaking in CC Docket No. 00-256, Fifteenth Report and Order in CC Docket No. 96-45, Report and Order in CC Docket 98-77, Report and Order in CC Docket 98-166, 16 FCC Rcd 19613, 19725-19726 (¶¶ 274-276) (“MAG Order”).

⁶⁴ In the *MAG Order*, the Commission increased SLC caps for rate-of-return ILECs and moved the recovery of non-traffic sensitive interstate loop costs embedded in traffic-sensitive interstate access rates to a new, explicit and portable support mechanism, ICLS. See *id.* at 19622-25 (¶ 11).

of high cost support for rate-of-return ILECs, ICLS and LTS (for ILECs) are calculated as a lump sum for each ILEC study area, and are paid on a monthly basis.⁶⁵

Two factors result in all of these high cost support mechanisms (i.e., HCLS, LSS, LTS, and ICLS) serving as revenue guarantees for rural, rate-of-return ILECs. First, all are based on an ILEC's historical "book" costs or, in the case of LTS, are simply a fixed amount. In other words, these mechanisms merely shift the recovery of an ILEC's historic, embedded costs from one recovery mechanism (rates) to another (USF) without evaluating whether these "book" costs reflect the cost of providing a supported service most efficiently. Accordingly, there is no consideration of whether support is being paid for "costs" that are excessive, *i.e.*, above the levels necessary for an efficient carrier to provide the supported services.⁶⁶

Second, the Commission calculates high cost support for rural, rate-of-return ILECs based on total embedded costs for the study area rather than using these costs to determine a per-line support amount and providing support for lines actually served. Accordingly, as an ILECs number of lines in service changes, there is no longer a correlation between the high cost support it receives and the provision of service to its customers. Although it may have been appropriate to assume in a monopoly environment that all ILEC costs would be for the provision of supported universal services to customers, that is no longer the case in a multi-provider environment. In such an

⁶⁵ See *id.* at 19673-74 (¶ 142); 47 C.F.R. §§ 54.303 (LTS), 54.901 (ICLS). The amount of LTS that an ILEC receives is based on the amount of LTS that carrier received in 1999, adjusted for inflation, rather than on study area costs or lines served.

⁶⁶ Though ILECs present their embedded costs as carried on their regulatory books as "actual" costs, these costs are not objective, unavoidable costs. These embedded book "costs" are a bookkeeping creation, grown out of years of state and federal ratemaking

environment, both ILECs and CETCs incur costs to be *ready* to serve a customer, even if only one ETC ultimately becomes any given customer's service provider.

The revenue guarantees embedded in HCLS, LSS, LTS and ICLS are exposed when ILECs lose lines to competitors (which may or may not be CETCs). As competitors win lines from ILECs, ILEC effective support per line automatically increases, because total study area support remains the same, while the number of lines served decreases.⁶⁷ This, as the Commission acknowledged in the *Rural Task Force Order*, creates an upward spiral of ILEC support:

Due to the nature of telecommunications as an industry with high fixed costs, an incumbent carrier's loss of subscriber lines to a competitive eligible telecommunications carrier is unlikely to be offset by a corresponding reduction in its total embedded cost of service. If the incumbent's lines decreased while its fixed costs remained roughly the same, its per-line costs would increase. Consequently, the incumbent would be entitled to higher support per line.⁶⁸

Revenue guarantees are not an inescapable feature of a high cost support mechanism for rural, rate-of-return ILECs. To the contrary, high cost support to offset the intrastate loop costs of ILECs not meeting the statutory definition of a "rural telephone company" is calculated according to the Commission's forward-looking

decisions and ILEC investments in a rate-of-return environment that provides little incentive for cost discipline. *See* text accompanying n.30, *supra*.

⁶⁷ Although 47 C.F.R. 54.307(a), particularly paragraph (a)(4), makes clear that ILECs should lose support as CETCs gain lines, GCI does not believe that this requirement has actually been effectuated in the high cost support mechanisms. Moreover, even if this requirement were actually implemented, ILEC support would simply increase automatically the next time per-line support is recalculated.

⁶⁸ *Rural Task Force Order*, 16 FCC Rcd at 11294 (¶ 125). Although the Commission was discussing HCLS, its observation is equally valid with respect to LSS, LTS and ICLS.

economic cost model on a *per-line basis* to all ETCs.⁶⁹ Had the Commission elected to calculate support for rural, rate-of-return ILECs in a similar manner, ILEC effective support per line would not automatically escalate as competitors gain market share. This is because support would not be tied to ILEC embedded costs but would instead be paid exclusively for each supported line served by ILECs. Such an approach, if applied to rural, rate-of-return ILECs, would help reduce high cost support to the lowest amount necessary to achieve the 1996 Act’s universal service objectives, consistent with Principle No. 1 (support must be adequate, but not excessive).

Use of a cost model is not, however, the only means of eliminating revenue guarantees in the high cost support mechanisms for rural, rate-of-return ILECs. The Rural Task Force previously recommended a partial solution with respect to the HCLS mechanism. Specifically, it proposed that, when a CETC is certified to provide service in a rural study area, HCLS support should be capped at the then-existing level of HCLS support *per ILEC line*, and would grow thereafter according to the Rural Growth Factor.⁷⁰ The goal was to prevent excessive fund growth following competitive entry.

Unfortunately, the Commission did not adopt this aspect of the Rural Task Force’s recommendations. At that time, however, it recognized that, “as competition develops in high cost areas and rural incumbent carriers lose lines to competitors,

⁶⁹ See n.56, *supra*.

⁷⁰ See *Rural Task Force Order*, 16 FCC Rcd at 11293 (¶ 120). The use of the Rural Growth Factor, as proposed by the Rural Task Force, would have double-counted loop growth because both the per-line nature of the support and the Rural Growth Factor’s inclusion of rural ILEC line growth reflect ILEC loop growth. The Commission recognized this double counting and cited it as a reason for not adopting the Rural Task Force’s proposal. *Id.* at 11295 (¶ 126). However, in an analogous situation with respect to the Rural Task Force’s proposed cap on corporate operations expenses, it modified the

excessive fund growth may occur.”⁷¹ It is now time to reconsider that decision, as the *Public Notice* invites.⁷²

B. ILEC Revenue Guarantees Through USF Are Not Competitively Neutral, and Result in Double Support.

Rate-of-return revenue guarantees, and the attendant upward spiral in per-line support, distort the high cost support mechanisms from a principled, competitively neutral approach. In the first instance, revenue guarantees insulate ILECs against the full effects of competition, violating Principle No. 5 (let the market work as it would in the absence of subsidies). In an unsubsidized market, an ILEC loses all of the revenue associated with service to a customer when it loses that customer to a competitor. By contrast, in an area receiving high cost support, although the ILEC loses the end user revenue associated with that customer, it *retains* the high cost support associated with the facilities that were formerly used to serve that customer, because its high cost support does not decline when it loses the line. Thus, the ILEC does not face the same financial incentive to retain customers that it faces in a competitive market

Moreover, even when CETCs receive “portable” support for every line they serve⁷³ the fact that ILECs are paid on a lump sum, per-study area basis rather than on a per-line basis creates competitive inequality. As an ILEC loses lines to any CLEC, the

Rural Task Force’s proposal and adjusted that cap based on inflation only, eliminating the increase for rural ILEC line growth. *Id.* at 11277 (¶ 72).

⁷¹ *Id.* at 11293 (¶ 124).

⁷² *See Public Notice* at ¶ 24.

⁷³ CETCs receive support based on the effective per line support rate derived from the cost and line count data that the ILEC files with NECA. *See* 47 C.F.R. §§ 54.307, 54.901.

ILEC's *effective* support per line automatically increases. In contrast, the CETC's per-line support amount does not change until the ILEC submits new cost data or line counts to USAC and this information is used to recalculate the amount of high cost support the ILEC receives divided by the ILEC's lines. The CETC's high cost support per line served will therefore lag the ILEC's effective support per line served, providing the ILEC greater per-line support during the interim.⁷⁴ Thus, if an ILEC consistently loses lines to CLECs, the current rural, rate-of-return ILEC high cost support mechanisms ensure that the CETC will consistently receive less support per line than the ILEC.

Also in violation of Principle No. 5 (let the market work as it would in the absence of subsidies), revenue guarantees and the lack of the per-line support cap recommended by the Rural Task Force mean that these mechanisms actually subsidize rural, rate-of-return ILECs' response to competition. To illustrate, consider the combination of HCLS, LTS, and ICLS. Together, these mechanisms can support *all* of a rural ILEC's incremental loop investment above 150% of the nationwide average loop cost. If an ILEC decides to upgrade its loop plant in response to competitive entry, the High Cost Fund will reimburse it in full for this investment if its loop costs exceed \$30 per working loop.⁷⁵ The ILEC will also receive substantial reimbursement for its

⁷⁴ The following example illustrates the anticompetitive effect of lag. Assume that an ILEC requires \$10,000 in high cost support to serve a study area comprised of 1,000 customers. The ILEC effectively receives \$10 per line in high cost support prior to competitive entry. If a CETC enters the study area, it will receive \$10 in high cost support for each line it serves, consistent with § 54.307 of the Commission's rules. If the CETC wins 100 customers from the ILEC, the ILEC's per-line support effectively increases: \$10,000 divided by 900 customers is approximately \$11.11 per line. Until the ILEC submits its revised line count data to USAC, the ILEC will receive \$11.11 in high cost support for each customer it serves while the CETC only will receive \$10.

⁷⁵ \$23 is 115% of the nationwide average loop cost of \$20. At or above \$30 per working loop, rural, rate-of-return ILECs shift 75 percent of their loop costs above that

incremental investment even if its loop costs are between \$23 and \$30 per working loop. This contrasts sharply with an unsubsidized market, in which competitors must fund their own competitive response and can increase revenue only to the extent they can convince consumers to pay more for existing service or to buy additional service. Funding ILEC competitive response is not competitively neutral, especially if ILECs never lose support as they lose lines.

It is also apparent that ILEC revenue guarantees result in double support, in violation of Principle No. 4 (no double payments). Because ILECs do not lose high cost support as they lose lines, whenever a CETC wins a line from an ILEC, the ILEC continues to receive support that essentially duplicates the support paid to the CETC. Take the simplest example in which a CETC provides the primary telephone line to a particular customer entirely over its own facilities (such as over a wireless network or a cable telephony system). In that situation, the CETC receives per-line high cost support because it is the entity actually providing supported services to the customer. The ILEC no longer provides service to that customer at all. Yet, because the ILEC receives its high cost support on a lump sum, per-study area basis, rather than on a per-line basis, the ILEC continues to receive support for its investment in the facilities that it formerly used to provide service to that customer.

