

**Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554**

In the Matter of	)	
	)	
Federal-State Joint Board on	)	CC Docket No. 96-45
Universal Service	)	
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**COMMENTS OF THE NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE**

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SEEMA M. SINGH, ESQ.  
RATEPAYER ADVOCATE  
31 Clinton Street, 11<sup>th</sup> Floor  
Newark, NJ 07102  
(973) 648-2690 - Phone  
(973) 648-2193 - Fax  
[www.rpa.state.nj.us](http://www.rpa.state.nj.us)

*On the Comments:*

Christopher J. White, Esq.  
Deputy Ratepayer Advocate

Date: September 30, 2005

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**I. INTRODUCTION.**

The New Jersey Division of the Ratepayer Advocate (“Ratepayer Advocate”) submits these comments in response to the August 17, 2005 *Public Notice* seeking comments with respect to several proposals to modify Federal Communications Commission (“FCC” or “Commission”) rules regarding high-cost universal service support mechanisms.<sup>1</sup>

**A. INTEREST OF THE RATEPAYER ADVOCATE IN THE INSTANT PROCEEDING.**

**1. The Ratepayer Advocate Has a Distinct Interest in this Proceeding.**

The Ratepayer Advocate is an independent New Jersey State agency that represents and protects the interests of all utility consumers, including residential, business, commercial, and industrial entities. The Ratepayer Advocate participates actively in relevant Federal and state administrative and judicial proceedings. The above-captioned proceeding is germane to the

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<sup>1/</sup> Federal Communications Commission, “Federal-State Joint Board on Universal Service Seeks Comment on Proposals to Modify the Commission’s Rules Relating to High-Cost Universal Service Support,” Public Notice, FCC 05J-1, August 17, 2005 (“Public Notice”).

Ratepayer Advocate's continued participation and interest in implementation of the Telecommunications Act of 1996 ("Act" or "1996 Act").<sup>2</sup>

New Jersey consumers' interests concern, among others, the following:

- As net contributors to the high cost fund, New Jersey consumers have an interest in ensuring that the high cost fund is sufficient but not excessive. Ultimately, consumers foot the bill for universal service charges.
- As users of the public switched network, seeking to communicate with consumers throughout the nation, including consumers located in high cost areas, New Jersey consumers have an interest in ensuring that high cost funds are sufficient to enable rural consumers to pay charges that are reasonably comparable to those in urban areas: as has been long-recognized, the value of the network increases as the number of subscribers increases. To the extent that high rates discourage subscribership, consumers throughout the country lose on the positive externality associated with interconnectedness.
- As consumers of virtually monopoly basic local exchange service, who must ultimately pay for universal service fund ("USF") charges, New Jersey consumers have an interest in a high cost fund mechanism that encourages economically efficient investment in the local network, and that covers only those costs that are properly associated with the provision of basic local exchange service.

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<sup>2/</sup> Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ("1996 Act"). The 1996 Act amended the Communications Act of 1934. Hereinafter, the Communications Act of 1934, as amended by the 1996 Act, will be referred to as "the 1996 Act," or "the Act," and all citations to the 1996 Act will be to the 1996 Act as it is codified in the United States Code.

## **B. SCOPE OF THE PROCEEDING.**

With this *Public Notice*, the Federal-State Joint Board on Universal Service (“Joint Board”) seeks input regarding four proposals authored by Joint Board members and staff, which address several problems related to high-cost universal service support for rural carriers.<sup>3</sup> These proposals include:

1. The State Allocation Mechanism: A Universal Service Reform Package;
2. Three Stage Package for Universal Service Reform;
3. A Holistically Integrated Package; and
4. Universal Service Endpoint Reform Plan.<sup>4</sup>

The proposals address outstanding issues related to the calculation of support for competitive eligible telecommunications carriers (“ETC”), including whether the support mechanism should be based on forward-looking or embedded costs; whether multiple study areas within a state should be consolidated; and whether the Commission should modify or retain rules regarding the amount of universal service support associated with transferred exchanges.<sup>5</sup> The Joint Board also seeks supplemental information with respect to additional issues that have emerged since the previous comment period regarding high-cost universal service for the August 2004 Public Notice was closed.<sup>6</sup>

The current universal service support mechanism plan, adopted in the *Rural Task Force*

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<sup>3/</sup> Public Notice, at para. 1 and Appendix A through D.

<sup>4/</sup> Public Notice, at footnote 2 and Appendix A through D.

<sup>5/</sup> Public Notice, at footnote 1. See, also, Federal Communications Commission, “Federal-State Joint Board on Universal Service Seeks Comment on Certain of the Commission’s Rules Relating to High-Cost Universal Service Support,” Public Notice, CC Docket 96-45, FCC 04J-2, August 16, 2004, at para. 1 (“August 2004 Public Notice”).

<sup>6/</sup> Public Notice, at para. 1.

*Order*, is a five-year plan due to expire in June 2006.<sup>7</sup> Three federal universal service mechanisms provide high-cost support to rural carriers: High Cost Loop Support; Long Term Support; and Local Switching Support.<sup>8</sup> The 1996 Act requires the Commission, in consultation with the Joint Board, to establish mechanisms to ensure universal service and to ensure that consumers in rural and high cost areas have reasonably comparable access to telecommunications and information services at rates that are reasonably comparable to those charged for similar services in urban areas.<sup>9</sup> Since the enactment of the 1996 Act, the Commission has worked towards the goal of reforming the universal service system so that it contains explicit subsidies and is sustainable in a competitive telecommunications market.

