

**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
)	
High-Cost Universal Service Support)	WC Docket No. 05-337

Reply Comments

The AdHoc Telecommunications Users Committee (“AdHoc”) hereby submits its Reply Comments in the above-captioned proceedings in response to comments filed by parties on March 27, 2006.¹

A. Introduction and Summary

The comments of other parties reveal no consensus on how the Commission should alter the methodology that it uses to determine high-cost universal service subsidies for non-rural carriers in response to the Court of Appeals decision.² Unlike some parties, AdHoc submits that the Commission has already correctly specified the non-rural carrier high cost subsidy mechanism – at least for the time being – and should focus on addressing the far greater problem of RLEC high cost support. Action in some long open proceedings and issuance of a Further Notice of Proposed Rulemaking to consider use of reverse auctions to award high cost subsidies should be high on the Commission’s list of priorities.

¹ Federal-State Joint Board on Universal Service, Notice of Proposed Rulemaking, FCC 05-205 (rel. Dec. 9, 2005) (“NPRM”).

² Qwest Communications Int’l, Inc. v. FCC, 398 F.3d 1222 (10th Cir. 2005) (“Qwest II”).

To satisfy the Court of Appeals, the Commission should use data supplied by NASUCA and Verizon to prove that its Universal Service program has established rate comparability. Data provided herein and in the comments of AT&T and Verizon also demonstrate that telecommunications service is affordable in this country. The Commission should remind the Court that the agency has been concerned about “affordability” from the inception of the program adopted to implement section 254 of the Communications Act.³ The Commission should also explain that its periodic review of the deployment and use of advanced services and its low income outreach concerns assure that the Commission’s Universal Service program will be adjusted to further statutory goals. The current program may, in fact, go further than necessary to advance the Universal Service goals specified in section 254 of the Communications Act.

B. The Commission Should Act In Existing Proceedings To Limit Growth In High-Cost Subsidies

AdHoc cannot allow this proceeding to pass without pleading for the Commission to begin soon a process to change fundamentally the rural high cost subsidy mechanism. The current mechanism is broken. Although parties likely differ on the nature of the changes needed, AdHoc is not alone in calling for overhaul of the Universal Service subsidy program.⁴ AdHoc appreciates that there is a “political” overlay to the universal service problem, positions that the Commission must consider if for no other reason than that the views of elected

³ 47 U.S.C. § 254.

⁴ See, e.g., AT&T Comments at 1, CTIA Comments at 15-16, Verizon Comments at 23.

officials should be considered along with the views of other interested parties.

That said, the growth of the USF cannot continue unchecked.

There appears, however, to be no end in sight for growth of the USF, particularly the high cost portion of the fund. Verizon points out that the high cost component of the USF was \$1.718 billion in 1999, and that the same subsidy component will likely more than double to over \$4.1 billion in 2006. AdHoc also has long been concerned about growth of the high cost subsidy component of the USF. For example, in its reply comments in Elimination of Rate-of-Return Regulation of Incumbent Local Exchange Carriers, AdHoc concluded as follows,

In sum, the comments submitted on Western Wireless' petition for rulemaking support, rather than undercut, the need for the Commission (1) to get to the bottom of the rapid and large increase in RLEC USF subsidies, and (2) to initiate a long delayed rigorous look at replacing embedded costs with forward looking economic costs as the basis for RLEC high cost USF subsidies. Existing Commission rules undoubtedly have contributed to the astonishing growth in the USF. These rules have in effect encouraged profligate spending with little or no regulatory oversight, not even the oversight needed to detect possible material cost misallocations. As a steward of the public interest the Commission has a responsibility to take a fresh, hard look at its rules and enforcement mechanisms for the high cost component of the USF.⁵

Over two years later, the Commission still has taken no action on the Western Wireless petition for rulemaking, despite continued growth in the high cost subsidy component of the USF. When it adopted the Rural Task Force Order,

