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Universal Service and Access Reform for Smaller LECs The RTF Recommendation and the MAG Plan

Introduction

Two recent proposals to federal and state regulators promise to significantly impact the delivery of affordable and advancing services to consumers in rural America. While coming from distinctly different groups and perspectives, these filings are inter-related and propose policy solutions that are more similar than they are different. How federal and state regulators manage the implementation of these proposals will have a significant impact on rural telephony for years to come.

On September 29, 2000, The Rural Task Force (RTF) issued their *Recommendation to the Joint Board on Universal Service.* The RTF is a diverse group appointed by the Joint Board that includes of representatives from the ILEC and CLEC industries as well as consumer and state regulatory members. The RTF was originally tasked with examining the application of the non-rural support rules and proxy model to the rural carriers. During its two-year tenure the RTF's mission was expanded to include an examination of alternative universal service support mechanisms and other necessary changes for rural carriers. While its primary focus is on universal service mechanisms, it also offers principles for the reform of access charges.

On October 20, 2000 the Multi-Association Group (MAG) filed a Petition For Rulemaking (PFR) with the FCC proposing a comprehensive reform of federal regulatory mechanisms for rate-of-return carriers. The MAG plan addresses, on a holistic basis, the interrelated issues of access charge reform, universal service, Separations reform and rate-of-return represcription. The MAG is composed of the four trade associations representing rural telephony interests: The National Rural Telecom Association (NRTA), The National Telephone Cooperative Association (NTCA), the Organization for the Promotion and Advancement of Small Telecommunications Companies (OPASTCO) and the United States Telecom Association (USTA). While the primary focus is on access charge reform and a new form of incentive regulation for non-price cap carriers, it also offers principles for reform of the current universal service mechanisms.

In many respects universal service and access charges are different sides of the same coin. As discussed in the McLean & Brown and Center for the New West Special Report, *America's Telecommunications Revolution – Not Available in All Locations,* universal service is supported by a complex system of implicit and explicit mechanisms. The Telecommunications Act of 1996 directs that implicit support be removed from rates and replaced with "specific, predictable and sufficient" explicit support mechanisms. Major support for rural LECs comes from access charges that are significantly higher than those charged in urban areas.

Both the MAG plan and the RTF recommendation recognize that without fundamental access reform it will be difficult to maintain comparable long distance rates and discount calling plans for rural consumers. The MAG plan sets target access rates and Subscribe Line Charges that are related to the recently approved CALLS plan for price cap LECs, and creates a new support mechanism, called Rate Averaging Support (RAS), to make this support explicit and portable to CLECs. The

RTF plan, while not as specific, outlines principles for the creation of a "USF III", which is very similar to the RAS.

Both filings recognize the critical role that explicit universal service funding plays in the delivery of advancing services to consumers in high-cost rural areas at affordable rates, comparable to those in urban areas. The RTF recommendation specifically rejects the FCC's proxy model and statewide averaging rules that resulted in virtually no explicit support for the high-cost rural areas of the "non-rural" carriers. Both plans call for the lifting of the "interim" caps on the size of the universal service fund, although the RTF recommends the re-imposition of a capping mechanism. Both plans make explicit support mechanisms portable to CLECs, and both address the acquisition of exchanges from "non-rural" carriers, although the RTF plan proposes limitations and caps on the amount of explicit funding that would be available for such exchanges.

The constraints and caps within the RTF plan reflect the pragmatism that was necessary to gain consensus among a diverse group of stakeholders. As the RTF and MAG plans move through the public policy arena they must contend with the natural tensions that have existed throughout the universal service debate. Low-cost states and providers who do not serve rural markets have consistently resisted any proposals that would have increased the size of the "new" universal service fund beyond that which existed in the pre-1996 Act market environment. The universal service goals of the 1996 Act are noble, but ultimately some way must be found to pay for them. With little appetite for increases from current funding sources, it might be timely to explore other avenues for funding the new explicit support plans that will be necessary if the goals of the 1996 Act are to be achieved.