Again, this duplicate support for ILECs is not competitively neutral. While CETCs only receive high cost support when they *actually* provide service to customers,

threshold from the intrastate jurisdiction to the interstate jurisdiction to be covered by HCLS. The other 25 percent of loop costs are allocated to the interstate jurisdiction through separations. However, because the residential and single line business SLC is capped at \$6.50, above approximately \$26 per working loop in unseparated loop costs,

ILECs receive support for sitting idle. However, Section 214(e)(1) requires both ILECs and CETCs to be prepared to serve their entire service areas.⁷⁶

Calculating and distributing all rural, rate-of-return ILEC high cost support on a per-line basis, both for ILECs and CETCs, can restore competitive neutrality. ILECs would not continue to receive support for lines over which they no longer provide service. Moreover, at any given point in time, ILECs and CETCs would receive the same support per line, with the calculation of support for both carriers subject to the same data reporting lags. In other words, ILEC effective per-line support would no longer automatically increase while CETC support remained constant.

C. Revenue Guarantees Also Provides Revenue Windfalls to CETCs.

Revenue guarantees, and the consequent upward spiral in effective per-line ILEC high cost support, also provide CETCs with an inadvertent revenue windfall by increasing the amount of CETC per-line support as ILEC per-line support increases. This allows CETCs to enjoy increased revenue per connection, without any work or ingenuity on their part. As the Commission acknowledged in the *Rural Task Force Order*:

Because the higher per-line support amount would be available to both the incumbent and the competitor for each line served under our portability rules, the size of the fund could grow significantly as competition increases, particularly if there is a net increase in the total number of lines served in the study area.⁷⁷

This problem plagues not only HCLS, but also LSS, LTS and ICLS.

the incremental loop investment that is allocated to the interstate jurisdiction and not recovered through HCLS will be recovered through ICLS or LTS.

⁷⁶ See 47 U.S.C. § 214(e)(1). In Alaska, GCI has also offered to assume carrier of last resort obligations under state law once it serves more than 35 percent of a market through its own facilities or UNEs.

⁷⁷ *Rural Task Force Order*, 16 FCC Rcd at 11294 (¶ 125) (citations omitted).

This growth in CETC support would not occur in an unsubsidized market. Without access to increased per-line support, a CETC's revenue would increase only to the extent it could provide supported services more efficiently than the ILEC (*i.e.*, at a lower cost or at a higher level of quality so consumers choose the CETC over the ILEC), or by adding new, innovative services or packages that increase value for the consumer and thus revenue per consumer. With ILEC revenue guarantees creating an upward spiral of per-line high cost support, however, CETC revenues increase even in the absence of added ingenuity, efficiency or effort. To the extent there is a valid criticism of the current mechanism for "subsidizing competition," it relates to this flawed method for calculating high cost support, which increases per-line revenue for both the ILEC and the CETC in response to competitive entry.

Notably, this unearned "bonus" does not flow from certifying multiple ETCs or creating portable high cost support. Rather, it flows most directly from ILEC revenue guarantees built into the high cost support mechanisms. Without revenue guarantees for rural, rate-of-return ILECs, there would be no upward spiral of support per line for either ILECs or CETCs. Without ILEC revenue guarantees, CETCs would know that they could not expect increasing revenue per line from the high cost support mechanisms, but could gain revenue increases only through their own superior skill, foresight, or knowledge.

Again, the solution is simple: prevent the upward spiral of support from occurring in the first place. By calculating support for both ILECs and CETCs on a per-line basis, and then capping that per-line support upon CETC entry, the upward spiral of

support could be halted, and carriers would not enjoy undeserved revenue windfalls courtesy of the USF.

D. Revenue Guarantees Are Not Necessary to Provide ILECs With a Reasonable Opportunity to Recover Revenue Associated with Lines Lost to CETCs.

Rural, rate-of-return ILECs will likely claim that ending their revenue guarantees will effect a Constitutional violation under the Takings Clause of the Fifth Amendment, which “protects utilities from being limited to a charge for their property serving the public which is so ‘unjust’ as to be confiscatory.”⁷⁸ Such claims would fail. In the first instance, not every diminution in revenue creates a “Taking.” As the Supreme Court noted in *Hope Natural Gas v. FPC*, “the fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated . . . [b]ut the fact that the value is reduced does not mean that the regulation is invalid.”⁷⁹ To establish a Taking, an ILEC must be able to demonstrate that a regulator has set prices at such a low level that the ILEC is unable “to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed.”⁸⁰ It is the “total effect” of a regulation that must be evaluated “in the context of the system under which they are imposed.”⁸¹ ILECs are unlikely to meet this stringent standard.

⁷⁸ *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989) (citing *Covington & Lexington Turnpike Road Co. v. Sanford*, 164 U.S. 578, 597 (1896)) (“*Duquesne*”).

⁷⁹ *FPC v. Hope Natural Gas*, 320 U.S. 591, 605 (1944) (“*Hope*”).

⁸⁰ See *Verizon Communications, Inc. v. FCC*, 122 S. Ct. 1646, 1658 (2002) (“*Verizon*”) (citing *Hope*, 320 U.S. at 605).

⁸¹ *Duquesne*, 488 U.S. at 310, 313.

To the extent that the Joint Board and the Commission wish to provide ILECs with an opportunity to recover lost revenue formerly received in high cost support, they could simply allow ILECs to increase the cap on their SLCs, reflecting the revenue requirement formerly but no longer offset by high cost support. The critical distinction is that – consistent with *Alenco* – the ILEC would be given an *opportunity* to earn these revenues, not a USF-based guarantee.⁸² In other words, ILECs would be subject to a competitive market test: if an ILEC can convince its customers that it truly provides superior value to a CETC, it will be able to sustain its price increase. However, the increase will be visible to the customer, and will be subject to competitive pressure.

The presence of CETCs also provides an important safeguard to prevent rates from escalating to levels that are neither affordable nor reasonably comparable. As GCI proved in Anchorage, CETCs will not mindlessly follow ILEC price increases in all circumstances.⁸³ This is because CETCs have the opportunity to gain market share by exploiting their own efficiencies. CETCs can “hold the line” in the face of ILEC price increases, as GCI did in Anchorage when ACS raised its rates 24 percent. GCI refused to follow ACS’ rate increase, notwithstanding a corresponding increase in the UNE loop rate charged by ACS. Indeed, GCI’s experience in Anchorage illuminates the very rationale for making high cost support portable among ETCs: in the battle to operate more efficiently and win customers by offering lower prices, high cost support in excess of the minimum amount the most efficient provider requires to charge affordable and

⁸² *Alenco*, 201 F.2d at 619.

⁸³ Although ACS and GCI receive only a small amount of high cost support in Anchorage, the CETC’s competitive response calculus would not change as per-line support increased.

reasonably comparable rates is naturally exposed over time. Once exposed, excessive support can be eliminated.

VI. THE JOINT BOARD AND THE COMMISSION SHOULD NOT SUPPORT PAYING CETCS AND ILECS DIFFERENT AMOUNTS OF PER LINE SUPPORT.

The *Public Notice* seeks comment on whether high cost support for CETCs should be calculated on a basis other than ILEC per-line support, specifically CETC costs.⁸⁴ The Joint Board should take no action resulting in different CETC and ILEC per-line support amounts. Supporting rate-of-return ILECs based on ILEC embedded costs and CETCs based on CETC costs would violate both Principle No. 3 (ensure equal opportunity for support) and Principle No. 5 (let the market work as it would without subsidies) by skewing the market from the results that would be obtained in the absence of a subsidy, and would also lead to excessive support. This would be the case regardless of whether a CETC provides universal service entirely over its own facilities, using UNEs, or some combination of the two.

GCI does not object to determining support for both ILECs and CETCs based on CETC per-line costs. Nor does GCI object to determining support for both ILECs and CETCs based on ILEC per-line costs. Support could also be based on a cost model. But the support payment – however determined – *must be the same* for all market participants, consistent with Principle No. 3 (equal opportunity for support).

⁸⁴ See *Public Notice* at ¶ 18.

A. Providing CETCs Less Support than ILECs Subverts Market Efficiency and Serves Only to Shield ILEC Revenues from Competition.

Differential support for ILECs and CETCs would deprive the market of each carrier's superior skill, knowledge and foresight, because it would deprive more efficient carriers the benefits of their efficiency. Such a mechanism would thus prevent the market from discovering the smallest necessary subsidy (or whether, in some cases, service can be provided without subsidy at all). It would instead merely protect bloated existing subsidies.

To demonstrate the inherent inefficiencies and competitive biases created by a system that pays differential support to ETCs in the same market, it is useful to consider how that market would function in the absence of support payments. As an example, ACS today receives lump-sum monthly high cost support roughly equivalent to \$12.17 per line per month for serving residential customers in Zone 2 of ACS' Fairbanks study area. GCI also receives \$12.17 per line per month in support for serving lines in the same area.⁸⁵ In the absence of this subsidy, ACS' retail rates would need to be approximately \$12.17 per line per month higher in order for ACS to receive the same revenue it now receives with the subsidy. GCI, as the newer entrant, would have the opportunity to compete for that entire \$12.17 for every customer. In the absence of this subsidy, GCI would have the incentive to enter whenever it could do so profitably, based on the unsubsidized amount of revenue it would receive in competition with ACS' unsubsidized prices. If GCI were 10 percent more efficient than ACS, it would have the option of cutting its rates by up to 10 percent in order to attract more customers, or charging the

⁸⁵ See 47 C.F.R. § 54.307(a).

same rates as ACS, and earning a greater margin, or something in between. The market would dictate GCI's pricing in response to ACS' pricing, and would dictate ACS' response to any price reductions implemented by GCI. Over time, basic economics predicts that competition will move prices toward the long run incremental costs of the most efficient provider. Providing a \$12.17 subsidy to both ETCs for residential lines simply reduces customers' price by \$12.17, while maintaining the same revenue opportunity for each ETC, and transmitting the same pricing signals and efficiency incentives to both carriers.

By contrast, competitive incentives and market discipline would be greatly skewed if a subsidy were provided to only one ETC but not another, or in a greater amount to one ETC than to another. If, for example, ACS were to receive a subsidy of \$12.17 per line, and GCI were to receive no subsidy for providing the same service to the same subscriber, GCI would have no incentive to enter unless it could provide lines at an average of \$12.17 *less* than ACS. Put another way, ACS could be as much as \$12.17 per line per month less efficient (and more costly) than GCI before GCI could begin to impose competitive discipline on ACS by attracting some of its customers. Under such a system, the competitive market's incentives for efficient service would be blunted dramatically, and the ratepayer, through universal service fees, would fund inefficient service. Such a system of disparate support would wholly disengage the competitive market's self-propagating mechanism, which ensures that CETCs and ILECs both have incentives to deliver the highest value to customers at the lowest price.