The Commission determined in 1997 that universal service support should be based on forward-looking economic costs and that rural carriers would gradually shift to a forward-looking cost methodology.<sup>10</sup> In so doing, the Commission concluded that:

... a forward-looking economic cost methodology is the best means for determining the level of universal service support. We find that a forward-looking economic cost methodology creates the incentive for carriers to operate efficiently and does not give carriers any incentive to inflate their costs or to refrain from efficient cost-cutting.<sup>11</sup>

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<sup>7/</sup> August 2004 Public Notice, at para. 5. See, also, *Federal-State Joint Board on Universal Service, and Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap 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 (2001), as corrected by Errata, CC Docket Nos. 96-45, 00-256 (Acc. Pol. Div. rel. June 1, 2001)(“Rural Task Force Order”).

<sup>8/</sup> See, e.g., *Rural Task Force Order*, at para. 13.

<sup>9/</sup> *Rural Task Force Order*, at para. 2.

<sup>10/</sup> *Id.*, at para. 4.

<sup>11/</sup> *In the Matter of Federal-State Joint Board on Universal Service*, FCC CC Docket No. 96-45, *Report and Order*, 12 FCC Rcd 8776 (1997)(“1997 Universal Service Report and Order”), at para. 226.

With respect to rural carriers, the Commission found that:

Although it recommended using forward-looking economic cost calculated by using a cost model to determine high cost support for all eligible telecommunications carriers, the Joint Board found that the proposed models could not at this time precisely model small, rural carriers' cost. The Joint Board expressed concern that, if the proposed models were applied to small, rural carriers, the models' imprecision could significantly change the support that such carriers receive, providing carriers with funds at levels insufficient to continue operations or, at the other extreme, a financial windfall. The Joint Board noted that, compared to the large ILECs, small, rural carriers generally serve fewer subscribers, serve more sparsely populated areas, and do not generally benefit from economies of scale and scope as much as non-rural carriers. Rural carriers often also cannot respond to changing operating circumstances as quickly as large carriers. We agree with the Joint Board and adopt its recommendation that rural carriers not use a cost model or other means of determining forward-looking economic cost immediately to calculate their support for serving rural high cost areas, but we do support an eventual shift from the existing system.<sup>12</sup>

. . . we disagree with commenters that contend that using embedded cost is the only way to set the level of universal service support needed for rates to be affordable. Because rural carriers' contributions to universal service support mechanisms will be small relative to the support they will draw, we do not find persuasive RTC's contention that the Commission should maintain the current support mechanisms because rural carriers may suffer significant reductions in net support if all carriers are required to contribute to the new universal service mechanisms.<sup>13</sup>

The Ratepayer Advocate urges the Commission to modify the high cost mechanism so that it achieves this goal, expressed almost ten years ago, of basing support on forward-looking economic costs. Rural carriers have been amply put on notice that their high cost support would gradually be based on economic rather than embedded costs. In 1997, the Commission determined that available forward looking cost mechanisms were not yet appropriate for rural carriers, but expressed confidence that forward looking cost models would be developed to address the unique characteristics

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<sup>12/</sup> *Id.*, at para. 291.

<sup>13/</sup> *Id.*, at para. 292.

of rural carriers.<sup>14</sup>

Rural carriers continued to receive support based on existing embedded cost mechanisms until the adoption of the current plan in 2001. The Joint Board established the Rural Task Force, comprised of representatives of rural telephone companies, competitive local exchange carriers (“CLECs”), interexchange carriers (“IXCs”), wireless providers, consumer advocates, and state and federal agencies, to develop an appropriate forward-looking mechanism for rural carriers.<sup>15</sup> Instead, the Rural Task Force recommended a plan that modified the embedded cost mechanism in an attempt to “strike a careful balance between the need to provide a fund that is ‘sufficient’ under the provisions of the 1996 Act while insuring that the overall size of the fund is reasonable.”<sup>16</sup> The Commission adopted the modified embedded cost mechanism for rural carriers as an interim plan for a five-year period noting that it intended “to develop over the next few years a long-term universal service plan for rural carriers that is better coordinated with the non-rural mechanism. In particular, we intend to develop a long-term plan that better targets support to carriers serving high-cost areas, while at the same time recognizing the significant differences among rural carriers, and between rural and non-rural carriers.”<sup>17</sup>

The five-year plan for the high-cost loop support fund for rural telephone companies adopted by the Commission in its *Rural Task Force Order* includes the following main elements:

- Indexed cap (after fund was re-based);

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<sup>14</sup>/ *Id.*, at para. 293.

<sup>15</sup>/ *Rural Task Force Order*, at para. 5.

<sup>16</sup>/ *Id.*, at para. 6, citing Letter from William R. Gillis, Chair, Rural Task Force, to Magalie Roman Salas, FCC, Dated September 29, 2000 (“Rural Task Force Recommendation”), at 4.

<sup>17</sup>/ *Id.*, at para. 8.

- Rural growth factor (based on GDP-CPI and total number of working loops);
- National average loop cost frozen at \$240;
- Revised corporate operations expense limitation calculation (dollar values in formula re-based and indexed by GDP-CPI);
- Raised minimum cap in corporate operations expense limitation calculation;
- Safety net additive (carrier receives support for its incremental expense adjustment related to new investment);
- Section 54.305 retained (carrier that acquires exchanges from unaffiliated carrier will receive same per-line levels of high-cost support);<sup>18</sup>
- Required eligible telecommunications carriers (“ETCs”) to provide update line counts on a regular quarterly basis; and
- “Three paths” for disaggregation and targeting of high-cost universal service support.<sup>19</sup>

The Commission declined to adopt the Rural Task Force’s proposal to freeze high-cost loop support “upon competitive entry in rural carrier study areas” concluding that the proposal “may be of limited benefit in serving its intended purpose of preventing excessive fund growth, and in some circumstances might increase high-cost loop support levels . . . would be administratively burdensome and may have the unintended consequence of discouraging investment in rural America.”<sup>20</sup>

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<sup>18/</sup> *Id.*, at para. 12. The Commission modified the rule to establish a safety valve that allows for support for additional investment made in the acquired exchanges. *Id.*

<sup>19/</sup> *Rural Task Force Order*, at para. 12.