In the following section we will examine the similarities and differences between the RTF and MAG plans. Following that we will look at some of the critical issues that will be faced in implementing the new universal service and access reform initiatives.

RTF and MAG Plans

The following chart shows a side-by-side comparison of the two plans:

Comparison of RTF Recommendation and MAG Plan

Issue	RTF	MAG

High Cost Fund	Modified embedded cost formula:
	• No proxy model
	• Current USF formulas:
	  • Nationwide loop cost frozen at $240
	  • Adjusted for new indexed caps
		Current embedded cost formula:
		• For study areas under Incentive Regulation (Path A):
		  • Funding per-line is frozen (excludes RAS)
		  • Grown annually for inflation

Funding Caps	Fund caps reset:: • HCL Cap set at 2000 levels (+$118.5M) • Increased annually by Rural Growth Factor • A "safety net" mechanism covers significant increases in plant investment • Corporate Operations Cap reset and grown by RGF	Funding caps eliminated

Disaggregation	HCL, LSS and LTS may be disaggregated:
	• Three Disaggregation Options:
	  • No disaggregation
	  • State approved plan
	  • Self-certification plan
	    • Maximum of 2 zones per wire center
		HCL, LSS, LTS and RAS may be disaggregated:
		• Up to 3 zones per wire center
		• More than 3 zones, if needed, would require a waiver

Portability	Support portable to eligible CLECs • When CLEC enters, support per line is frozen (HCL, LSS, LTS)	RAS (as well as HCL,LSS and LTS) portable to eligible CLECs

Issue	RTF	MAG
Transfers	Establishes principles for support of transferred exchanges: • Support should not inflate sales price • Support should be driven by post-transaction investments • This "safety valve" mechanism should be capped at some appropriate level	Exchanges acquired by Path A and Path B LECs are eligible for support

Access Reform	Establishes principles for High Cost Fund III:
	• Develop a target rate for access
	• Difference between current and target rates recovered in explicit and portable HCF III
	• Decreases disparity between urban and rural access to insure geographically averaged toll rates
		Creates optional Incentive Regulation (Path A):
		• Interstate Revenue Per Line (RPL) frozen and adjusted annually for inflation.
		• Provides incentives for efficiency
		
		Fundamentally reforms access rates:
		• Establishes target access rate of 1.6 cents per minute for Path A LECs
		• Reduced access passed on to consumers through lower toll rates
		• Increases SLCs to match CALLS levels
		• Expands Lifeline support for low income
		• Creates a Rate Averaging Support (RAS) element to remove and make portable implicit support in access rates
		• Reduces disparity between urban and rural access rates
		  • Preserves nationwide toll rate averaging
		  • Assures access to discount calling plans for rural consumers

Advanced Services	• Calls For Joint Board to Reexamine Definition of supported services • Recommends that a "no barriers to advanced services" policy be adopted • Fund should be sized so that investment in rural infrastructure will be permitted to grow	As universal service definition evolves, RPL will be adjusted to keep support sufficient
Duration of Plan	• Should be implemented immediately and remain in effect for 5 years • Plan should be reevaluated prior to end of 5 year period	• LECs electing Path A have 5 years to transition study areas to incentive regulation • LECs remaining on rate of return regulation may convert to Path A at any time during the five year transition period • Proposes effective date of July 1, 2001

High Cost Fund

Both plans would continue to rely on some form of the current embedded cost-based funding rules to determine the basic funding needs. The RTF plan would freeze the nationwide average loop cost used in the USF calculations at $240, and revise the capping mechanisms on the fund as discussed in the next section. It would also introduce a new "safety net" mechanism to provide additional funding to companies with significant increases in plant investment. The MAG plan would retain the current formulas (without caps), but would freeze the per-line support for company study areas that elect the new incentive regulation plan for rate-of-return carriers. This frozen per-line amount would be grown annually for inflation.