The Commission has previously recognized the competitive inequities and market distortions created by paying ILEC support that is unavailable to new

entrants. Indeed, it declared that Section 253 preempts as unlawful barriers to entry intrastate universal service mechanisms that deliver disparate or no support to CETCs. As the Commission concluded:

A new entrant faces a substantial barrier to entry if its main competitor is receiving substantial support from the state government that is not available to the new entrant. A mechanism that makes only ILECs eligible for explicit support would effectively lower the price of ILEC-provided service relative to competitor-provided service by an amount equivalent to the amount of the support provided to ILECs that was not available to their competitors. Thus, non-ILECs would be left with two choices – match the ILEC’s price charged to the customer, even if it means serving the customer at a loss, or offer the service to the customer at a less attractive price based on the unsubsidized cost of providing such service. A mechanism that provides support to ILECs while denying funds to eligible prospective competitors thus may give customers a strong incentive to choose service from ILECs rather than competitors.⁸⁶

The Commission hit the nail on the head. Unequal support cannot be competitively neutral and will skew the market in favor of one competitor – the ILEC.

Differential support would also completely eliminate any incentive for cost cutting by either carrier. Both ILECs and CETCs would essentially be under parallel, but non-interacting, systems of rate-of-return regulation. As each carrier increases its costs, its support and therefore total revenue per unit (but not the price on which it competes to win customers in the marketplace) would increase. The more each carrier increases its costs, the more support it would receive. To prevent an unchecked upward climb in support, the Commission would have to institute full rate-of-return regulation of CETC rates.

⁸⁶ *In the Matter of Western Wireless Corporation Petition for Preemption of Statutes and Rules Regarding the Kansas State Universal Service Fund Pursuant to Section 253 of the Communications Act of 1934*, Memorandum Opinion and Order, 15 FCC Rcd 16227, 16231 (¶8) (2000) (“*Kansas Preemption Order*”).

As an alternative, the Commission could cap universal service support for CETCs. However, this proposal suffers from essentially the same deficiency that results from placing CETCs under rate-of-return regulation: a CETC would still have no incentive to reduce its costs below the level at which its high cost support would begin to phase-out. If it were to do so, it would simply lose high cost support without gaining any competitive advantage in the marketplace. Because ILECs would continue to receive support based on their higher costs, and CETC support would fall as they became more efficient, universal service support would shield ILECs entirely from the consequences of their inefficiency. Under these circumstances, CETCs would not be able to capitalize on their efficiencies, because the benefit of efficiencies would actually flow *to the USF* in the form of support reduction.

High cost support for all ETCs should be measured by the same ruler. This is the only means to replicate the price signals that would occur in a competitive market. The Commission adopted such an approach more than seven years ago when it determined that high cost support for CETCs should be based on ILEC support.⁸⁷ The wisdom of the Commission's policy choice is proven by the fact that, in Alaska, GCI's competitive entry is exposing precisely the sort of inefficiencies in ACS' operations that the Commission and the Joint Board anticipated.

B. UNE-Based Competition Should Not Be Subject To Different Rules.

In the *Public Notice*, the Joint Board seeks comment on whether CETCs that provide supported services using UNEs should receive different levels of high cost

⁸⁷ See *Universal Service First Report & Order*, 12 FCC Rcd at 8932-8934 (¶¶ 286-290).

support than those providing supported services solely using self-deployed facilities.⁸⁸

The Commission should not make such a differentiation, which would violate Principle No. 3 (ensure equal opportunity for support) and Principle No. 5 (let the market work as it would in the absence of subsidies).

The Commission has already taken steps to match both high cost support and UNE prices with the variations in the costs of underlying facilities: neither high cost support nor UNEs must be geographically averaged. In the *Rural Task Force Order* and the *MAG Order*, the Commission allowed ILECs to disaggregate high cost support by zone and, with the concurrence of the relevant state commission, to establish as many zones as the state commission finds are in the public interest.⁸⁹ This allows greater high cost support to flow to the high cost portions of ILEC study areas. Similarly, state commissions are required to deaverage UNE rates into at least three geographic zones.⁹⁰ This ensures that ILECs can receive a higher rate when they lease UNE loops in high-cost portions of their study area than when they lease UNE loops in high-density, low-cost zones. These rules already provide rural ILECs adequate protection from “uneconomic” entry, which can occur when a new entrant only targets the relatively low-cost customers in a study area with averaged UNE rates and high cost support. But further differentiating support for UNE-based CETCs would only distort the results that would occur in the absence of high cost support payments.

⁸⁸ *Public Notice* at ¶ 18.

⁸⁹ *See* 47 C.F.R. §§ 54.315(c), 54.901.

⁹⁰ *See* 47 C.F.R. § 51.507(f).

1. A Principled Approach Does Not Distinguish Between UNE Entry and Other Entry.

As the Commission recognized in the *Universal Service First Report & Order*, UNE-based service is simply an alternative to full facilities-based service. More importantly, it is an alternative that the 1996 Act specifically contemplated, in recognition of the fact that it would be extremely difficult, and in some cases, impossible, for new entrants to duplicate the ILEC networks that were built over decades at ratepayer expense.⁹¹ UNE facilities leased by a CETC meet Section 214(e)(1)(A)'s requirement that an ETC provide service, at least in part, over "its own facilities."⁹² As the Commission has observed, "unbundled network elements are the requesting carrier's 'own facilities' in that the carrier has obtained the 'exclusive use' of the facility for its own use in providing services, and has paid the full cost of the facility, including a reasonable profit, to the ILEC."⁹³ The Commission further distinguished UNEs from telecommunications services obtained for resale, stating:

Unlike a pure reseller, a carrier that provides service using unbundled network elements bears the full cost of providing that element, even in high cost areas. Section 252(d)(1)(A)(i) requires that the price of an unbundled network element be based on cost; a carrier that purchases access to an unbundled network element incurs all of the forward-looking costs associated with that element.⁹⁴

⁹¹ See *Universal Service First Report & Order*, 12 FCC Rcd at 8867-8870 (¶¶ 164-166).

⁹² See *Id.* at 8862-8870 (¶¶ 154-168); see also 47 U.S.C. § 214(e)(1).

⁹³ *Universal Service First Report and Order*, 12 FCC Rcd at 8866 (¶ 160).

⁹⁴ *Id.* at 8866-8867 (¶ 162).

As the Commission explained, the lack of high cost support for services obtained for resale stems directly from the fact that a carrier purchasing services for resale does not pay the full economic cost of the underlying facilities:

The purpose of the [high cost] support is to compensate carriers for serving high cost customers at below cost prices. When one carrier serves high cost lines by reselling a second carrier's services, the high costs are borne by the second carrier, not by the first, and under the resale pricing provision the second carrier receives revenues from the first carrier equal to end-user revenues less its avoidable costs. Therefore it is the second carrier, not the first, that will be reluctant to serve absent the support, and therefore it should receive the support.⁹⁵

Calculating high cost support for CETCs on a basis other than ILEC support would be grossly inefficient and would not be competitively neutral for the reasons discussed in Section VI.A, *supra*. For the same reasons, calculating high cost support for CETCs using UNEs on a basis other than ILEC support would also be grossly inefficient and discriminatory. A CETC using only its own facilities, in the absence of high cost support, can offer its services to consumers at a lower price than an ILEC, if, considering all costs, it can do so more efficiently than the ILEC. The same is true for a CLEC leasing UNE loops in combination with its own switches, or leasing all UNEs in combination (*i.e.*, UNE-P). Differentiating the level of support for CETCs using UNEs from the level of support for CETCs using entirely their own facilities does not generate greater efficiencies; it only provides ILECs with a universal service-based advantage.

The Commission's existing rules fully address any potential for artificial "windfalls" to CETCs providing supported services using UNEs. First, UNE rates must be geographically deaveraged into at least three cost zones, reflecting the underlying forward-looking costs of the UNEs within those zones. Thus, if an ILEC has pursued its

⁹⁵ *Id.* at 8834 (¶ 290).

rights under the Commission’s local competition rules, it should not face a situation in which it charges averaged rates for UNEs while high cost support is provided to CETCs on a deaveraged basis.

Second, ILECs can elect to disaggregate high cost support into zones.⁹⁶ Even if an ILEC makes an erroneous election, a state commission can, on its own motion, direct the ILEC to disaggregate high cost support. ILECs can design their own disaggregation plans, within certain prescribed limits.⁹⁷ And, while the *Rural Task Force Order* limited the number of zones that an ILEC can establish using the self-certification option, there are no limits placed on the number and nature of zones that a state commission can create in response to an ILEC’s Path Three disaggregation plan, or order on the state commission’s own motion or upon petition by an interested party.⁹⁸ Thus, ILECs have adequate means to ensure that high cost support is targeted to the higher cost portions of their study areas, and can avoid applying averaged high cost support to lines in high-density, low-cost UNE zones.

Third, as a backstop to these two other rules, Section 54.307 limits a CETC using UNEs to no more high cost support (other than LSS) than it pays the ILEC for a UNE

⁹⁶ The Commission adopted the Rural Task Force’s recommendation that HCLS “should be disaggregated and targeted below the study area level so that support will be distributed in a manner that ensures that the per-line level of support is more closely associated with the cost of providing service.” *Rural Task Force Order*, 16 FCC Rcd at 11302 (¶ 145). The Commission also granted rate-of-return ILECs substantial flexibility to determine how HCLS should be disaggregated, allowing these carriers to choose from one of the three paths: under “Path One,” a rate-of-return ILEC may choose not to disaggregate; under “Path Two,” a rate-of-return ILEC can disaggregate based on a plan that has been approved by the appropriate state regulatory authority; and under “Path Three,” a rate-of-return ILEC can self-certify a disaggregation plan, subject to limitations imposed by the Commission. *Id.* at 11302-11306 (¶¶ 144-55).

