McLean & Brown

ISSUE UPDATE

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FCC Releases MAG Plan Order and FNPRM

MAG Plan Order

On November 8, 2001 the FCC released the text of its Order on the MAG plan. The Order and its attachments total 160 pages, and contain a number of significant changes for Rate-of-Return (RoR) ILECs including:

- Increased Subscriber Line Charges (SLC)
- Modifications to Traffic Sensitive rate structures
- Replacement of the Carrier Common Line (CCL) charge with a new explicit and portable Interstate Common Line Support (ICLS) mechanism
- Major new reporting requirements for ILECs.
- An FNPRM on incentive regulation of RoR ILECs

Following is a summary of the major provisions of this Order and issues raised in the FNPRM.

Increased SLC Charges

The Order generally moves the cap on SLC charges for RoR carriers to levels equivalent to those of the Price Cap carriers under the CALLS plan. In one significant departure from the CALLS plan, the Commission declined to adopt a separate and higher charge for "non-primary" residential lines. The current caps on SLC charges are $3.50 for residence and single-line business, and $6.00 for multi-line business. The plan establishes new SLC caps as follows:

Residence and Single-Line Business (RES/SLB)

$5.00 1/1/2002

$6.00 7/1/2002

$6.50 7/1/2003

Multi-Line Business (MLB) (Incl. Centrex)

$9.20 1/1/2002

The increases in the RES/SLB caps to $6.00 and $6.50 are contingent on a cost study to be submitted by the Price Cap carriers as part of the CALLS plan to justify SLC charges at these levels.

The Order also grants RoR carriers "limited" ability to deaverage SLC charges to "zones" ILECs may establish under the universal service disaggregation provisions of the RTF Order. The limitations, however, are crafted so that few RoR carriers will be able to benefit from SLC disaggregation. This is so because no zone may have a SLC higher than the SLC cap. The Order allows for "voluntary" reductions in certain zones, however the ILEC would be forfeiting this revenue, as maximum SLC revenues will be imputed for computation of ICLS payments.

Traffic Sensitive (TS) Changes

The Commission rejected proposals to establish a specific target rate for access charge levels. The MAG sponsors had proposed a target rate of 1.6 cents per minute, and AT&T and others had countered with a proposal of 0.95 cents per minute. Instead, the Commission will allow the TS rate elements to recover actual costs under a modified cost allocation scheme. The Order retains the authorized RoR at 11.25%

The Commission orders two specific changes in cost allocation. First, the Order moves line port costs currently in the Local Switching element to the Common Line category. To ease the burden of this shift, carriers will have the option of assigning 30% of their Local Switching cost in lieu of conducting a cost study. Second, the Order eliminates the TIC rate element, and concludes that the costs recovered through the TIC should be reallocated to other access categories.

The Order also permits, but does not require, RoR carriers to adopt revised Local Switching and Local Transport rate structures with additional rate elements. It also provides new and streamlined procedures for the introduction of new switched access services. Finally, it requires R0R carriers who provide non-regulated billing and collection services to allocate a portion of their GSF costs to the billing and collection category.

Common Line Changes

The Commission seeks to establish an "efficient" rate structure that better matches prices with the manner in which costs are incurred. It reasons that the Carrier Common Line (CCL) charge is "inefficient" since it recovers the fixed cost of the loop through per-minute charges to IXCs. It further reasons that the CCL charge represents "implicit" universal service support that should be replaced with "explicit" support that is portable to all CETCs. To accomplish this, the Commission creates a new Interstate Common Line Support (ICLS) mechanism.

The ICLS is designed to recover all Common Line revenue requirements that are not recovered by end user charges and LTS. It is to be implemented July 1, 2002 coincident with the movement of the RES/SLB SLC cap to $6.00. Since this cap is scheduled to increase to $6.50 on July 1, 2003, the Commission will retain a "transitional" CCL rate element to recover this $0.50 difference during the 2002-2003 tariff year, allowing the ICLS to be based on the $6.50/$9.20 SLC cap levels. There will be no "cap" on the size of the ICLS fund. USAC will be the administrator of the ICLS mechanism.

As an explicit universal service mechanism, ICLS will be portable to all competing carriers who receive ETC status from the state commission. The Order provides that ILECs may disaggregate ICLS in the same manner and to the same support zones as they disaggregate HCL and LTS under the universal service disaggregation options provided in the RTF Order. The Commission has extended the election period for RoR carriers to make a disaggregation Path election by 60 days. Carriers must now select one of the three available disaggregation Paths by May 15, 2002. (See *Issue Update* 5/29/2001 for a discussion of disaggregation options)

USAC will compute the portable per-line ICLS amounts available for each ILEC study area and, if applicable, for each support disaggregation zone. The portable ICLS amount for residence and single-line business lines will be up to $2.70 higher than for multi-line business lines in the same support zone. The Commission has reasoned that since residence and single-line business lines pay a lower SLC rate, they therefore receive more support from the ICLS mechanism. If the CETC is to get the same support as the ILEC, then the FCC believes that they should get a higher amount of support for these lines. Functionally, portable ICLS support will first be targeted to RES/SLB lines up until the difference in SLC caps is achieved ($9.20 - $6.50 = $2.70, or other amount based on actual SLC levels) —before allocating the remaining support equally between the customer classes.