Funding Caps

The size of the current USF is constrained by two caps. There is a cap on the overall size of the High Cost Loop (HCL) fund that limits the fund to be no larger than the prior year's fund increased by the percentage growth in lines. There is also a cap on the amount of corporate operations expenses that any carrier may include in the funding calculations. The MAG plan would eliminate both caps. The RTF plan would re-compute the fund size for the year 2000 as if neither cap had been in place. It would impose a new cap at those levels and increase that amount annually by a Rural Growth Factor (RGF) composed of growth in lines plus inflation. The corporate operations cap on individual LECs would also be re-computed by one of several optional formulas and grown annually by the RGF.

Disaggregation

Both plans recognize the importance of the disaggregation and targeting of support below the wire center level. The MAG plan would allow for the creation of up to three zones within each wire center, with provisions for waiver filings if the unique characteristics of a wire center required more. The RTF plan would require rural carriers to make a filing within 270 days of rules becoming effective to elect one of three "paths":

Path 1: No disaggregation below the wire center level.
Path 2: State review and approval of disaggregation plan. There would be no constraints on such a filing.
Path 3: Self-Certification. Disaggregation would be limited to no more than two zones per wire center, and require a showing that the zones are reasonably related to the cost of service.

Portability
Both plans provide for the portability of support to eligible CLECs. Under both plans High Cost Loop (HCL), Local Switching Support (LSS) and Long Term Support (LTS) would be portable. The MAG plan defines a new Rate Averaging Support (RAS) element for LECs that opt for the new incentive regulatory plan that would likewise be portable. The RTF recommendation proposes that when a CLEC enters an ILECs serving area, the support per line (HCL, LSS and LTS) would be frozen and grown annually by the Rural Growth Factor (RGF).

Transfers
Both plans address the issue of the acquisition of exchanges by rate-of-return LECs from "non-rural" LECs. The RTF plan would define a "safety valve" mechanism that would provide partial support for new investment that a "rural" carrier makes in an exchange acquired from a "non-rural" carrier, although the total amount of such support would be capped. The MAG plan would allow rate-of-return LECs who acquire exchanges from a "non-rural" LEC to receive support for the acquired exchanges.

Access Reform
The MAG plan offers a comprehensive proposal for access reform patterned after the CALLS plan of the price cap LECs, and introduces a new form of incentive regulation for rate-of-return carriers. All rate-of-return carriers would increase subscriber line charges (SLCs) and reduce per-minute access charges, with reductions passed on to consumers through lower long distance rates. Long distance providers would also be required to maintain nationwide averaged toll rates as mandated by Section 254(g), and offer to rural consumers the same discount calling plans available in urban areas. LECs who elect not to participate in the new incentive plan (Path B) would continue essentially business-as-usual as either average schedule or cost companies. LECs electing the incentive plan (Path A) would have their interstate access revenue per line (RPL) frozen and adjusted annually for inflation. Path A LEC access charges would be reduced over a two-year period to 1.6 cents per minute (from an average of 3.9 cents today). Any shortfall between the new rates and current revenues would be recovered through a new and portable support element called Rate Averaging Support (RAS).

The RTF Recommendation, while not proposing a specific access charge plan, does include principles for the explicit recovery of implicit support currently contained in access charges. It defines a new and portable USF III that would be computed as the difference between target access rates and current access revenues. The USF III and the RAS thus appear to be quite similar.

Advanced Services
The RTF recommends that the Joint Board review the definition of the services supported by the federal support mechanisms, and that a "no barriers to advanced services" policy be adopted. Importantly, the RTF reasons that by adopting the embedded cost basis for funding, it is providing incentives for investment in advanced services. The MAG plan does not specifically address advanced services, but does state that the RPL component of the incentive plan should be adjusted as the definition of universal

service advances, to keep the support fund sufficient.

Duration of the Plan

Both plans have a durational component of 5 years, although it is used somewhat differently. The RTF recommends that their plan be implemented immediately, and that it remain in place for a five year period. Prior to the end of this period the funding needs of rural carriers should be reviewed. The MAG plan proposes that its plan be implemented July 1, 2001, with a five year period for carriers to elect the new optional incentive regulatory structure.