<sup>20/</sup> *Id.*

In June 2004, the Commission asked the Joint Board to begin anew the consideration of the high-cost universal support mechanism for rural carriers.<sup>21</sup> The Joint Board sought comments in August 2004 regarding the appropriate support mechanism to replace the current five-year plan. The Commission and Joint Board once again asked for input regarding whether forward-looking economic costs or embedded costs “would most efficiently and effectively achieve the goals set forth in the Telecommunications Act of 1996.”<sup>22</sup> The Joint Board also sought comments regarding the definition of “rural telephone company,” and whether it should retain or modify section 54.305 of the Commission’s rules concerning support for transferred exchanges.<sup>23</sup>

### **Relationship to other Commission proceedings**

The Commission’s resolution of the high cost funding mechanism relates directly to other pending proceedings. For example, the issues that the Commission is considering in this proceeding relate to the outcome of the Commission’s investigation of intercarrier compensation in CC Docket No. 01-92. In that docket, the Ratepayer Advocate cautioned the Commission against using universal service funding to protect ILECs from the effects of competition stating:

The Ratepayer Advocate also cautions the Commission against creating a bloated universal service fund to address ILECs’ request to be protected against revenue erosion. The Ratepayer Advocate concurs with the statement of the New York Department of Public Service that it “is especially important that federal universal service funding not be used as a mechanism to shield significant portions of the ILECs’ revenues from competitive erosion.”<sup>24</sup>

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<sup>21/</sup> Federal-State Joint Board on Universal Service, FCC CC Docket No. 96-45, *Order*, Rel. June 28, 2004 (“Referral Order”).

<sup>22/</sup> August 2004 Public Notice, at para. 1.

<sup>23/</sup> *Id.*

<sup>24/</sup> In the Matter of Developing a Unified Intercarrier Compensation Regime, CC Docket No. 01-92, Reply Comments of the New Jersey Division of the Ratepayer Advocate at 8, citing Comments of the New York Department of Public Service at 5.

This principle applies also to this proceeding. The Ratepayer Advocate also urged the linkage between the demonstration of quality services and universal service fund disbursement, which is a continuing concern of the Ratepayer Advocate:

Furthermore, the Ratepayer Advocate concurs with the recommendations of the Iowa Utilities Board that Lifeline customers should be exempt from any incremental increase in monthly charges that result from intercarrier compensation, and also that states “should condition distribution of universal service funds based on an appropriate demonstration that the carrier is providing quality services at reasonable rates throughout their supported areas.”<sup>25</sup>

The Ratepayer Advocate continues to recommend that carriers’ receipt of universal service funds should be linked to the demonstration of the provision of quality service throughout their supported areas.

Also, key aspects of the Commission’s 2003 order on remand,<sup>26</sup> were further remanded to the Commission, the resolution of which affects the Commission’s decision regarding the high cost fund mechanism. Specifically, in February 2005, the level of the rate benchmark was remanded to the Commission for further review.<sup>27</sup> The 1996 Act states that federal universal service support “should be explicit and sufficient.”<sup>28</sup> *Qwest II* found that:

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<sup>25</sup>/ *Id.*, at 11, citing Iowa Utilities Board, at 3.

<sup>26</sup>/ In the Matter of Federal-State Joint Board on Universal Service, FCC CC Docket No. 96-45, *Order on Remand, Further Notice of Proposed Rulemaking, and Memorandum Opinion and Order*, released October 27, 2003.

<sup>27</sup>/ *Qwest Communications International, Inc. V. FCC*, 398 F.3d 1222 (10<sup>th</sup> Cir. 2005) (“Qwest II”).

<sup>28</sup>/ 47 U.S.C. § 254(e).

The FCC's definition of "sufficient" ignores the vast majority of § 254(b) principles by focusing solely on the issue of reasonable comparability in § 254(b)(3). The Commission has not demonstrated in the Order on Remand or the limited record available to this court why reasonable comparability conflicts with or outweighs the principle of affordability, or any other principle for that matter, in this context. The issue is more than semantic. As discussed more fully below, this failure to consider fully the Act's principles as a whole further undermines the FCC's definition of "reasonably comparable" and the cost mechanism at issue in this case.

*Qwest II* states that “[o]n remand, the FCC must articulate a definition of ‘sufficient’ that appropriately considers the range of principles identified in the text of the statute.”

Also, under the 1996 Act, rural customers must receive services “that are available at rates that are *reasonably comparable* to rates charged for similar services in urban areas.”<sup>29</sup> *Qwest II* also remands to the Commission the task of redefining the term “reasonably comparable”:

The Commission explains its selection of two standard deviations as the appropriate benchmark on the basis that it approaches the outer perimeter of the variance in urban rates. As rural rates approach the level of the highest urban rate, the FCC believes closer scrutiny is appropriate. While there is a certain logic to this approach, the benchmark is rendered untenable because of the impermissible statutory construction on which it rests. From this perspective, the Commission's selection of a comparability benchmark based on two standard deviations appears no less arbitrary than its prior selection of a 135% cost-support benchmark. See *id.* at 1202-03. On remand, the FCC must define the term "reasonably comparable" in a manner that comports with its concurrent duties to preserve and advance universal service.