⁹⁷ *See id.*

⁹⁸ *See id.*

loop. Of course, this rule is unnecessary and violates the principle of competitive neutrality, because it assumes that a CETC's only loop costs are the price paid for the UNE loop (ignoring collocation, multiplexing, the cost of transport from the ILEC central office to the CETC's switch, and many other costs). Nonetheless, the rule does prevent CETC "windfalls." Similarly, CETCs cannot receive LSS support that exceeds the amount they pay ILECs for unbundled local switching.⁹⁹

With all of these safeguards in place, there is no principled basis for departing from the Commission's conclusions in the *Universal Service First Report & Order*. Service provided via UNEs should receive the same amount of high cost support that is made available to service provided via other, non-resale forms of entry.

2. ACS-F's Dissatisfaction with the Foreseeable Consequences of its Own Regulatory Choices Provides No Basis for Departure from a Principled Approach to Support for UNE-Based Services.

The Joint Board, in a footnote, cites a *Petition for Declaratory Ruling* filed by ACS of Fairbanks, Inc. ("ACS-F") last year, which asserted that CETCs using UNEs should not receive HCLS when their costs fall below the Commission's high cost loop benchmark for HCLS, currently set at approximately \$23 per month.¹⁰⁰ ACS-F relies on the fact that the Fairbanks UNE loop rate is below its book costs per loop to argue that,

⁹⁹ See 47 C.F.R. §54.307(a); see also *Universal Service First Report & Order*, 12 FCC Rcd at 8892 (¶ 287). Any high cost support per line that exceeds the UNE price must be paid to the ILEC. *Id.*

¹⁰⁰ See *Public Notice* at ¶ 21 n.49 (citing ACS Fairbanks, Inc., *Petition for Declaratory Ruling and Other Relief Pursuant to Section 254(e) of the Communications Act*, CC Docket No. 96-45 (filed July 24, 2002) ("*ACS-F Petition*"). GCI already has responded to an identical proposal advanced by ACS, and remains opposed to ACS' most recent proposal, which is nothing more than a naked attempt at ILEC revenue protection.

while it should receive high cost support, GCI should not. Properly understood in context, the Fairbanks market does not demonstrate a problem with the Commission's rules regarding high cost support for UNE-based services, but demonstrates instead a failure by ACS-F to use the tools the Commission has created under the local competition and universal service rules.

As a preliminary matter, ACS-F's argument that a CETC should not receive HCLS if it pays a UNE loop rate less than \$23 incorrectly assumes that a CETC's costs, even its loop costs, are limited to the price paid to the ILEC for the UNE loop. In fact, the UNE loop represents only a portion of loop costs for a CETC that provides service, as GCI does, using an ILEC-provided UNE loop *in combination with* its own facilities. In GCI's case, these additional costs add no less than \$12.82 to GCI's loop costs, and the true amount is likely even higher.¹⁰¹ In the Fairbanks market, for example, GCI has invested more than \$2 million to collocate, *inter alia*, multiplexing equipment at ACS-F's host switch and at one remote. The equipment that GCI has collocated at the ACS-F switch and remote switch is generally comparable to digital loop carriers and line concentrators that are included in ILECs' embedded loop costs. Additionally, GCI installed its own fiber to provide the rest of the loop function between the ILEC-provided loop and GCI's own switch in Fairbanks. Just like costs associated with ILEC fiber feeders, GCI's investment in facilities to carry multiplexed signals to the switch also constitutes loop costs.¹⁰² The bottom line for GCI is that the total cost of providing its

See Petition for Declaratory Ruling and Other Relief of ACS of Fairbanks, Inc., Opposition of General Communication Inc., CC Docket No. 96-45 (filed Sept. 3, 2002).

¹⁰¹ See Hitz Declaration at ¶ 10.

¹⁰² See *id.* at ¶ 7.

loop function exceeds ACS-F's UNE loop price, which, again, represents only one component of GCI's costs.

In any event, ACS-F's problems in the Fairbanks market have more to do with ACSI-F's own regulatory choices than with the universal service rules. Because it no longer likes the consequences of these choices, ACS-now makes what can only be described as "heads-I-win, tails-you-lose" arguments. When GCI and ACS-F arbitrated the current Fairbanks UNE rates in 2000, ACS-F had an opportunity to seek deaveraged UNE loop rates in arbitration proceedings before the RCA.¹⁰³ ACS-F, however, did not even propose the adoption of disaggregated UNE loop rates in that proceeding.¹⁰⁴ ACS-F thus had the chance to address its own complaint that GCI can purchase UNE loops at prices averaged across the study area, but receives disaggregated high cost support for lines in higher cost Zone 2. While GCI does not know why ACS-F did not seek deaveraged UNE rates in the 2000 arbitration, one possible explanation is that ACS-F sought to keep its UNE loop rates relatively high in low-cost areas, making UNE-based entry less attractive. In any event, ACS-F now has another opportunity to seek to

¹⁰³ The RCA stated: "We believe . . . that ACS had the opportunity to advance unbundled network element prices based on geographic zones during the arbitration process and would have strongly advocated such an approach if deaveraging were necessary to its ability to compete in the market. ACS did not do so." *In re Request by GCI Communication Corp. d/b/a General Communication, Inc., & d/b/a GCI for Designation as a Carrier Eligible To Receive Federal Universal Service Support Under the Telecommunications Act of 1996 for the Fairbanks, Fort Wainwright, & Juneau Areas*, Order No. 1, Regulatory Commission of Alaska Docket No. U-01-11 (Aug. 28, 2001).

¹⁰⁴ The arbitration was conducted under "last best offer," or "baseball," arbitration. ACS-F's final best offer included a single, averaged UNE loop rate for the entire Fairbanks service areas. *See* Hitz Declaration at ¶ 3.

deaverage its UNE loop rates in an ongoing negotiation concerning the successor to the 2000 interconnection agreement between GCI and ACS-F.

Having failed to deaverage its UNE loops rates, ACS-F next elected to disaggregate its HCLS, LTS and ICLS support according to its own, self-certified plan (*i.e.*, ACS-F opted for “Path Three” disaggregation). Path Three allowed ACS-F to design its own disaggregation plan, and, pursuant to the *Rural Task Force Order*, ACS-F elected to avoid state commission review by using only two disaggregation zones.¹⁰⁵ ACS-F now complains that it was not able to disaggregate its high cost support into a sufficient number of zones to reflect the full range of underlying loop costs.¹⁰⁶ ACS-F’s inability to disaggregate into a greater number of zones was, of course, a consequence of its decision to elect Path Three rather than Path Two. Had ACS elected to pursue a Path Two disaggregation plan, ACS-F could have, for example, prepared a highly granular disaggregation plan, but such a plan would have been subject to RCA approval. The two-zone constraint on disaggregation of which ACS-F now complains was nothing more than the foreseeable consequence of its own election.

Moreover, ACS-F made several questionable choices as it drew its own zone boundaries under its Path Three disaggregation plan and specified the support assigned to each zone (as Path Three permitted it to do). First, in drawing zone boundaries, it placed GCI’s switch in ACS-F’s high cost support zone. This means that loops for customers

¹⁰⁵ See 47 C.F.R. § 54.315. See also *Rural Task Force Order*, 16 FCC Rcd at 11304 (¶ 151) (noting that the two-cost-zone limitation was necessary to ensure that self-certified disaggregation occurred “in a competitively neutral manner”).

¹⁰⁶ See *ACS-F Petition* at 30-33.

collocated at or near GCI's switch receive the higher Zone 2 support, rather than lower Zone 1 support. This choice was particularly odd because support zones only determine CETC support, which is provided on a per line basis, and do not affect ILEC support, which is provided on a lump sum, per-study area basis. Second, when ACS-F designated its allocation of support to each of the two zones, it apparently did not use a benchmark approach by which it would have allocated support to each zone to the extent its book costs exceeded a specified level (which, for example, could have been \$23 per month). Instead, ACS-F apportioned support on a roughly two-to-one basis between Zone 2 and Zone 1.¹⁰⁷

Thus, the relationship between high cost support and UNE prices in Fairbanks is *sui generis*, presently changing in ongoing interconnection arbitrations, and largely the foreseeable result of ACS-F's own regulatory choices. The Joint Board thus should not view ACS-F's complaint as grounds for any change in the nationwide rules governing high cost support for either ILECs or for CETCs that use UNEs to provide supported services.

3. Any Concerns With Respect to TELRIC Pricing of UNEs Should Be Addressed in the Local Competition Rules, Not the Universal Service Rules.

What ACS-F really argued in its *Petition for Declaratory Ruling* – as revealed by its repeated assertions that its embedded costs are its “actual” costs – is that its embedded costs are the proper measure of its costs, and that the Commission (and the RCA acting

¹⁰⁷ Indeed, ACS' disaggregation methodology assigned far less than \$23 in embedded cost per loop (the ILEC support threshold for HCLS) to all Zone 1 loops. By contrast, all Zone 2 loops were assigned embedded costs greater than \$27 per loop. *See*

pursuant to FCC rules) should have allowed ACS-F to price UNEs based on embedded costs. Resolution of UNE pricing issues in the universal service rules is inappropriate. These issues must be addressed, if at all, in the local competition rules. If, as ILECs contend (unsupported by the evidence), TELRIC rates are “below cost,” then this contention applies to all TELRIC prices, not just TELRIC prices in areas eligible for high cost support.

Of course, the argument that cost-based prices under the 1996 Act must be determined with respect to embedded costs was exactly the argument that the Commission rejected in its *Local Competition Order*,¹⁰⁸ and that the Supreme Court also rejected in *Verizon v. FCC*.¹⁰⁹ In the *Local Competition Order*, the Commission expressly found that “[t]he substantial weight of economic commentary in the record suggests that an ‘embedded cost’-based pricing methodology would be pro-competitor – in this case the incumbent LEC – rather than pro-competition.”¹¹⁰ By contrast, setting the UNE price at the forward-looking cost provides new entrants with appropriate price signals in deciding whether to enter markets and whether to construct their own facilities.¹¹¹ For those reasons, the Commission “decline[d] to adopt embedded costs as

ACS of Fairbanks, Inc. – Disaggregation and Targeting Plan, at 4 (attached as Exhibit B to these Comments).

¹⁰⁸ *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, First Report & Order, 11 FCC Rcd 15499, 15857-58 (¶ 605) (1996) (“*Local Competition Order*”).

¹⁰⁹ *See Verizon Communications, Inc. v. FCC*, 122 S. Ct. 1646 (2002) (“*Verizon*”).

¹¹⁰ *Local Competition Order*, 11 FCC Rcd at 15857-58 (¶ 705) (citation omitted).