⁵ AdHoc Reply Comments, CC Docket No. 96-45, RM 10822, filed Feb. 13, 2004. Parties as diverse as CTIA and BellSouth support use of efficient and forward looking economic costs as the cost standard for high cost subsidies.

five years ago, the Commission stated that “[i]t would use the use the transitional period during which a modified embedded cost support mechanism is in place to develop a long-term universal service plan that better targets support to rural carriers serving the highest cost areas, while recognizing the significant distinctions among rural carriers and between rural and non-rural carriers.”⁶ Five years later, the Commission is not even close to adopting a successor to the Rural Task Force Order, and the public is still awaiting the long-term plan that “better targets support to rural carriers serving the highest cost areas.”

AdHoc also supported calls to limit high cost subsidies to “primary lines,” whether provided by wireline or wireless carriers.⁷ Even though a recommendation from the Federal-State Joint Board on Universal Service launched the “primary line” inquiry, there still has been no action, and the high cost subsidies continue to grow.

AdHoc implores the Commission to act in both of these proceedings. The USF should not be a seemingly ever-expanding vessel into which telecommunications service subscribers must pour their money without effective regulatory oversight and which results in subsidization of more than the primary connection to the telecommunication network.

C. The Commission Should Seek Comment On Using Reverse Auctions To Set High Cost Subsidies

⁶ Federal-State Joint Board on Universal Service, CC Docket No 96-45, 18 FCC Rcd 22559 (2003), citing Federal-State Joint Board on Universal Service (“Rural Task Force Order”), 16 FCC Rcd 11244, 11310-13 (2001).

⁷ AdHoc Reply Comments, Federal State Joint Board on Universal Service, CC Docket No. 96-45, filed Sep. 21, 2004.

Assuming an effective level of competition, AdHoc generally would prefer use of market mechanisms over regulatory intervention to allocate economic resources. Accordingly, AdHoc would under the appropriate circumstances support use of reverse auctions to size and allocate high cost universal service subsidies.

The current high cost subsidy mechanism for non-RLECs is more efficient than the RLEC high cost subsidy mechanism. For non-RLECs, the level of subsidy is determined by the output of the Commission's Synthesis Cost Model and reflects forward looking costs.⁸ RLEC cost subsidies, on the other hand, merely are the result of comparing claimed RLEC costs to a Commission established national benchmark.⁹ The Commission does not audit the RLECs, and as a consequence does not know whether the costs claimed by the RLECs are the result of proper cost allocations and accounting. Moreover, these costs are embedded costs and once the costs exceed the cost benchmark, an RLEC has no economic incentive to constrain growth in those costs because the RLEC receives higher subsidies as its cost increase. At least with respect to the RLECs, the current high cost subsidy system provides no incentive for a LEC to control or to reduce its costs, nor does it provide any objective information as to what the costs associated with a rural area would be if served by an efficient provider.

⁸ 47 CFR 54.301, 54.303.

⁹ 47 CFR 54.309.

In AdHoc's preliminary vision of a high cost subsidy reverse auction, once an area qualifies for high cost subsidies under the existing system, the high cost subsidies for the area would be put up for competitive bid. For a competitive bidding process to be fair, the incumbent carrier should be required to disclose relevant market characteristics. Absent disclosure of such information, competitive providers who have been certified as Eligible Telecommunications Carriers may lack the information needed to avoid distortion of the bidding process.

The provider requiring the lowest high cost subsidy to serve an area at or below a pre-specified rate and pre-specified quality of service would be the exclusive recipient of high-cost subsidies for a specified term. The length of term, the service quality standards and the rate levels could vary from area to area. This process would provide a more economically efficient outcome than the current high cost subsidy scheme because where high cost support is warranted, it would be provided at the least cost to society.