### **C. EXISTING HIGH COST SUPPORT**

Total payments from all universal service mechanisms in 2004 were \$5.4 billion, including nearly \$3.5 billion (or just over 64% of the total fund) related to the high-cost support mechanism.<sup>30</sup>

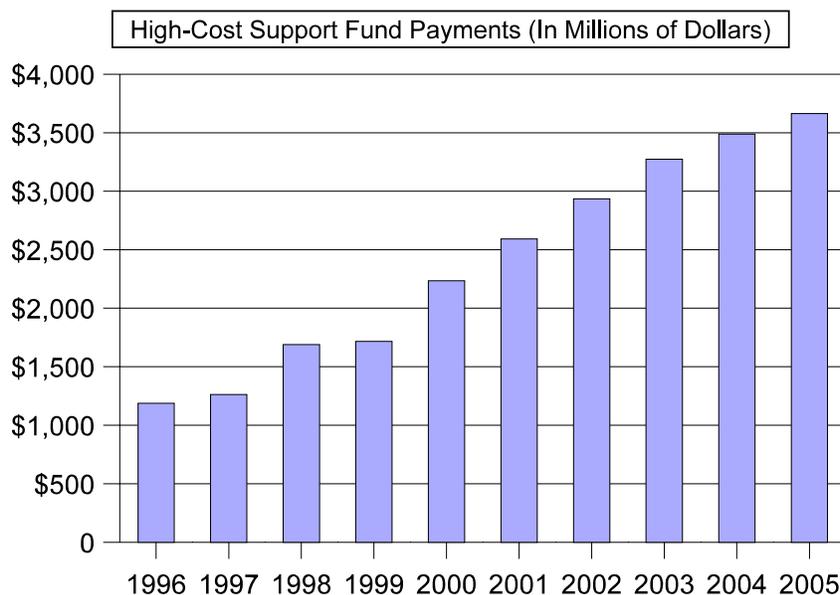
As the figure below shows, high-cost fund payments have grown from approximately \$1.2 billion in

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<sup>29/</sup> 47 U.S.C. § 254(b)(3), emphasis added.

<sup>30/</sup> Federal Communications Commission, Wireline Competition Bureau, Industry Analysis and Technology Division, *Trends in Telephone Service*, Tables Compiled as of April 2005, at Table 19.1.

1996 to an estimated \$3.7 billion in 2005.<sup>31</sup> The tripling of the high cost fund (costs which consumers ultimately bear) during a period of declining costs in the telecommunications industry is troubling.



The Ratepayer Advocate urges the Commission to scrutinize the reasons for the growth, and to implement mechanisms to prevent unnecessary use of the fund.

New Jersey carriers, which serve approximately four percent of the nation’s switched access lines,<sup>32</sup> received a negligible \$1.2 million of the total \$3.5 billion in high-cost support disbursements in 2004 (that is, only three-hundredths of one percent).<sup>33</sup> The Universal Service Fund contribution factor for the first quarter of 2005 was 10.7%; carriers contribute based on “projected, collected, end-

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<sup>31/</sup> *Id.*, at Table 19.3. Data for 2005 based on Universal Service Administrative Company (USAC) projections.

<sup>32/</sup> Federal Communications Commission, Wireline Competition Bureau, Industry Analysis and Technology Division, *Local Telephone Competition: Status as of December 31, 2004*, July 2005, at Table 6.

<sup>33/</sup> Federal Communications Commission, Wireline Competition Bureau, Industry Analysis and Technology Division, *Trends in Telephone Service*, Tables Compiled as of April 2005, at Table 19.4.

user interstate and international telecommunications revenues.” Prior to the second quarter of 2003, carriers contributed based on historical gross-billed revenues.<sup>34</sup>

## **II. Overview of the Four Proposals**

### **Overview**

The Ratepayer Advocate has reviewed each of the four proposals, as described in Appendices A through D to the Commission’s Public Notice. The discussion below summarizes the Ratepayer Advocate’s understanding of the four proposed plans for modifying the nation’s high cost fund, and, in some instances, its analysis of those proposals. The Ratepayer Advocate commends the authors for their efforts to improve the mechanics of the high cost fund within the parameters of the 1996 Act’s directives. The Ratepayer Advocate is hopeful that the plans’ authors will submit initial comments that provide greater detail about their proposals than that provided in the appendices to the Public Notice. Based on its review of the initial comments, the Ratepayer Advocate will supplement its analysis, accordingly, in reply comments.

Furthermore, although the Ratepayer Advocate commends the Commission for analyzing this matter with deliberation and thoroughness, the Ratepayer Advocate is concerned that the passage of time benefits carriers and harms consumers. Several factors likely cause the high cost fund to be unnecessarily high: (1) the use of embedded costs rather than forward-looking costs as the basis for computing high cost need and disbursement, (2) local exchange carriers’ pursuit of competitive and/or unregulated ventures (the costs of which may be being covered in part by the high cost fund), and (3) local exchange carriers’ sale of rural exchanges, which, pre-sale, were averaged in with low-cost exchanges, and thus did not qualify for high cost support then yield costs that are suddenly, on

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<sup>34/</sup> *Id.*, at Table 19.16 and footnote 4 to Table 19.16.

average, high cost.<sup>35</sup> The Ratepayer Advocate urges the Commission to rein in this fund in a timely manner and to establish economically efficient incentives so that mass market consumers do not bear the brunt of the cost of the delay.

### **The State Allocation Mechanism: A Universal Service Reform Package.**

The State Allocation Mechanism, proposed by Joint Board Member Ray Baum, contemplates a six-step transition over six years.<sup>36</sup> This plan proposes that, beginning in 2009, the FCC would make allocations to the Federal Universal Service High Cost and Lifeline/Linkup Funds to separate state accounts maintained by the Universal Service Administrative Company (“USAC”). Each state would then determine the individual distributions from that allocation to ETCs in the state. However, the FCC would adopt guidelines for distribution and ensure compliance with Section 254 of the Act concerning affordability and reasonable comparability. The FCC would act in place of the state in any instance where the state did not comply with FCC guidelines or failed to perform its role. States could support their own additional universal service programs by adopting an “increment” to the funding mechanisms only applicable to consumers in their own states.