¹¹¹ As the Commission explained:

In dynamic competitive markets, firms take action based not on embedded costs, but on the relationship between market-determined prices and forward-looking economic costs.

the appropriate basis of setting prices for interconnection and access to unbundled elements.”¹¹² In short, the Commission rejected embedded costs as a measure of the ILEC’s true economic costs for the purposes of setting UNE prices “based on cost.”¹¹³

ACS-F’s proposal to preclude payment of high cost support to CETCs leasing UNE loops for less than \$23 per line per month is nothing more than a thinly disguised attempt to use high cost support for a completely inappropriate purpose – to make up the difference between the forward-looking loop costs established by the RCA after an arbitration pursuant to Section 252 of the 1996 Act, and ACS-F’s historical book costs.¹¹⁴ The proposal has little to do with the provision of universal service, and, indeed, would divert USF to the reimbursement of historical book costs ILECs have not even proved are stranded.

Moreover, even if ACS-F were correct that the only permissible cost-based UNE rates are those that permit full recovery of an ILEC’s embedded loop costs (and it is not, as the Supreme Court confirmed in *Verizon*), the universal service rules are the wrong venue in which to effect such a policy change. The appropriate change would be to the

If market prices exceed forward-looking economic costs, new competitors will enter the market. . . . New entrants should make their decisions whether to purchase unbundled elements or to build their own facilities based on the relative economic costs of these options.

Id. at 15813 (¶ 620).

¹¹² *Id.* at 15858 (¶ 705).

¹¹³ 47 U.S.C. § 252(d)(i).

¹¹⁴ In Alaska, as elsewhere around the country, the state commission has generally found that the forward-looking costs of an ILEC UNE loop is less than the historical cost of those loops as reflected in the ILEC’s “regulatory books.” This differential, which exists regardless of high cost support, is approximately 66.3 percent, on average, nationwide, and in Fairbanks, UNE rates are approximately 65 percent of ACS-F’s historical book costs.

pricing standards that establish the rates for UNEs. Such a change would maintain a single measure of compensation due an ILEC for a UNE, regardless of whether the ILEC leasing the element is in an area receiving high cost support. Under ACS-F's approach, ILECs that lease UNEs in areas receiving high cost support would recover their historical book costs, but ILECs that lease UNEs in other areas would receive only forward-looking costs. There is no rational basis for such an approach.

Even if UNE loops were priced under the pro-ILEC embedded cost standard – in direct contravention of the *Local Competition Order* – there still would be no justification for paying the ILEC a different, and higher, support amount than the CETC. Once the level of per-line support for a market is established, the only competitively neutral, nondiscriminatory and non-arbitrary approach is to pay all ETCs the same amount of support, regardless of whether they are incumbents or new entrants, and regardless of whether they use UNEs to provide supported services.

VII. RATHER THAN ELIMINATING OR SELECTIVELY REDUCING HIGH COST SUPPORT TO ETCs, USF SIZE SHOULD BE ADDRESSED BY IMPLEMENTING SIX RECOMMENDATIONS.

Indisputably, high cost support is skyrocketing. This rampant growth in the High Cost Fund is not, however, a reason to retreat from an approach that uses competition to achieve universal service goals to the maximum extent possible. Indeed, growth in the High Cost Fund makes it all the more important to reform the current high cost support mechanisms to eliminate ILEC revenue guarantees and double support. To curb the potential for future excessive fund growth, however, the Joint Board and the Commission must also better define the goals of the high cost support mechanisms, including whether support should be provided for one connection to a subscriber or multiple connections,

and the procedure for determining “affordable” and “reasonably comparable” rates. High Cost Fund reform along the lines suggested by GCI will ensure that high cost support is targeted where it is truly necessary, and not provided where it is not necessary.

USAC data show that much of the increase in the High Cost Fund to date is attributable to increases in explicit support paid to ILECs. For example, in the First Quarter of 2001, rate-of-return ILECs received almost \$408 million in High Cost Fund support (for an annualized High Cost Fund size of \$1.63 billion). By the Second Quarter of 2003, rate-of-return ILECs are projected to receive \$550 million (for an annualized High Cost Fund size of \$2.2 billion).¹¹⁵ Although some of this annualized \$600 million increase is due to the Commission’s transfer of implicit support formerly embedded in interstate access charges to the High Cost Fund (approximately \$380 million),¹¹⁶ the remainder is due to increases in the support paid to ILECs under other high cost support mechanisms, particularly as a result of the implementation of the *Rural Task Force Order*.

¹¹⁵ Compiled from data submitted to the Federal Communications Commission by USAC.

¹¹⁶ The Commission created two new funds to make these subsidies explicit. Price cap carriers draw support from the Interstate Access Support Fund, which is capped at \$650 million. This funding will be available to price cap carriers through 2003. *See In the Matter of Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low-Volume Long Distance Users; Federal-State Joint Board on Universal Service*, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962 (2002), *aff’d in part, rev’d in part, and remanded in part, Texas Office of Public Utilities Counsel v. FCC*, 265 F.3d 313 (5th Cir. 2001), *cert. denied, Nat’l Ass’n of State Util. Consumer Advocates v. FCC*, 122 S. Ct. 1537 (2002). Rate-of-return carriers draw support from the Interstate Common Line Support Fund, and the projected demand for 2003 is \$383 million. *See MAG Order*, 16 FCC Rcd at 19668-90 (¶¶ 128-178).

While ILECs have received a large share of the High Cost Fund growth over the past two years, it is also apparent that wireless CETCs are substantially increasing the amount of support drawn from the Fund. Support for wireless CETCs has grown one hundred fold since First Quarter of 2001, when wireless CETCs received approximately \$364,000 in high cost support (for an annualized level of \$1.4 million). As of the Second Quarter of 2003, wireless CETCs were projected to receive over \$36 million per quarter (\$144 million per year) in high cost support. While some of the service provided by wireless CETCs is primary line service to households in areas unserved or underserved by ILECs or provided to customers that have “cut the cord” and abandoned wireline service, the vast majority of wireless CETC subscribers likely retain their wireline service. For most wireless CETC subscribers, wireline service and wireless service are complements, not substitutes.

In contrast with both ILECs and wireless CETCs, wireline CETCs continue to receive only a tiny fraction of high cost support. Wireline CETCs, like GCI, will receive approximately \$350,000 in high cost support in Second Quarter 2003 – or about five one-hundredths of a percent (.05%) of the total High Cost Fund.

These numbers make it clear that high cost support must be better targeted to achieve the 1996 Act’s universal service goals. GCI therefore respectfully makes six recommendations to the Joint Board for ways to better target high cost support to those areas that truly need it.

- A. Recommendation No. 1: Eliminate Duplicate High Cost Support Payments to ILECs When a CETC Serves the End User Through a Method Other Than Resale.**
Recommendation No. 2: Cap Per-Line High Cost Support Within a Study Area Upon CETC Entry.

As discussed in Section V, *supra*, the current high cost support mechanisms contain inappropriate ILEC revenue guarantees, cause the High Cost Fund to increase in size, pervert the efficient operation of competitive markets, create double payments for ILECs when CETCs win customers, and provide unearned windfalls to CETCs. The best solution is to: (1) provide support to all ETCs, including ILECs, on a per-line basis; and (2) cap per-line support upon CETC entry at the ILEC's then-effective per-line support, (and subsequently increase that support, if at all, only by the inflation rate). Implementing these two recommendations would restore a sound and principled economic foundation to the high cost support mechanisms.

- B. Recommendation No. 3: Reduce Per-Line High Cost Support When a Market Can Be Served at a Lower Cost.**

Once Recommendations Nos. 1 and 2 are undertaken, the market can better determine whether the existing level of high cost support is truly the minimum amount necessary for the most efficient carrier in the market to provide supported services at affordable and reasonably comparable rates (and therefore in accordance with Principle No. 1) or whether the support being provided is excessive (in violation of Principle No. 1). The Joint Board and Commission should reduce high cost support in those areas where it can be reduced without jeopardizing the goal of affordable and reasonably

comparable rates.¹¹⁷ Better targeting will ensure that there is greater capacity to provide support to the areas that truly need it.

Because support levels initialized from revenue requirements determined under rate-of-return regulation have likely been inflated by years of inadequate efficiency incentives, support could be reduced to adequate (but not excessive) levels in several different ways:

Base high cost support on the costs of the most efficient LEC. This approach would move HCLS, LSS, LTS and ICLS to a “most efficient LEC” standard, similar to the standard used to calculate high cost support for the intrastate loop costs of non-rural ILECs. Though the Commission accepted the Rural Task Force’s recommendation to base HCLS for rate-of-return ILECs on embedded cost, this was an interim decision, not a permanent solution.¹¹⁸ Moreover, use of the most efficient LEC standard, calculated and distributed on a per-line basis, would break the link between support provided under HCLS, LSS, LTS and ICLS and ILEC embedded costs, thereby ending the upward-spiral of support that distorts market signals to ILECs and CETCs under the current mechanisms.

Step down per line subsidies upon CETC entry. The efficient LEC standard could be reached over a period of time by stepping down per-line subsidies upon CETC entry. High cost support – provided per line, per month for areas served by rural, rate-of-

¹¹⁷ It will also be necessary to better define the upper limit of “affordable” and “reasonably comparable” rates, *see* Recommendation No. 6, *infra*, so that policymakers can determine when support has been reduced sufficiently.

¹¹⁸ *See Rural Task Force Order*, 16 FCC Rcd at 11256 (¶ 25) (“In light of the diversity among rural carriers, and based on our experience in developing the forward-looking high-cost support mechanism for non-rural carriers, we find that five years is a

return ILECs (and ICLS and LTS for areas served by non-rural carriers) – could be stepped down by a pre-determined amount annually (*e.g.*, 50 cents per year) until the rates reached the upper end of those that would be considered affordable and reasonably comparable. All ETCs, especially those that are inefficient (or less efficient), would be subject to market discipline in the face of declining support, and all ETCs would be challenged to find more efficient ways to provide service. Consistent with Principle No. 1, high cost support would not be reduced beyond the point that rates would become unaffordable or not reasonably comparable: in other words, support would always remain sufficient.

Stepping down high cost support per line, per month would also have the salutary effect of encouraging state commissions to complete their own intrastate rate reforms more quickly. If a state commission would fail to complete necessary intrastate reform, it would face the prospect of losing, at least temporarily, interstate high cost support per line once intrastate rate reforms were complete. With respect to HCLS, LSS, LTS, and ICLS, this would meet the 10th Circuit’s request for “carrots and sticks” to encourage the state commissions to complete intrastate universal service reform.¹¹⁹

To implement either or both of the steps described above, an ETC should also be able to petition the Commission to reduce per-line high cost support if the ETC can serve the market at “affordable” and “reasonably comparable” rates with less support than its competitors. Such a process would allow a carrier such as GCI to reduce the support available to all ETCs in that market if the carrier believes that it can better withstand a

reasonable amount of time to maintain the Rural Task Force plan in place, while we consider long-term solutions.”)