Obviously, a competitive bidding process would require detailed bidding rules. The Commission should issue a Further Notice of Proposed Rulemaking in this docket seeking comment on the wisdom of a competitive bidding process to determine recipients of high cost USF subsidies and the rules that should govern such a process.¹⁰

¹⁰ For scholarly discussions of using reverse auctions for Universal Service, see, Weller, Auctions for Universal Service Obligations, presented at the twelfth biennial conference of the

Incumbent provider interests should not militate against using reverse auctions to award high cost subsidies. The Universal Service support system envisioned in section 254 of the Communications Act exists to assure that an evolving mix of telecommunications services are available to low income subscribers and subscribers in rural areas at just, reasonable, affordable and reasonably comparable rates. Nothing in section 254 entitles incumbent local exchange carriers to continuing flows of USF high cost subsidies if the core services could be provided to subscribers at rates that satisfy the requirements of section 254 with lower high cost subsidies. If incumbent carriers lose in the bidding process, they still may retain their customers because of high quality service, customer loyalty and/or a decision to maintain rates without the USF high cost subsidy. The Commission should, however, be prepared to allow losing vendors to lose.

Some losing vendors may have won rate deregulation, and thus, should not be heard to argue for regulatory treatment as if they continue to be regulated carriers. Others still subject to rate regulation, can petition their state regulatory authorities for rate increases, if they are unable to provide service without rate increases. They of course will have to decide how to compete for business. The Commission cannot be pro-competition and ensure the survival of incumbents when competitive alternatives exist.

ITS, June 1998 and Milgrom, Procuring Universal Service: Putting Auction Theory to Work, Nobel Foundation, 1997.

The Commission should not perpetuate the existing high-cost subsidy scheme. The astonishing growth in high-cost subsidies, proves that the current system should be changed. Replacing the existing high-cost subsidy mechanism with a reverse auction would be a controversial step, but it is a step that the Commission should seriously consider by issuing the suggested Further Notice of Proposed Rulemaking.

D. The Commission Should Better Explain The Existing Non-Rural LEC High Cost Subsidy Mechanism

Turning to the specific issues raised in the NPRM, AdHoc submits that the Commission largely “got it right” in the Order on Remand. Rather than fundamentally altering its high cost non-RLEC high cost subsidy system (as some parties advocate), the Commission should use data supplied by parties to demonstrate the comparability and affordability of urban and rural rates and explain in a slightly fuller fashion how the Commission’s entire Universal Service program, albeit an ever-evolving system, furthers the goals and principles set out in section 254 of the Communications Act.

1. The Commission Should Not Measure “Affordability” As A Percentage Of Income

Contrary to the suggestions of some parties, the Commission’s Universal Service program fully serves the goal of quality service being available at affordable rates. AT&T asserts that, “There is no empirical evidence whatsoever that any of the Commission’s existing universal service mechanisms produce

affordable rates.”¹¹ Accordingly, AT&T argues that the Commission should place more emphasis on rates, and suggests that the Commission should determine affordable rates in a particular geographic area based on a fixed percentage of median income.¹² AT&T, however, has not demonstrated that the core telecommunications services are unaffordable.

It would be utterly simplistic and very bad economics to assess the affordability of telecommunications service by only considering how much consumers spend on telecommunications service as a percentage of median household income. Affordability is the ability and willingness of consumers to bear the actual cost of service. A standard using only a percentage of income measures neither ability nor willingness.

Elasticity of demand data certainly are relevant to assessing the affordability of telecommunications services in the face of possible rate changes. In its May 23, 2005 comments in the Intercarrier Compensation proceeding, AdHoc provided evidence on the elasticity of demand for local telephone service, evidence that to date is unrefuted.¹³ Footnote 46 of the May 23 comments updates the elasticity data that AdHoc previously submitted in this docket. In commenting on the updated elasticity information (contained in a 2002 publication), AdHoc stated, “Other estimates put the value of local service elasticity of demand closer to -0.3 or -0.2.”⁴⁶

¹¹ AT&T Comments at 11 (emphasis in original).

¹² Id.

¹³ AdHoc Comments, CC Docket No. 01-92, filed May 23, 2005.