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<sup>35/</sup> By way of illustration, if Carrier A’s area includes wire centers with costs ranging between \$10 and \$50, but has an average cost below the high cost threshold, no high cost support will be provided. This outcome is appropriate, and indeed, carriers have been able to sustain more than sufficient rates of return for many years based on this type of averaging of low and high cost areas across a serving area. However, if Carrier A sells off its high cost exchanges to Carrier B, that new study area might then qualify for high cost support. Carrier A’s post-sale average costs would decline (although the consumers of Carrier A would likely see no rate reduction for non-competitive services) and Carrier B would then be eligible to dip into the high cost fund, which consumers must support. This creation of costs “out of thin air” undermines the integrity of the high cost fund and harms consumers. The ratchet mechanism inherent in the high cost fund harms consumers because it is a one-way process where the high cost fund only increases: As carriers shed their high cost areas through sales to other carriers, the high cost fund increases yet at the same time, the carriers that sell their high cost exchanges do not self-proclaim that they have below-average costs and therefore voluntarily lower their rates. Section 54.305 of the Code of Federal Regulations addresses, in part, the influence of universal service support payments on carriers’ decisions to purchase exchanges from other carriers.

<sup>36/</sup> Public Notice, at Appendix A.

The State Allocation Mechanism proposal does not put forth a particular method of allocation except that such method should be determined by the FCC, but Joint Board Member Ray Baum suggests that “applying a model on a statewide basis is a good way to manage unavoidable error. The errors will tend to cancel out across the wire centers in each State.”<sup>37</sup> Mr. Baum also suggests that states be able to make adjustments to an ETC’s allocation on a case-by-base basis “no matter what the allocation methodology employed.”<sup>38</sup>

The State Allocation Mechanism proposal contains a “rate benchmark” that remains fairly vague. The rate benchmark would be used to make state allocations and “would establish an expectation that local consumers would be responsible for the costs of the local network serving them up to a level at which the price of supported services would not be affordable or reasonably comparable, as required by §254.”<sup>39</sup> The proposal calls for a rate benchmark to be developed for each state based on the following factors: the amount of and eligibility criteria for Lifeline/Linkup support; data regarding penetration rates of supported services; and economic and demographic data.

The State Allocation Mechanism would not use jurisdictional data for state allocations and rate benchmarks. Thus, all revenues, including subscriber line charges, would be included in the rate benchmark and all costs would be included in the cost model. This proposal contemplates that all ETC distributions would be frozen as of second quarter 2006 until the first distributions under the State Allocation Mechanism in June 2009.<sup>40</sup> Offsets for “intercarrier compensation losses” would be

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<sup>37/</sup> Public Notice, at Appendix A, page 4.

<sup>38/</sup> *Id.*

<sup>39/</sup> *Id.*

<sup>40/</sup> *Id.*, at 6.

added to the frozen distributions as determined by the FCC in its pending intercarrier compensation order.

### **Three Stage Package for Universal Service Reform.**

The Three Stage Package, proposed by Joint Board Member Billy Jack Gregg includes a short-term first stage that attempts to “rationalize and simplify” existing rural support mechanisms. Stages two and three of the “package” are properly outside of the context of the current Joint Board referral, and thus, the Ratepayer Advocate does not discuss these stages in detail at this time, instead focusing on Stage One of the proposed plan.<sup>41</sup> Stage One of the plan contemplates consolidation of study areas.<sup>42</sup> High-cost support would be based on cost data for an entire carrier’s study area for the state five years after acquisition of the study area or two years after the adoption of this plan, whichever is later. Mr. Gregg suggests that a combination of study areas would properly account for efficiencies of scale and scope and that “[c]onsideration of a carrier’s entire operations will ensure that local switching support goes only to truly small carriers that cannot obtain such efficiencies, and should reduce the total amount of switching support.”<sup>43</sup> Furthermore, the proposal allows for the recovery of costs related to acquired exchanges after a number of years thus removing the barrier to sales of rural exchanges.

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<sup>41/</sup> *Id.*, Appendix B, at 8.

<sup>42/</sup> Insular areas and Alaska would be exempted for the combination of study areas. *Id.*, at 9.

<sup>43/</sup> *Id.*, at 9.

Support for large rural carriers (*i.e.*, those serving 100,000 lines or more) would be determined by the FCC's high cost model currently applied to non-rural carriers.<sup>44</sup> However, the statewide averaging applied to non-rural support would not apply for these rural carriers. Mr. Gregg suggests that use of the FCC's high cost model will "reduce the total amount of high cost support and eliminate problems with determining per line support for individual wire centers."<sup>45</sup>

A freeze in per line support would apply for the remaining carriers subject to embedded cost model support when a competitive ETC entered the study area. According to Mr. Gregg, the freeze "would prevent per line support determined under the modified embedded cost methodology from spiraling to unreasonable levels as a result of lines lost to competitors."<sup>46</sup> Line support would not be completely frozen in that it would be allowed to grow at the rate of the rural growth factor recommended by the Rural Task Force in 2000. In addition, the per line support for carriers under the embedded cost model would be based on the ETC's own costs and would be capped at the per line support of the incumbent.<sup>47</sup>

Finally, Mr. Gregg, while acknowledging that the current level of the rate benchmark the FCC adopted for non-rural carriers has been remanded, nevertheless observes that rural customers should also be protected from excessive rates through a benchmark the same as non-rural customers.<sup>48</sup> As

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<sup>44/</sup> Under the proposed plan, 94 rural study areas (12 million access lines) would move to the FCC's high cost model and 1, 255 rural study areas (9.5 million access lines) would continue to receive support based upon the current modified embedded methodology. *Id.*

<sup>45/</sup> *Id.*

<sup>46/</sup> *Id.*, footnote omitted.

<sup>47/</sup> *Id.*, at 6-7.

<sup>48/</sup> *Id.*, at 9.