Critical Implementation Issues

Federal Implementation

The FCC has placed the RTF Recommendation out for public comment, and it its expected to do the same with the MAG plan. Early indications are that past patterns will repeat themselves, with low-cost states and providers who do not serve rural areas opposing new universal service funding initiatives, and rural providers, high-cost states and spokespersons for rural communities supporting them. Unknown at this time is what impact, if any, the Presidential election will have on the implementation of needed rural reforms.

Time is of the essence in getting this important work done. In a few months we will all be blowing out the candles on the 1996 Act's fifth birthday cake. That it has taken so long to get a comprehensive proposal for rural universal service reform before regulators is unconscionable. Further delay in implementing a plan is unacceptable. The RTF took two years of dedicated, hard and sometimes combative work to craft a compromise proposal that totally pleases no one, but that gets the job done and that everyone can live with. It accomplishes the mandates of the 1996 Act and serves the public interest. To expect that more years of battle in the regulatory arena will result in a better solution is wishful thinking, at best. The RTF Recommendation should be approved by the Joint Board and sent on to the FCC for immediate implementation. If problems develop with specific aspects of the plan they can be addressed at a later date, but it is critical to get the fundamental framework in place as soon as possible.

Taken individually, the twin issues of universal service and access reform are each so complex that they make your head hurt. The RTF plan contains a comprehensive plan for universal service and principles for access reform. The MAG plan contains a comprehensive plan for access reform and principles for universal service. As discussed previously, the principles of one appear to be reasonably compatible with the plans of the other. With the universal service framework of the RTF plan in place, parties can turn their attention to the important task of addressing access reform. The MAG plan offers an excellent vehicle to begin this next phase of the debate.

Parallel State Plans and Proceedings

As tough as the federal implementation process will be, this is only part of the challenge. Each state must insure that its intrastate universal service support mechanisms are in sync with the new federal "non-rural" and "rural" plans. Interstate access charges have already been adjusted for price cap companies under the CALLS proposal, and are proposed for similar modification under the MAG plan. States will need to re-align their intrastate access charges to avoid arbitrage and insure efficient recovery of intrastate revenue requirements.

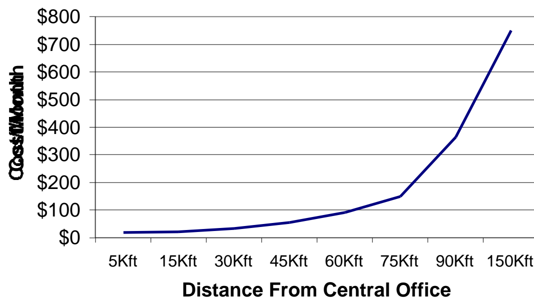
Disaggregation

In McLean & Brown's February, 2000 *Issue Update "Not Available in All Locations" – One Year Later,* we offered an analysis of the importance of the disaggregation and targeting of support so that limited funding dollars can be used to maximum public benefit. One of the strategies discussed in that paper was the concept of defining a "no-support" zone within each wire center. One of the primary reasons that it is essential for LECs to disaggregate support is to avoid arbitrageurs coming in to low cost areas of the wire center (usually downtown), serving the lower cost customers (generally businesses), and pocketing support based upon wire center average costs. Even in the wire centers with the highest average costs,

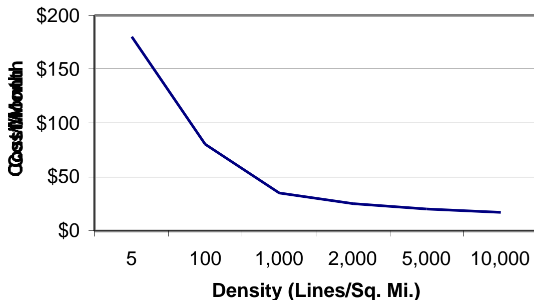
there are customers located near the central office who are relatively inexpensive to serve and do not require support. By defining this "no-support" zone first, the support for each wire center can be assigned to the remaining areas by simply dividing the total wire center support by the number of customers located outside of the "no-support" zone. This would avoid the need for complex algorithms to assign support to the zones.