⁴⁶ Lester Taylor, "Customer Demand Analysis," in Martin Cave and other, eds., *Handbook of Telecommunications Economics*, vol. 1, *Structure, Regulation and Competition* (Amsterdam: Elsevier, 2002) pp. 126-127. See, in the same volume, Michael H. Riordan, "Universal Residential Telephone Service," at 447.

Additional demand elasticity data and comments thereon are found in a Progress and Freedom Foundation (PFF) October 2005 document entitled "Digital Age Communications Act, Preliminary Proposal of the Universal Service Working Group, Release 1.0." The PFF quotes from the work of Jerry Ellig, a Senior Fellow at George Mason University's Mercatus Center:

[M]ost research suggests that cross-subsidies from long-distance to local service generate little increase in telephone subscriptions. Consumer decisions to subscribe to telephone service are not very sensitive to the fixed monthly charge.¹² In other words, local service has a relatively low price elasticity of demand. This elasticity appears to have fallen over time. Several recent studies using census data, for example, have found that the elasticity in 1999 was about one-third of the value in 1970, and in 2000 it was only one-eighth of the 1970 value.¹³ It may even equal zero in the United States and other developed countries.¹⁴

¹² Jerry Ellig, Public Interest Comments of the Mercatus Center Regulatory Studies Program on Unified Intercarrier Compensation at 6 (May 2005), citing A.H. Barnett & David L. Kaserman, *The Simple Welfare Economics of Network Externalities and the Uneasy Case for Subscriber Studies*, 13 *J. Reg. Econ.* 252-53 (1998); Michael H. Riordan, *Universal Residential telephone Service*, in *Handbook of Telecommunications Economics* 431 (Cave, Majumdar & Vogelsang eds. 2002); David L. Kaserman, John W. Mayo & Joseph E. Flynn, *Cross-Subsidization in Telecommunications: Beyond the Universal Service Fairy Tale*, 2 *J. Reg. Econ.* 231-49 (1990).

¹³ Ellig, citing Christopher Garbacz & Herbert G. Thompson, *Estimating Demand with State Decennial Census Data from 1970-1990*, 21 *J. Reg. Econ.* 326 (2002); Garbacz & Thompson, *Estimating demand with State Decennial Census Data from 1970-1990: Update with 2000 Data*, 24 *J. Reg. Econ.* 376 (2003).

¹⁴ Ellig citing Garbacz & Thompson, *Universal Telecommunications Services: A World Perspective*, 17 *Information Economics and Policy* 495-512 (2005); Robert Crandall & Leonard Waverman, *Who Pays For*

Universal Service? When Telephone Subsidies Become Transparent
(Brookings Institution Press 2000).

In its February 16, 2005 ex parte submission in this docket responding to ex parte communications made by the West Virginia Consumer Advocate and the Keep USF Fair Coalition, AdHoc cited a study by Jerry Hausman and Howard Shelanski, *Economic Welfare and Telecommunications Regulation: The E-Rate Policy for Telecommunications Subsidies*, 16 Yale J. on Reg. 19, 38, n.85 (1999), which had estimated the price elasticity of demand for local telephone service at approximately -0.005 . In short, demand for basic telephone service is very inelastic and would not be much affected by moderate increases in the flat monthly rates for basic telecommunications service. Put differently, even if rates for basic telecommunications service were to increase, demand for the service would be relatively unaffected. That, of course, does not mean that current rate levels are correct. If service is affordable at current levels, as is the case, service certainly would be affordable if rates were reduced because of excessive returns.

National average data submitted by AT&T and Verizon indicate that at the national level rates for basic telecommunications services are affordable. Verizon notes that although the consumer price index for local residential service changed in line with movement of the consumer price index for all consumer items for the period 1996 to 2005, the prices for total telephone service decreased from 1998 to 2005 by 5.8 percent, while the cost of all consumer

items was increasing by 15.3 percent for the same period.¹⁴ According to Verizon, “On average, in 1998, consumers spent 2 percent of their income on telephone services; today, that number is only 1.8 percent. Thus, phone service has been getting more affordable, both in real terms, and compared to the costs of other services.”¹⁵ Even AT&T acknowledges that, “[s]ubstantial numbers of consumers could well afford to spend more and be subsidized less.”¹⁶ Nevertheless, AT&T proposes to set an affordability index at 1.5% of household income for basic telephone services.