Mr. Gregg observes: “[e]xtension of rate comparability review to rural carriers would ensure that all rural customers are protected against unreasonably high rates, regardless of changes in universal service funding and intercarrier compensation.”<sup>49</sup>

Mr. Gregg predicts that although Stage One of his proposal will stabilize the size of the fund over the next three to five years, it fails to address increasing support to competitive ETCs due to the support of multiple lines of multiple ETCs within the same high cost areas. Stage Two of the “Three Stage Package” would use a unified approach to support for rural carriers remaining under the auspices of the modified embedded method, similar to the Universal Service Endpoint Reform Plan (“USERP”) (discussed below) and use a revenue benchmark approach. Finally, the amount of support would be based on a percentage of the costs in excess of revenues (thus not 100% compensatory).

Stage Three of the “Three Stage Package” would adopt a unified approach in that high-cost area support would be determined without reference to rural and non-rural carriers and incumbent and new entrants, as well as technology. The allocation system would be similar to the State Allocation Mechanism and the amount of the allocations would be adjusted for GDP-CPI index changes on an annual basis with reviews of the level of support after five years.<sup>50</sup>

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<sup>49</sup>/ *Id.*, at 10.

<sup>50</sup>/ *Id.*, at 12.

### **A Holistically Integrated Package.**

The Holistically Integrated Package (“HIP”), proposed by Commissioner Robert Nelson, draws upon the plans submitted by other members of the Joint Board, by Staff, and by the NARUC Intercarrier Compensation Proposal (NICP).<sup>51</sup> The HIP includes a State Allocation Mechanism<sup>52</sup> that would leave states discretion as to the amount each carrier receives “provided that the permanent rate benchmark proposed in the NICP (125% of the national urban rate) is honored.”<sup>53</sup> The State Allocation Mechanism would take effect after a three-year transition in which rural carriers would be held harmless. However, states would have the authority to lower a given carrier’s support if earnings were “unreasonably high” or if service quality deteriorated. Commissioner Nelson observes that “[s]tates are in a better position to ensure the USF funds are distributed to where they are needed because they are closest to the customers and can provide the day-to-day oversight that is necessary to monitor potential abuse.”<sup>54</sup>

The Holistically Integrated Package does not distinguish between high cost rural areas being served by rural and non-rural carriers. Instead, after the three year transition period, all carriers serving rural areas would be eligible for high cost support. States that opted out of the State Allocation Mechanism would continue to use the current rural carrier definition.<sup>55</sup>

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<sup>51/</sup> *Id.*, Appendix C, at 14.

<sup>52/</sup> As Commissioner Robert Nelson explains, the State Allocation Mechanism is similar to a block grant, yet adheres to the requirements of Section 254 of the Act because allocations would be subject to FCC guidelines and oversight. *Id.*, at 14-15.

<sup>53/</sup> *Id.*, at 15.

<sup>54/</sup> *Id.*, at 16.

<sup>55/</sup> *Id.*

As stated by Commissioner Nelson: “Since the HIP adopts the principles that states should be given discretion to allocate USF funds and support should be based on the characteristic of the study area and not the carrier, the combination of study areas is a logical extension of these principles.”<sup>56</sup> The use of study areas would continue during the transition period and the use of statewide average costs in the HIP when the full plan takes effect is intended to provide an incentive for investments in rural facilities. The HIP also contemplates that existing high cost support be combined into one program<sup>57</sup> and that Section 54.305 of the Code of Federal Regulations (limiting support provided to acquiring carriers) be repealed.<sup>58</sup>

Although acknowledging that the Joint Board referral does not address USF contribution methodology, the HIP includes a recommendation that contributions be expanded. Commissioner Nelson suggests that all carriers that utilize the public switched telephone network should contribute to the fund and that the “expansion of contributions is necessary to continue to provide the support contemplated in the rest of the HIP.”<sup>59</sup> Commissioner Nelson asserts that the “dramatic decrease in traditional long distance wireline traffic and the increase in the use of VoIP and the deployment of IP networks has changed the dynamics of USF so irrevocably that immediate attention to the issue is required.”<sup>60</sup>

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<sup>56/</sup> *Id.*, at 17.

<sup>57/</sup> *Id.*, at 17.

<sup>58/</sup> *Id.*, at 18. Safety valve support would continue through the transition period. *Id.*

<sup>59/</sup> *Id.*

<sup>60/</sup> *Id.*

### **Universal Service Endpoint Reform Plan.**

The Universal Service Endpoint Reform Plan (“USERP”), proposed by Joint Board staff members Joel Shifman, Peter Bluhm, and Jeff Pursley, addresses support for both wireline incumbent local exchange carriers (“ILEC”) and competitive ETCs. The USERP, similar to the other plans, proposes a State Allocation Mechanism in which state commissions determine allocations to carriers within the state. The support would be cost-based, using embedded, or accounting, costs.<sup>61</sup> A revenue requirement would be calculated but costs would be limited by the use of “best in class” standards.<sup>62</sup> Costs would be calculated on an aggregate basis, *i.e.*, loops, switching and transport as well as across jurisdictions. Federal support would then be disbursed in two parts: Part I would be calculated based on aggregated costs and be provided to states with higher than average costs; Part II support would go to those state with the highest ratios of high-cost customers to offset USF burdens on urban ratepayers in those states.

Part I support would aggregate the costs of all incumbent carriers in the state and thus consolidate study areas. The plan includes a benchmark standard of 125% of the national average urban cost against which rural consumer rates would be judged for affordability and comparability.<sup>63</sup> States would receive no more federal support than needed to keep rates at or below the benchmark everywhere in the state. Federal Part II support would be given to states without regard to whether they received Part I support and be provided to states “in which an explicit high-cost fund would

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<sup>61/</sup> *Id.*, Appendix D, at 20.

<sup>62/</sup> *Id.*, at 21, citing the approach of Lee L. Selwyn outlined at the Joint Board’s hearing on Universal Service, June 7, 2005.

<sup>63/</sup> *Id.*, at 22. See, also, the discussion of the 125% benchmark and the Tenth Circuit’s *Qwest II* decision at footnote 12.

impose an undue internal burden on state ratepayers, but only to states that actually have explicit USF programs.”<sup>64</sup> Part I support would offset Part II support.