¹¹⁹ See *Qwest*, 258 F.3d at 1204.

drop in high cost support than its competitors. This would, to some extent, emulate an auction process. Again, this would help reduce high cost support to the minimum level necessary to ensure that the most efficient provider can offer the supported universal services at affordable and reasonably comparable rates.

C. Recommendation No. 4: Limit High Cost Support to a Single Line to a Home or Business.

The Joint Board appropriately seeks comment on whether the Commission should alter its rules,¹²⁰ which now permit ETCs to recover high cost support for all eligible residential and business connections, rather than for a single line to a residence or business, as the Joint Board recommended in 1996 but the Commission declined to adopt.¹²¹ GCI, however, believes the Joint Board's *1996 Recommended Decision* was both correct and prescient: limiting high cost support to a single residential connection would limit such support to a manageable task – ensuring that every household and business has basic telephone service, without subsidizing one or more connections to every man, woman and child. As the Commission has recognized, in crafting universal service policies and programs, it must strike a fair and reasonable balance among the goals and principles of the 1996 Act, and consider both the adequacy of support and the burden on contributors.¹²²

¹²⁰ See *Public Notice* at ¶ 26.

¹²¹ See *Universal Service First Report & Order*, 12 FCC Rcd at 8828-8830 (¶¶ 94-96).

¹²² See *Rural Task Force Order* at 11244, 11258, citing *Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393, 412 (5th Cir. 1999) (“*TOPUC I*”) and *Alenco*, 201 F.3d at 620.

The Joint Board concluded in 1996 that the objective of Section 254 was to support one connection per household or business, a conclusion that remains sound today. Multiple connections are not “essential to education, public health, or public safety.”¹²³ As the Joint Board recognized in 1996, “support for a single residential connection will permit a household complete access to telecommunications and information services,” and “[a]ll supported services, including access to emergency services, would be available to a household by providing support for this residential connection.”¹²⁴ The Joint Board contrasted support for the first line with support for additional residential lines, stating, “[s]upport for a second connection is not necessary for a household to have the required ‘access’ to telecommunications and information services.”¹²⁵ If universal access to the Public Switched Telephone Network is the goal, that goal is fully served by supporting one connection at each residence and business.

Second, there is no evidence that subsidies are required to provide multiple connections at affordable rates, or that the provision of multiple lines is necessary to ensure reasonably comparable service between rural and urban areas. The vast majority of multiple connections provided today – the overwhelming bulk of the 148 million CMRS handsets – are not subsidized. The FCC’s most recent CMRS Competition Report

¹²³ See 47 U.S.C. § 254(c)(1)(A) (requiring the Joint Board and the Commission to “consider the extent to which . . . telecommunications services” included in the definition of universal service “are essential to education, public health, or public safety”).

¹²⁴ *Federal-State Joint Board on Universal Service*, Recommended Decision, 12 FCC Rcd 87, 132 (¶ 89) (1996) (“1996 Recommended Decision”).

¹²⁵ *Id.* at 132-133 (¶ 89).

show that CMRS is available virtually everywhere.¹²⁶ Indeed, many rural areas not only have service, but also already have competition, as rural areas are already served by an average of over three wireless carriers.¹²⁷ Moreover, studies have shown little if any difference in pricing between rural and urban markets.¹²⁸ As the Joint Board noted in its *1996 Recommended Decision*, there is a presumption that consumers who subscribe to second lines “can afford to pay rates that accurately reflect the carrier’s costs.”¹²⁹ Experience in the wireless industry appears to have borne out this presumption.

Third, administrative difficulties in designating the single residential connection eligible for high cost support should not present an obstacle for limiting the size of the USF.¹³⁰ GCI believes that the means to implement this proposal in a competitively neutral manner will be identified through industry collaboration.

D. Recommendation No. 5: Consolidate Study Areas Within a State for High Cost Support Purposes.

The Joint Board and Commission should also take steps to reduce the subsidy gamesmanship that plagues the current mechanisms. The historical organization of rural, rate-of-return ILECs, for example, places artificial pressure on the USF. ACS’ organization provides a perfect example of how an ILEC can “game” the Commission’s

¹²⁶ See *Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services*, 17 FCC Rcd 12985, 13111-13 (App. E, Maps 1-3) (2002) (“*Seventh Annual CMRS Report*”).

¹²⁷ See *id.* at 13024. More urban areas have an average of five wireless carriers. See *id.*

¹²⁸ *Id.* at 13023 (citing, for example, an Econ One study finding “that there was virtually no difference in the average monthly charge for wireless service between the [urban and rural wireless service]”).

¹²⁹ *1996 Recommended Decision*, 12 FCC Rcd at 133 (¶ 90).

¹³⁰ See *Public Notice* at ¶ 20.

universal service policies to generate additional high cost support for itself, over and above the level required to provide supported services at affordable and reasonably comparable rates. This type of gaming inflates the USF, and should no longer be tolerated by the Joint Board and the Commission.

ACS was formed through the acquisition of several independent ILECs in Alaska, including the ILECs serving the state's three largest markets: Anchorage, Juneau and Fairbanks.¹³¹ Upon acquiring each exchange, ACS sought a waiver from the Commission allowing it to calculate its high cost support on the basis of these historical study areas, rather than ACS' combined territory throughout Alaska. ACS' high cost support is therefore not determined based on its average cost to serve all of its Alaska customers, including customers in Anchorage, a lower-cost "non-rural" study area. Instead, ACS' high cost support is calculated based on the average cost to serve each of its five, historically independent study areas. Under the Commission's waiver, ACS also meets the definition of a "rural telephone company" under the 1996 Act in Fairbanks and Juneau, Alaska's second and third largest cities, respectively.¹³² If ACS' Alaska study areas were consolidated, however, ACS would not be a rural telephone company in these relatively large urban markets.

In the absence of study area consolidation, ACS receives more high cost support than necessary. If, for example, ACS consolidated all of its study areas, it would be a non-rural ILEC, serving over 330,000 access lines – the fourth largest rate-of-return

¹³¹ See n.36, *supra*.

¹³² 47 U.S.C. § 153(37).

carrier in the nation. Under such an arrangement, ACS would be phasing out its HCLS and would receive no LSS. ACS thus uses the historical accident of multiple study areas to obtain greater federal USF support than it would otherwise, even when such support may not be necessary to keep its rates affordable and reasonably comparable using rates in other urban areas across the country.

A particularly egregious example is the calculation of ACS' high cost support for the study areas served from ACS' Fairbanks switch. As previously discussed, ACS has deployed a class 5 switch in the Fairbanks study area, which it uses (or has proposed to use) to serve three additional exchanges (Fort Wainwright, Eielson Air Force Base and North Pole) with remote switches that subtend from the ACS-F switch. Because these exchanges are in three separate study areas for the purpose of calculating ACS' federal high cost support¹³³ and because each study area is comprised of fewer than 50,000 lines, ACS receives LSS in each study area. ACS receives this support despite the fact that LSS itself was implemented to offset the "diseconomies" of scale facing small ILECs, while ACS' network was designed to overcome these very diseconomies by operating three parts of three study areas as a single network. Were these Fairbanks area exchanges combined into a single study area corresponding with ACS' network architecture, ACS' Fairbanks operations would no longer qualify for LSS. In other words, ACS has been able to generate a USF windfall by maintaining historical ILEC boundaries for universal service that do not reflect its network architecture.

¹³³ See text accompanying n.36, *supra*.

These types of regulatory games do not promote universal service. This support could be better targeted to areas that truly need it. Study area consolidation would do that.

E. Recommendation No. 6: Define the Upper Limit of “Affordable” and “Reasonably Comparable” Rates.

One singular flaw of the Commission’s high cost support mechanisms has been the failure to define with any specificity the regulatory outputs that these mechanisms seek to achieve. Although rates are supposed to be “affordable” and “reasonably comparable,” there has not yet been a serious examination of the rates (as opposed to costs) that would violate either affordability or reasonable comparability, especially with respect to the rural, rate-of-return high cost support mechanisms. The Joint Board and the Commission must better define these objectives. Without a more specific definition, it is impossible to tell whether support is inadequate, adequate or excessive.

1. Neither the Commission nor the Joint Board has ever adequately defined the term “affordable.”

The Commission is required to base its universal service program on all the principles in Section 254(b).¹³⁴ Thus, among other requirements, “[q]uality services should be available at just, reasonable and *affordable* rates.”¹³⁵ The Commission has developed a two-pronged definition of affordability, stating that it includes “an absolute component (‘to have the means for’) and “a relative component (‘to bear the cost of without serious detriment’).”¹³⁶ This vague “definition,” however, bears a striking

¹³⁴ *Qwest*, 258 F.3d at 1200.

¹³⁵ 47 U.S.C. § 254(b)(1) (emphasis added).

¹³⁶ *Universal Service First Report & Order*, 12 FCC Rcd at 8837-8838 (¶ 110).

resemblance to the formulation of “reasonably comparable” rejected by the Tenth Circuit Court of Appeals as legally inadequate.¹³⁷ More importantly, the Commission’s failure to adequately define “affordability” means that it lacks a principled basis to determine whether USF in fact provides support that is “sufficient” to ensure that universal service is “affordable.” By its plain meaning, the term “sufficient” can only be defined with respect to its goal – answering the question “sufficient to do what?” To answer this question, the Commission must have a more definite concept of “affordable” than is provided in the Commission’s present formulation.

Without a specific and concrete definition of “affordable,” the Commission has no means to determine the amount of high cost support necessary, or even *whether* high cost support is necessary in a given area. Indeed, without any consideration of whether retail rates are affordable, USF likely provides high cost support where it is not needed. As discussed above, for example, ACS’ Anchorage, Fairbanks and Juneau study areas each now receive high cost support, but would not if these study areas were consolidated. Without a clear and specific definition of “affordable” rates, however, it is impossible to target high cost support to those areas that really need it, such as the Alaska Bush, and away from those areas that might not, such as Anchorage, Fairbanks and Juneau.

Moreover, failure to establish a clear definition of affordability also potentially violates Section 254(f), which precludes a state from “rely[ing] on or burden[ing] Federal universal service support mechanisms.”¹³⁸ Intrastate retail rates below those necessary to be affordable and reasonably comparable violate Section 254(f) by needlessly increasing

¹³⁷ See *Qwest*, 258 F.3d at 1202.