AT&T offers no rationale for this index other to state that it is more than reasonable given other consumer expenditures. AT&T points to Bureau of Labor Statistics that show that the average household spends 3.1% of its annual income on energy, 3.1% on gasoline and motor oil (surely higher now), and 4.7% on food away from home. None of these expenditures are subsidized, except perhaps energy for qualifying low income households. Combined with the very low elasticity of demand for basic telecommunications services, the cost of residential telephone service could increase materially before it ceased being affordable.

Moreover, the Commission subsidizes the availability of basic telephone service to low income residential consumers through the Lifeline and Linkup

¹⁴ Verizon Comments at 15.

¹⁵ Id.

¹⁶ AT&T Comments at 26.

programs, which are funded through the USF.¹⁷ This aspect of the program when combined with the affordability and elasticity of demand data set out above should satisfy even the Tenth Circuit that the Commission has adequately considered whether its rules preserve and advance the affordability of basic telecommunications services.

2. Rates Currently Are Reasonably Comparable

Verizon, of course, is correct in observing that Congress requires that rural and urban rates be “reasonably comparable,” not identical to each other.¹⁸ If Congress wanted rural rates to be no higher than urban rates it would have specified identical rates, not reasonably comparable rates. Thus, the Commission’s task is to explain to the Tenth Circuit that under its Universal Service program, rural and urban rates are reasonably comparable.

The comments of Verizon and the National Association of State Utility Consumer Advocates (NASUCA) provide a plethora of data that demonstrate conclusively that rural and urban rates are “reasonably comparable.” NASUCA observes that,

The data show that there is not that much difference between current rural rates and current urban rates. The rural minimum rate is 23% greater than the urban minimum rate, but the average rural rate is only 7% greater than the average urban rate. Most importantly, the highest rural rate is only 7% higher than the highest urban rate. Further, there are only about 245 wire centers that have current rates greater

¹⁷ 47 CFR 54.410 – 54.417.

¹⁸ Verizon Comments at 25.

than two standard deviations above the urban average.¹⁹

AdHoc urges the Commission to use NASUCA's comprehensive data to explain that rural and urban rates are, indeed, reasonably comparable.

In addition to compelling data, Verizon's comments also provide observations that the Commission should use to explain why its Universal Service program fully satisfies the requirement for reasonable comparability of urban and rural rates. Verizon states that,

When viewed in the aggregate, currently available data suggests that rural and urban local telephone rates generally are reasonably comparable, and have been since at least 2001.²⁰

Verizon acknowledges that use of a national comparability benchmark could result in some rural rates being substantially above the national benchmark.²¹ It then correctly reasons that the Commission should not seek individual comparability, pointing out that,

[e]ven if the court was correct that the Commission's rate benchmark would allow some individual rural rates to be 70-80 percent above the urban average rates, if roughly the same proportion of urban rates also are 70-80 percent above the urban average, then the rural and urban rates are "reasonably comparable." In other words, as the Commission has recognized, the statute cannot plausibly be read to require that rural rates be more comparable to urban rates than urban rates are to each other.²²

¹⁹ NASUCA Comments at 41.

²⁰ Verizon Comments at 27. See also Declaration of Patrick Garzillo, Attachment to Verizon Comments.

²¹ Id. at 28.

²² Id. at 28-29.

Section 254 does not require rate comparability at the granular level that might be inferred from the Court's opinion.

E. Conclusion

In view of the foregoing, AdHoc respectfully requests that the Commission adopt a Report and Order and Further Notice of Proposed Rulemaking consistent with the views set out in these Reply Comments.

Sincerely,



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