The USERP plan adopts a “declining hold-harmless mechanism” whereby in the first year, support to the state would be equal to the previous year and then support would decrease in each subsequent month by \$1.00 per switched line until the mechanism no longer had any effect. As with the other proposed plans, the plan does not rely on jurisdictional costs and aggregates high cost loop, local switching, safety net, high cost model, interstate access, and interstate common line support into one program.<sup>65</sup>

States would retain authority over distribution decisions subject to a few limitations under the USERP: distributions should ensure reasonable and affordable rates; support would not be limited to rural carriers; distributions would be limited by the declining hold-harmless mechanism described above; and distributions should be “predictable” and based on published data and “predetermined calculations.”<sup>66</sup> States would be required to file an annual allocation plan with the FCC concurrent with the ETC certification filing. Any carrier or customer could petition the FCC to review the state’s allocation decisions with respect to whether they are “sufficient to produce affordable and comparable rates.”<sup>67</sup>

The USERP also envisions a situation where some states may not adopt their own programs and may fail, in the eyes of the FCC and the Joint Board, to meet the requirements of Section 254 of the Act. In such a case, the proponents of the USERP plan propose that the FCC provide a remedy

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<sup>64</sup>/ *Id.*, at 23.

<sup>65</sup>/ *Id.*

<sup>66</sup>/ *Id.*, at 24.

<sup>67</sup>/ *Id.*, at 25.

given that the FCC holds ultimate responsibility for ensuring compliance with Section 254. The FCC could then operate a state specific program (termed a “federal overlay”) that impose a supplemental universal service charge in a single state that would then be allocated to carriers in that state by the FCC.<sup>68</sup>

The USERP also addresses portable support to competitive ETCs. Under the plan, wireless ETCs would no longer receive portable universal service support based on the wireline ILEC costs, thus reducing the opportunities for “financial windfalls.” The plan correctly acknowledges that wireless service is not a substitute for wireline service and that universal service should not fund a “second, parallel network.”<sup>69</sup> Instead, wireless competitive ETCs would be supported from a separate fund only available to wireless carriers and capped at \$1 billion per year.<sup>70</sup> This fund would be set up for five years and then sunset. States would allocate funds based on a “competitive grant method” with the goal of providing more wireless services to unserved or underserved areas and roads. Shifman, Bluhm, and Pursley suggest that although the above modifications to portable support “should slow the growth of the fund’s CETC payments, more fundamental policy changes would be needed to fully insure the universal service fund against growth of this kind.”<sup>71</sup>

The USERP still envisions support for wireline competitive ETCs based on ILEC costs. However, measurement would be disaggregated below the wire center level. UNE prices would also

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<sup>68</sup>/ *Id.*, at 25-26.

<sup>69</sup>/ *Id.*, at 27.

<sup>70</sup>/ Shifman, Bluhm and Pursley note that the CETC support in 2005 was projected to be \$800 million, yet the wireless industry contributes \$1.8 billion to the USF.

<sup>71</sup>/ *Id.*, at 26.

be deaveraged according to the new zones created within wire centers.<sup>72</sup>

### **III. RATEPAYER ADVOCATE RECOMMENDATIONS**

The 1996 Act provides, among others, the following directive regarding universal service: “Consumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas.”<sup>73</sup> Among the principles that should guide the Commission as it seeks to ensure reasonable comparability of rates in rural and urban areas are:

- The mechanics of the high cost fund should reward efficient deployment of infrastructure to provide “[q]uality services ... available at just, reasonable, and affordable rates.”<sup>74</sup> The Commission’s ultimate goal should be to rely on forward-looking efficient networks rather than embedded ones so as not to reward bloated costs. As the Commission concluded in its 1997 Universal Service Report and Order: “a forward-looking economic cost methodology creates the incentive for carriers to operate efficiently and does not give carriers any incentive to inflate their costs or to refrain from efficient cost-cutting”<sup>75</sup> and “embedded cost[s] provide the wrong signals to potential entrants and existing carriers.”<sup>76</sup>

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<sup>72/</sup> *Id.*, at 27.

<sup>73/</sup> 47 U.S.C. § 254(b)(3).

<sup>74/</sup> 47 U.S.C. § 254(b)(1).

<sup>75/</sup> *1997 Universal Service Report and Order*, at para. 224.

<sup>76/</sup> *Id.*, at para. 228.

- The high cost fund mechanics should not encompass perverse economic incentives for large companies to sell off high cost exchanges so that the acquiring company can then obtain high cost universal service support. Where a company serves large numbers of below-cost customers, the inclusion of some high cost areas yields average costs such that the company does not qualify for high cost support: *i.e.*, on average, the company does not need high cost support. If same company sells off the above cost exchanges, suddenly areas not now eligible for high cost support may become eligible for support. The sale harms consumers in two ways: (1) the cost of the selling carrier declines, but lacking competitive pressure to flow through the cost reduction, the selling carrier is unlikely to reduce rates for basic local exchange service; and (2) consumers nationwide must now foot the bill for the newly created high cost area.
- Companies' pursuit of fiber to the premises, fiber to the curb, digital subscriber line, and other services raises serious concerns about cross-subsidization of their competitive and/or non-regulated services with revenues from basic local exchange services. This matter bears on the high cost fund because, in no instance, should high cost funds be used to subsidize carriers' provision of competitive and/or unregulated services.