¹³⁸ 47 U.S.C. § 254(f).

the support drawn from USF – thereby “burdening” the federal high cost support mechanisms. As the Tenth Circuit pointed out with respect to the non-rural intrastate high cost loop support mechanism, the Commission is not permitted simply to rely on state commissions’ historic rate-making decisions to assure that rates are “affordable.”¹³⁹ To the contrary, the Commission, with guidance from the Joint Board, should develop a more precise definition of “affordable,” and the setting of rates within this range should be a prerequisite to receiving universal high cost support.

2. The Joint Board should also establish a specific definition of “reasonably comparable” rates to guide implementation of HCLS, LSS, LTS and ICLS.

GCI also encourages the Joint Board to develop a specific definition of “reasonably comparable” rates to guide its implementation of HCLS, LSS, LTS and ICLS. The Joint Board should not merely adopt a benchmark equal to 135 percent of nationwide average costs, as proposed in its Recommended Decision responding to the Tenth Circuit’s remand of the Commission’s *Ninth Report & Order*.¹⁴⁰

This benchmark, even as supplemented by the proposed process under which state commissions would certify that intrastate rates are “reasonably comparable,” suffers the same shortcomings as the Commission’s current approach to ensuring “affordable” rates under Section 254(b): there is no objective way to determine whether high cost support is too little or too much. Indeed, if USF is used to keep intrastate rates below “reasonably comparable” levels, then the support is likely excessive (therefore violating Principle No. 1), and the carrier’s intrastate rates likely burden the federal high cost support

¹³⁹ See *Qwest*, 258 F.3d at 1204.

¹⁴⁰ *Ninth Report & Order Joint Board Recommended Decision*, 14 FCC Rcd (¶ 53).

mechanisms. Notably, the certification process called for by the *Recommended Decision* does not cure this problem, but merely provides a mechanism for increasing support that is not deemed to be sufficient, rather than reducing support that is excessive.

This is a backwards approach to determining high cost support – one that needlessly increases the size of USF. Reasonable comparability (and affordability) should be determined by first assessing the retail rate for supported services, not the cost to provide these services. If the retail rate falls within a range of rates that are reasonably comparable (and affordable), but does not recover the ILEC’s cost to provide the service, the retail rate should be raised to the maximum extent possible within that range *before* high cost support is made available. The 135 percent benchmark and the certification process do not contemplate the possibility of ILEC-initiated efforts to reduce reliance on high cost support. Such an approach should be fully considered before even contemplating funding so-called “rate-rebalancing” through USF, as has been recently suggested.

The Joint Board and the Commission cannot hope to successfully implement Section 254 without clear, objective and defensible articulations of which rates are affordable and reasonably comparable, and which rates are not. If the Joint Board and the Commission retreat once again behind meaningless verbal formulations, they will have failed to define the objective that regulation is supposed to serve. Without such a clear objective, universal service policies are doomed to continue to be *ad hoc*, lacking in a coherent policy framework, and ultimately, they will fail.

VIII. CONCLUSION

For the foregoing reasons, GCI respectfully asks the Joint Board to adopt the recommendations outlined herein. These proposals, founded on an Alaska success story, provide a blueprint for achieving the dual goals of the 1996 Act – competition and universal service – on a national basis.

Respectfully submitted,

By: _____ /s/

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May 5, 2003

EXHIBIT A

3. Pursuant to the terms of an Interconnection Agreement with ACS of Fairbanks, Inc. (ACS-F), GCI pays ACS-F a rate of \$19.19 per month for an unbundled loop. This rate was established through “last best offer” arbitration and then approved by the Regulatory Commission of Alaska. In its last best offer on UNE loops, ACS-F offered a single, averaged UNE loop rate for the entire ACS-F service area; ACS-F did not propose a deaveraged UNE loop rate. ACS-F had the opportunity to challenge each input in the cost model being used, but only challenged a few inputs. ACS did not challenge the inputs for the costs of burying cable or the fiber and copper cable for feeder and distribution.

4. GCI and ACS-F are currently negotiating a new interconnection agreement. In that negotiation, ACS-F has indicated that it intends to propose to deaverage its rates for UNE loops into zones.

5. The UNE loop rate that GCI pays provides GCI with access to ACS-F copper loops at ACS-F’s various switch and remote switches in the service area. In order to utilize the loops obtained at those various locations, GCI must collocate equipment at the ACS-F switch or remote switch, including digital loop carriers, fiber terminals, DSX cross connects, cable and ducts, multiplexing equipment, and more. GCI has invested over \$2,000,000 in such equipment and will invest additional amounts at other ACS-F remote switches.

6. The equipment that GCI has collocated at the ACS-F switch and remote switch is generally comparable to digital loop carriers and line concentrators that are used by incumbent local exchange carriers. When ILECs deploy such equipment, the cost is included in the calculation of the “embedded loop cost” for purposes of determining eligibility for federal universal service high cost loop support. Space and power costs for these facilities also qualify as ILEC loop costs and would have to be included in CETC loop cost calculations.

7. In addition to costs associated with collocation, GCI must also then transport the loop signals from the ACS-F switch or remote back to GCI's switch in Fairbanks. This requires additional investment or lease of facilities from ACS-F. These costs, when incurred for transport from digital loop carriers and line concentrators, also qualify as ILEC loop costs and would have to be included in CETC loop cost calculations.

8. GCI, just like ACS, has substantial overhead costs that are, in part, attributable to loop costs. For an ILEC such as ACS, Part 36 of the Commission's rules provides that overhead costs are allocated in proportion to investment in loops. That may be a reasonable allocation methodology for traditional ILECs, which generally incurred all investments costs of a local exchange system. However, such a methodology is not reasonable for a CLEC that leases large quantities of unbundled loops. The overhead costs are still there, and they are still partially attributable to loop costs, but they are not attributable to investment, so a different allocation methodology would have to be developed for CLECs that lease UNE loops.

9. I have not attempted to inventory herein all costs of loops that GCI incurs in addition to the ACS charge for an unbundled loop. I have not included, for example, the costs of the customer relations and operational problems created by ACS' chronically slow and discriminatory handling of GCI orders for unbundled loops.

10. Based on all of the above factors but not including the costs discussed in Paragraph 9, I estimate that at current market share levels, GCI has loop costs of approximately \$12.82 per month, and likely more, in addition to the \$19.19 UNE loop rate paid to ACS-F.¹ The vast

¹ In a previous declaration, I had estimated GCI's additional loop costs as at least \$9.37 per loop more than the ACS unbundled loop rate. That estimate had used ACS' tariffed transport rates to estimate GCI's costs. The estimate herein, however, better accounts for the sunk capital expenditures of the transport facilities GCI is actually using, which are its own Metropolitan Area Network.

majority of these costs are sunk expenditures for collocation, switch procurement and deployment and fiber transport facilities from GCI's collocation site to its switch. Thus, even at the low end, GCI's average loop costs in Fairbanks are no lower than \$32.01 per month.

Executed on May 5, 2003 by:


Frederick W. Hitz, III

EXHIBIT B



Introduction

ACS of Fairbanks, Inc. ("ACS-F") has selected a Path 3 self-certifying plan for disaggregating and targeting Universal Service Funds ("USF"), including Interstate Common Line Support ("ICLS"), pursuant to 47 C.F.R. § 54.315 (d) ("§ 54.315 (d)") and FCC Order 01-304, issued November 8, 2001 ("the ICLS Order").

ACS-F certifies that this Path 3 disaggregation plan (the "Plan") disaggregates support for the Fairbanks study area into no more than two cost zones per wire center, as required by § 54.315 (d)(1)(ii). The Plan designates only two cost zones. As a self-certifying Path 3 plan, the Plan becomes effective as of its filing date with the RCA--May 14, 2002.

As the Fairbanks study area is already subject to competition from a competitive eligible telecommunications carrier ("CETC"), ACS-F selected Path 3 in order to disaggregate and target the USF support, therefore avoiding the regulatory approval delay inherent in a Path 2 filing. ACS-F recognizes the intended duration of its Plan is four years, but notes that other circumstances arising in its competitive market, such as UNE de-averaging, make it likely that ACS-F will need to petition the Commission for a plan modification, as allowed under § 54.315 (d) (5).

This narrative provides a description of ACS-F's Plan and discusses the Plan's compliance with the FCC requirements in § 54.315 (d) and the ICLS Order. The Plan has been filed with the Regulatory Commission of Alaska ("RCA" or "Commission"), with copies sent to the Universal Service Administrative Company ("USAC") and the National Exchange Carriers Association ("NECA"). ACS-F's submission includes both printed and electronic (CD-ROM) filings of the Plan. The electronic filing also contains maps illustrating the ACS-F two cost zone areas.

A. General Plan Description

The Plan disaggregates and targets support into two cost zones covering the entire area within the Fairbanks study area boundaries. The cost zones are based primarily upon customer density per square mile. The two cost zones used in the Plan are derived from the modified High Cost Proxy Model for Fairbanks ("modified Model"), previously approved by the Commission for the Fairbanks area in Docket No. U-99-141 ("the Fairbanks UNE Proceeding"). See Exhibit 1. Similarly, the model input data used in the modified Model, including line counts UNE costs and embedded costs, are data utilized

in the Fairbanks UNE Proceeding.¹ The modified Model identifies nine customer density zones, approximates the number of lines in each of those zones and the corresponding cost to serve those zones, which ACS-F then uses to identify the more expensive loops and appropriately target greater USF support to those loops. In general terms, Cost Zone #1 comprises high-density areas, while Cost Zone #2 comprises low-density areas. On a study area basis, Cost Zone #1 will receive total USF support under this plan of \$7.62 per line, while Cost Zone #2 on a per-line basis will receive \$15.10.

The following table shows the USF support break down in the Plan's two cost zones:

Table II, Exhibit 2.

Zone	USF Embedded Lines	Lines Adjusted for CBG	Per line, HCL	Per line, LTS	per line, LSS	per line, ICLS	Total per Line	Total Monthly USF Support
	(r)	(s)	(t)=(m)/(s)	(u)=(n)/(s)	(v)=(J)/(B)	(w)=(p)/(s)	(x)=sum(t...w)	(y)=(s)*(v)
Zone 1	16,802	17,933	\$2.76	\$0.95	\$2.81	\$1.10	\$7.62	\$133,497.69
Zone 2	27,392	26,261	\$7.04	\$2.44	\$2.81	\$2.82	\$15.11	\$399,772.71
	44,194	44,194						\$533,270.41

The Plan's complete disaggregation and targeting tables are set forth in Exhibit 2.²

B. Rationale

Disaggregating and Targeting Support:

Once service cost differences are identified, then greater USF support can be applied to offset those services with the higher costs. Applying more support where the costs are highest is a fair matching of operational expenses with the USF subsidies. This approach is neutral and non-discriminatory toward any communication technology selections, and is neutral toward any class of service or competitive market segments among customers.