Since the RTF plan allows carriers to self-certify two zones per wire center, and the MAG plan allows up to three, either plan would accommodate this simplified form of support disaggregation. Both plans require some form of cost justification for the design of the cost zones. This should be relatively easy to do, since cost is a function of two primary drivers – distance and density. The following charts illustrate, based upon data used in the FCC universal service proceeding, how costs vary with these two drivers:

Cost vs. Distance



Cost vs. Density



By using some combination of these fundamental cost relationships, LECs should be able to easily configure and justify "no-sharing" zones for most of their exchanges. Of course there are always exceptional cases which do not neatly fit the standard model, and for these exchanges a more detailed cost analysis will be necessary to determine the appropriate number of zones, the distribution of support amounts among them and the appropriate cost justification.

High-Cost Rural Areas of "Non-Rural" Carriers

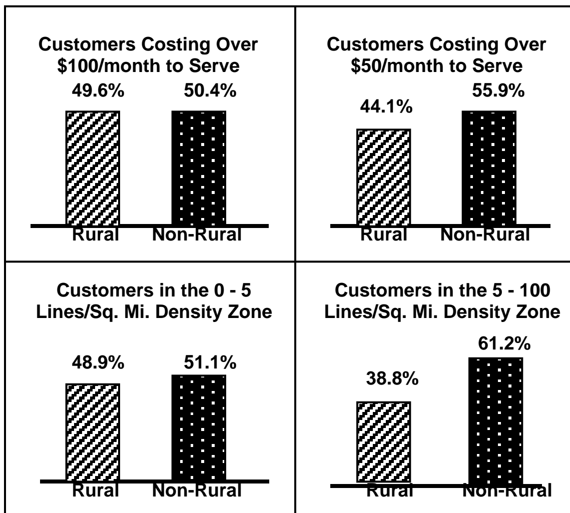
The true "sleeping dog" issue in the universal service debate is the fate of the high-cost rural areas of the "non-rural" LECs. If policy makers fail to adequately address the needs of the over half of all rural Americans who, through no fault of their own, were once served by an RBOC holding company, then we risk the creation of a caste of second class rural communities and digital have-nots.

The choice of the terms "rural" and "non-rural" to define what, in reality, is the difference between "small" and "large" telephone companies, is an unfortunate historical accident. The "non-rural" LECs are large holding companies that serve both urban and rural areas. Because they had the luxury of large quantities of low cost urban customers, they did not require the same level of explicit support to maintain affordable service in their rural areas. In a monopoly environment they were able to internally cross-subsidize – that is, use implicit support. The smaller companies, lacking the large urban areas, historically required more explicit support to keep rates affordable.

The competition created by the 1996 Act changes everything. The high margins on urban and business services that once supported rural areas are now attracting competition. One way or another, either through rate rebalancing or the loss of customers, this support will go away. Congress knew that implicit support would not be sustainable, and called for a new system of explicit supports that would be "specific, predictable and sufficient". However when the FCC and Joint Board completed their 3-year study of the explicit funding needs of the "non rural" LECs they concluded that that the new fund should be "not significantly larger" than the fund that

existed prior to the 1996 Act. There is a train-wreck waiting to happen here.

The facts clearly show that over half of the high-cost rural customers nationwide are served by the "non rural" LECs, primarily the "big 5" holding companies – Verizon, SBC, BellSouth, Sprint and Qwest. The following chart shows data comparing the percentages of high-cost customers and low-density customers located in the serving areas of the "rural" and "non-rural" carriers.