The Ratepayer Advocate commends the Commission for seeking ways to improve the mechanics of the high cost fund. Also the Ratepayer Advocate urges the Commission to address other pressing concerns that affect the nation's achievement of universal service goals:

- *Declining subscribership.* The National Association of State Utility Consumer Advocates ("NASUCA") recently sent a letter to FCC Chairman, Kevin J. Martin, seeking the commencement of an inquiry "into the source (methodological and/or actual) of the decline

in reported telephone subscribership.”<sup>77</sup> According to a recent FCC report, nationwide telephone subscribership has declined over the past two years from a high of 95.5% in March of 2003 to 92.4% in March of 2005.<sup>78</sup> This decline cannot be attributable to consumers “cutting the cord” and opting to use wireless phones instead; the FCC study counts such households as telephone subscribers.<sup>79</sup> NASUCA observes that this decline comes at a time when the federal universal service fund “has reached its highest levels ever.”<sup>80</sup> The FCC report indicates that the percentage of households with a telephone in New Jersey fell from a high of 96.6% in July of 2003 to 93.9% in March of 2005.<sup>81</sup> The Ratepayer Advocate urges the Joint Board and the FCC to ensure that the nation is achieving the universal service goals of the 1996 Act.

- *The societal implications of the technology haves and have-nots.* Based on the Ratepayer Advocate’s comprehensive examination of information provided in state and federal proceedings regarding mega-mergers between SBC and AT&T, and between Verizon and MCI,<sup>82</sup> the Ratepayer Advocate is concerned that the merged companies’ priorities will veer

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<sup>77</sup>/ National Association of State Utility Consumer Advocates, letter to Honorable Kevin J. Martin, Chairman, Federal Communications Commission, August 11, 2005 (“NASUCA Subscribership Letter”), at 2.

<sup>78</sup>/ Federal Communications Commission, Wireline Competition Bureau, Industry Analysis and Technology Division, *Telephone Subscribership in the United States*, data through March 2005, released May 2005 (“FCC Subscribership Report”), at Table 1.

<sup>79</sup>/ *Id.*, at 2.

<sup>80</sup>/ NASUCA Subscribership Letter, at 2.

<sup>81</sup>/ FCC Subscribership Report, at Table 3.

<sup>82</sup>/ *In the Matter of Transfer of Control filed by SBC Communications Inc. and AT&T Corp.*, FCC WC Docket No. 05-65; *Joint Petition of SBC Communications Inc. and AT&T Corp., Together with its Certificated Subsidiaries for Approval of Merger*, New Jersey Board of Public Utilities Docket No. TM05020168; *In the Matter of Verizon Communications Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, FCC WC Docket No. 05-75; *Joint Petition of Verizon Communications Inc. and MCI, Inc. for Approval of Merger*, New Jersey Board of Public Utilities Docket No. TM05030189.

even further toward big business, enterprise, and global customers and further away from the historic mission of providing basic local exchange service customers. Simultaneously, in pursuit of deploying fiber to the home, the companies will be targeting affluent, technologically-savvy households. The Commission should consider carefully the implications of a society with such widely disparate access to communications technology.

- *Disparate levels of access to the Internet by diverse demographic groups* continues to provide evidence of a sobering digital divide that conflicts with the directive in the 1996 Act that . “Consumers in all regions of the Nation, including low-income consumers...should have access to telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas.”<sup>83</sup> As the Commission recently stated, “[t]he availability of the Internet has had a profound impact on American life. This network of networks has fundamentally changed the way we communicate.”<sup>84</sup> Not only should the Commission consider how best to promote universal service in rural areas, but also the Commission should evaluate the disparate levels of access to broadband and to the Internet

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<sup>83</sup>/ 47 U.S.C. § 254(b)(3).

<sup>84</sup>/ In the Matters of Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, CC Docket No. 02-33, *Policy Statement*, released September 23, 2005, cite omitted.

throughout the country.<sup>85</sup>

#### IV. CONCLUSION.

WHEREFORE for the reasons set forth above the Ratepayer Advocate recommends that the Commission:

- *Examine closely the reasons for the tripling of the high cost fund between 1996 and 2004.* A price increase of \$2.3 billion over an eight-year period during a period of declining costs in the telecommunications industry raises significant questions about the high cost fund. The Ratepayer Advocate urges the Commission to distinguish between the sources of growth in the high cost fund that are inevitable and appropriate, and those reasons which relate to inefficient economic incentives and/or improper cross-subsidization, which the Commission should remedy.
- *Direct the industry to identify offsetting rate decreases:* the 1996 Act indisputably requires universal service support to become explicit, but this directive does not justify a revenue windfall for local exchange carriers: to the extent that high cost funds increased by \$2.3 billion, other rates should have declined by at least that amount.
- *Consider the merits of an audit.* Depending on the resources of the Commission, the Commission should consider engaging a third-party auditor to examine the reasons for the

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<sup>85/</sup> “Internet Access Disparity Hits Kids Hardest, Report Says,” *TR Daily*, September 27, 2005; *Are We Really A Nation Online? Ethnic and Racial Disparities in Access to Technology and Their Consequences*, Report for the Leadership Conference on Civil Rights Education Fund Robert W. Fairlie, University of California, Santa Cruz and National Poverty Center, University of Michigan; “A Nation Online: Entering the Broadband Age,” US Department of Commerce, Economics and Statistics Administration, National Telecommunications and Information Administration, September 2004, Appendix Tables 1 through 4, available at <http://www.ntia.doc.gov/reports/anol/NationOnlineBroadband04.doc>; HarrisInteractive, *Consumers and Communications Technologies: Current and Future Use*, prepared for National Consumers League, final report June 29, 2005, at page 7.

growth in the high cost fund to assist the Commission in ensuring that universal service payments (which, ultimately, consumers must pay) are being used in a way that is consistent with sound public policy.

In summary, the Ratepayer Advocate urges the Commission to ensure that in its implementation of the 1996 Act, consumers are, first of all, not harmed through higher rates or lower service quality, and preferably, are better off as a result of the transition to a more competitive marketplace. As it now stands, mass market consumers are paying higher universal service charges and confronting diminishing opportunities for local competition.

Respectfully submitted,

SEEMA M. SINGH, Esq.  
RATEPAYER ADVOCATE

By: *Christopher J. White*  
Christopher J. White, Esq.  
Deputy Ratepayer Advocate