Customer Density Zones:

Customer density is used because of its acceptance as a general cost relationship identifier. Generally, a service (a telephone circuit, or loop) has a lower cost if it serves a

¹ In using the modified Model for the Plan, ACS-F does not waive any objections, arguments, issues or appeals it has regarding the Commission's use of this model and the related data in the Fairbanks UNE Proceedings.

² For CD-ROM users: click the hyperlink underlined below to see the details of the disaggregation calculations by cost zone:

[Fairbanks Disaggregation.xls](#)

customer-dense area. If customers are few, a loop has a higher cost. This is basic ‘cost-spreading--where the service costs are spread among several customers, usually the cost per customer is a smaller amount than if the same cost is spread among fewer people. As a basic example, if the total services cost is \$100,000 and is spread across 10,000 customers, then the cost to any one customer averages \$10.00. If the same \$100,000 services cost is shared by only 3,000 customers, then each of those customer must shoulder \$33.33 dollars for the same services.

The density zone approach also upholds the policy goals behind the targeting of USF, as espoused by the FCC in both § 54.313 and the ICLS Order. It captures the cost differentials that vary due to physical loop characteristics (e.g. loop length) and numbers of customers served by a loop. This is important for several reasons. First, cost accounting “matching principles” require that expenses be matched with potential revenues in an appropriate accounting time period: the density zone approach identifies both cost differentials and rate revenue relationships, resulting in a proper matching of varying expenses and rate zones. Second, customer density zone rates, as calculated by the modified Model mentioned above, determine clear and quantifiable zone differences throughout a study area. The cost differences are therefore clearly and easily identified, resulting in a practical and functional administration of the USF allocation between cost zone #1 and cost zone #2. Third, the cost differential between zones is a proper basis for correctly emphasizing and applying more USF support for rural High Cost Loops, Long Term Support, and Interstate Common Line Support.

C. Methods and Data

Support Amounts:

Utilizing the RCA-approved modified Model, ACS-F’s Plan applies the most recent Second Quarter 2002 USF support level estimates from USAC for Fairbanks (See Exhibits 3 and 4), and the customer location density data from the Fairbanks UNE proceeding to determine cost differences and zone differences. The total forecasted USF support that ACS-F will receive is applied to the modified Model to determine a per-line level of support to disaggregate within the Fairbanks study area.

Model Outputs:

The output results of the modified Model are categorized into nine rate and density categories. Looking to those nine categories, Cost Zone #1 is comprised of the highest three density zones: 2550-5000 lines per square mile, 5000-10,000 lines per square mile and greater than 10,000 lines per square mile, as customized for Alaska. The remaining 6 lower density zones define Cost Zone #2.

The modified model established relative cost zone differences with the following line counts and UNE rates by density category:

Density	HCPM Physical Line Counts	UNE Rate	Conversion to USF Embedded Line Count	Conversion to USF Embedded Loop	USF Support per Line	Zone % of Total USF Lines
0-5	33	\$177.40	32	\$309.79	\$15.11	Zone 2 (62%)
5-100	2,962	\$51.85	2,874	\$90.54	\$15.11	
100-200	2,425	\$35.68	2,353	\$62.31	\$15.11	
200-650	5,723	\$21.84	5,554	\$38.14	\$15.11	
650-850	5,069	\$16.89	4,919	\$29.49	\$15.11	
850-2550	12,015	\$15.64	11,659	\$27.31	\$15.11	Zone 1 (38%)
2550-5,000	7,332	\$11.64	7,115	\$20.33	\$7.62	
5,000-10,000	6,923	\$9.37	6,718	\$16.36	\$7.62	
>10,000	3,060	\$7.22	2,969	\$12.61	\$7.62	
Total/Wtd. Avg.	45,542	\$19.19	44,194	\$33.51		

As shown by the table above, proposed Cost Zone #1 combines those modified Model density categories with the most customers per square mile, and the lowest rate per loop. From the modified Model, a line-count weighted average basis shows that Cost Zone #2 contains 27,392 lines of the total 44,194 USF lines, or 62% of the study area lines. Cost Zone #1 contains 16,802 of the total 44,194 USF lines, or 38% of the study area lines. These relative percentages, based upon USF lines, determine the weighting and boundary differences between zones.

As shown in Exhibit 2, the UNE rates listed above are used first to establish relative cost differentials, based upon real-world customer locations and density zones in relation to wire centers or interconnection points in Fairbanks, then they are adjusted to an equivalent USF Embedded Loop cost per line.

The Plan's level of support for each category of high-cost universal service support on a per line basis is shown below, and in Exhibit 2.

Zone Class	USF Embedded Lines	Lines Adjusted for CBG	per line, HCL	per line, LTS	per line, LSS	per line, ICLS	Total per Line	Total Monthly USF Support
	(r)	(s)	(t)=(m)/(s)	(u)=(n)/(s)	(v)=(J)/(B)	(w)=(p)/(s)	(x)=sum(t...w)	(y)=(s)*(x)
Zone 1	16,802	17,933	\$2.76	\$0.95	\$2.81	\$1.10	\$7.62	\$133,497.69
Zone 2	27,392	26,261	\$7.04	\$2.44	\$2.81	\$2.82	\$15.11	\$399,772.71
	44,194	44,194						\$533,270.41

Support Ratios:

The ratio of support between disaggregation zones on a study area basis, as shown in Exhibit 2, is as follows: Cost Zone #1 will receive support under this plan of \$7.62 per

line, while Cost Zone #2 will receive support under this plan of \$15.11 per line. Dividing 15.11 / 7.62 yields the ratio of support between disaggregation zones of 1.98: 1. Thus, Cost Zone #2 receives 1.98 more dollars for every 1.0 dollar received in Cost Zone #1.

Local Switching Support (“LSS”) Disaggregation:

LLS is disaggregated differently than the other USF subsidies. ACS-F did not apply LLS any differently between the two zones. Because the LSS costs do not vary with either loop distance or density, this support was applied equally among all customers in both Cost Zones #1 and #2.

This is allowed pursuant to the ICLS Order, paragraph 145. It provides:

On the other hand, a carrier’s local switching cost characteristics may differ from its loop cost characteristics in different disaggregation zones. Therefore, to the extent that the cost characteristics of providing loop and switching service in disaggregation zones differ, carriers will be permitted to allocate different ratios of high-cost support between disaggregation zones for LSS than for Interstate Common Line Support, LTS, and intrastate high-cost loop support.

USF Embedded Lines v. UNE Physical Line Counts:

These two line counts differ because ACS-F reports line count data to Federal and State governmental agencies in different formats, depending upon the specific statutory requirements for each report. The purpose of showing relationships between the formats is to allow a comparison and calculation of USF support for the Fairbanks study area by using the same study area customer location data, put on an equivalent basis. It is helpful to evaluate both the physical (the actual metal copper pairs of a phone line) and loops on a Voice Grade Equivalency (a way of measuring communication capacity) in the modified Model. The benefit is that both metallic wire-based costs and communication capacity costs are recognized as ‘cost drivers’ underlying the services receiving USF support. The modified Model used customer locations in Fairbanks, which is a similar study area to the USF study area, which requires “embedded working lines” for the Fairbanks USF calculations.

The task of calculating a just and reasonable USF disaggregation and targeting plan is to apply the USF total study area support to a similar line count basis, given the different formats. The immediate benefit is to show a commonality in the methodology, and to allow an audit trail of the calculations. The difference between USF embedded working lines and UNE physical counts has been translated, so that the Plan is comparable on an “apples to apples” basis.

CBG Adjustment:

The Modified Model utilizes hypothetical serving areas called clusters. The lines are in a voice-grade equivalent format at the DS-O level. Each CBG may have multiple clusters which may reflect different loop costs. The average cost per loop in each CBG is used for the final application. The conversion from voice-equivalency to USF Embedded Line count is also necessary to determine the final rate results for Cost Zones #1 and #2.

Line Synchronization:

During the Fairbanks UNE Proceeding, the final approved loop counts used in the modified synthesis model for Fairbanks were synchronized to match the study area physical loops and DS-0 voice-grade loops reported to NECA for Fairbanks USF Support. The Fairbanks USF Loop 'per-line' count is 44,194.⁴

Other Model Information:

Further information regarding the Plan are included in this filing, including explanatory information regarding the modified Model, spreadsheets from the modified model, the output reports, and the spreadsheets on which the tables listed above are based. See Exhibit 5 (Explanation of Census Block Groups); Exhibit 6 (CBG Zone Designations); Exhibit 7 (Form M Cost Inputs); Exhibit 8 (Modified Model Arbitrated Cost Inputs);

³ Click on the underlined hyperlinks below to view the data and underlying output reports from the modified Model.

[Fairbanks Customer Locations](#)

[Dissaggregation Schedule](#)

[Loop Cost Report](#)

[HCPM "Workfile"](#)

⁴ Updated USAC web site data is available at www.universalservice.org/HC/. The specific files used are the 2nd quarter 2002 high cost support estimates, found in file "HC1_2Q02_HC BY STUDY AREA.XLS", which is a Microsoft Excel Spreadsheet. ACS of Fairbanks appears in Row 11 of that spreadsheet, NECA/SAC number 613008. The NECA web site in www.NECA.org. There is a summary spreadsheet defining the synchronization of the line counts among total study area DS-0, physical, and USF line count standards.

Exhibit 9 (Modified Model Loop Costs); Exhibit 10 (Arbitrator's Modifications to HCPM Calculations); and Exhibit 11 (Data Outputs). Additionally, all of the formulae and data are open for viewing and auditing in the enclosed CD-ROM.⁵

CD-ROM Use:

The files are viewable directly using Microsoft Windows® Explorer or My-Computer functions. Simply click on the PC drive letter that describes your CD-ROM drive, and then the files will open for viewing, printing and auditing. ACS-F has obtained software permissions/licenses for the Windows formatted distribution of the work papers, as well as limited distribution of the Autodesk® graphic files, viewable by installing the VoloView Express® software enclosed on the CD-ROM. Use of this software is for viewing this filing for Federal and State regulatory compliance purposes.

⁵ Click on the underlined hyperlinks below to view the data and underlying output reports from the HCPM modified synthesis model.

Fairbanks Customer Locations

Dissaggregation Schedule

Loop Cost Report

HCPM "Workfile"