Source: BCPM3.0 with FCC Common Inputs

First note that those customers costing over $100/month to serve are almost evenly divided between the "rural" and "non-rural" LECs. The "non-rural" carriers serve almost 56% of customers whose basic service costs over $50/month. In the most rural of the density zones, 0 to 5 customers per square mile, "non-rural" companies serve 51% of the customers, with the percentage increasing to over 60% in the 6 to 100 zone.

What does this mean? It means that it ultimately will take a lot more money than people are currently talking about to insure affordable and advancing service for all rural Americans. Currently about $1.76 billion in funding is being provided annually for the HCL, LSS and LTS mechanisms. If the current caps on HCL are removed, and some form of Rate Averaging Support (RAS) or HCF III is implemented, this total will likely increase to something over $2 billion. But that still ignores the needs of the "non-rural-rural" customers.

The FCC's current proxy model and non-rural funding rules (including statewide averaging of cost) provide only $210 million of explicit high-cost funding for all non-rural carriers. When the same model and funding rules are applied at the wire center level (i.e., the federal fund provides support for 76% of wire center costs in excess of 135% of the nationwide average) then the funding requirements increase to $2.6 billion. If the funding benchmark were changed to the same 115% of nationwide average cost used for the "rural" carriers, the FCC model would call for $3.5 billion of federal funding for the "non-rural" carriers' high-cost wire centers.

The difference between the $0.2 billion of explicit funding and the $2.6 to $3.5 billion necessary to support high-cost wire centers vividly illustrates the amount of unsustainable implicit support that the FCC has left in the interstate rates of the "non-rural" carriers. Ultimately policy makers will have to deal with this problem, or face the reality of a new class of digital have-nots.

Funding for Acquired Exchanges

As described and quantified above, the FCC's "non-rural" universal service plan falls woefully short of providing sufficient funding to support the high-cost rural customers of the "non-rural" carriers. Furthermore, since these carriers will be forced to rely on large amounts of implicit support, they will need to compete even harder to keep their urban customers on their networks to generate this support. This means that scarce capital dollars will need to be directed to the urban areas where competition rages, further exacerbating the disparity between the networks serving their urban and rural customers.

All of this suggests that there might be strong incentives for the "non-rural" LECs to divest some or all of their high-cost rural exchanges to other carriers who would be in a better position to serve them. This could prove to be good public policy if the acquiring carrier has a business plan built around understanding the needs of rural customers and serving rural markets. Unfortunately, current FCC rules provide that when a new carrier acquires an

exchange, it is limited to the support received by the prior owner. For most "non-rural" carriers' rural exchanges this support is zero. This further threatens the second class digital citizenship of customers in the legacy-RBOC exchanges.

The RTF has made a good start at recognizing this problem, and has proposed a solution that would focus on providing support for new investment in exchanges acquired from "non-rural" carriers. Unfortunately, the example provided of how this "safety valve" mechanism would work indicates that such additional support would be limited to only five percent of the current HCL fund size, or around $50 million. Given the size of the problem identified above, the amount of such funding would need to be significantly greater if we are to meet the goals of the 1996 Act, and avoid the creation of a new class of information have-nots.

New Sources of Funding

While the exact amount of additional funding that will be required to meet the goals of the 1996 is still not known, the analysis above suggests that it is in the billions of dollars. Equally evident is the fact that there is growing opposition among the payers into the current universal service fund for even maintaining the fund at its present level, let alone better than doubling its size. It may be that now is the time to "think outside the box" in terms of how we fund the important universal service goals of the 1996 Act.

Recently there have been initiatives in Congress to repeal the 3% excise tax on telephone service, although at this writing it is unclear if they will survive the last minute budget haggling. Using this money to support universal service might represent good public policy and better use of these funds. In a time of unprecedented budget surplus, and with the clear promise that advanced telecommunications services offer to struggling rural communities, there must be some way in which funding for this important national priority can be provided.

McLean & Brown is a telecommunications consulting company specializing in universal service and access reform issues. To learn more about us, or to obtain copies of prior publications, visit our web site at www.mcleanbrown.com.