New Data Filing Requirements

In order for USAC to administer the new ICLS mechanism, ILECs will be required to make a number of data filings. Following is a summary of the new USAC filings that will be necessary for each study area:

Projected Common Line Revenue Requirements

- 3/31/02 file projected CL Rev. Req. 7/02 - 6/03
- Annual filing 3/31 each year thereafter

Actual Common Line Revenue Requirements

- 7/31 of each year for the proceeding calendar year
- Optional quarterly filings for faster true-ups

Line Count Data

- Separate counts by class of service and support zone
- Initial filing 3/31/2002
- Subsequent filings 7/31 of each year, until competitive entry
- After competitive entry, quarterly filings

Disaggregation Plans

- 5/15/2002 Path election and maps (if Path 3 filing)

Section 254(e) Certification

Section 254(e) of the 1996 Act states "Any carrier that receives [universal service] support shall use that support only for the provision, maintenance and upgrading of facilities and services for which the support is identified". The RTF Order dealt with HCL support that was intended to cover costs that otherwise would be in the intrastate jurisdiction. For that reason the FCC required that by October 1, 2001 states certify that rural carriers in their state were using these funds only for the required purposes. With the instant Order, the FCC establishes a new explicit support mechanism to support interstate costs. They will now require RoR ILECs to annually certify to the FCC that these funds are being used for their intended purposes. Carriers must make their initial filing by March 31, 2002, with subsequent filings due by June 30 of each succeeding year. The Commission makes quite clear that any carrier failing to file a certification letter will be precluded from receiving ICLS or LTS.

Recovery of Universal Service Contributions

In a recent Fifth Circuit decision the Court found that the recovery of ILEC universal service contributions through access charges represented an unlawful implicit subsidy. The Commission recently granted NECA a waiver to comply with the Fifth Circuit decision, and NECA has implemented an end user charge for the recovery of universal service contributions for carriers that participate in the NECA Common Line Pool. The FCC will now require all carriers to recover universal service contributions only through end user charges.

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Incentive Regulation FNPRM

The Commission declined to adopt any of the incentive regulation proposals of the MAG plan, and instead issued an FNPRM to gather additional information. Comments will be due 30 days after publication of the Order in the Federal Register, with reply comments 30 days later. Issues raised by the FCC include:

General Principles

- An alternative regulation plan must produce fair and reasonable rates
- For Price cap carriers rates were re-initialized and a productivity factor (X-factor) was employed going forward.
- How should this goal be achieved for RoR carriers? Should something akin to the Price Cap methods be used? Some other alternative?
- Should the plan have different risk/reward elements?
- A less stringent X-factor that allows less increased profit?
- Should a range of options be provided?
- An alternative plan must avoid creating incentives for reducing investment in and maintenance of plant in order to improve earnings.
- How should the Commission maintain quality assurance and expansion of new and advanced services?
- Does the existence of a CETC indicate incentives are present?
- What impact would such a plan have on small ILECs?
- What additional principles should be applied to the development of the alternative mechanism?

Optionality

- Should alternative regulation be optional, or should it be mandatory for a subset of larger RoR carriers?
- Should it be "one way" precluding a return to RoR regulation, or should there be ways to return given time or earnings levels?
- How would rates be determined upon return to RoR regulation?

Pooling Considerations

- Will pooling blunt the efficiency incentives of alternative regulation?
- Can NECA revise pooling procedures to facilitate meaningful incentive regulation, or must carriers leave the pool to avail themselves of alternative regulation?
- How would alternative regulation apply to carriers outside of the pool?

MAG proposal for use of Revenue Per Line (RPL)

- Is the MAG RPL concept different from a revenue cap?
- How will the presence of competition affect a carrier’s incentives under RPL?
- How can a plan avoid incentives to maximize costs and plant investment in the year a carrier enters an RPL incentive plan?
- Are there other alternatives that would work better than RPL over a broader range of competitive and regulatory landscapes?
- Rather than a new incentive plan for RoR carriers should carriers have options to adopt the CALLS plan?

Productivity and Sharing Considerations

- To what extent should a productivity offset or initial rate reduction be a part of any alternative regulation plan?
- How should the level of the X-factor be set?
- Should the alternative plan include a sharing mechanism to account for the difficulty in calculating the X-factor?
- Is RPL an appropriate baseline against which to apply a productivity offset?

Low-End Adjustment

- Is there a need for a low-end adjustment, and what would be the appropriate level?
- Should the low-end adjustment be applied retroactively (per MAG) or prospectively (as under Price Caps)?
- Do smaller carriers need a higher low-end adjustment?

Other Alternative Regulation Issues

- Is there a need to establish reporting requirements to monitor service quality and carrier investment in an alternative regulatory regime?
- How often should the Commission review an alternative regulatory plan?
- Should carriers be required to elect alternative regulation on one fixed date, or to elect at a time of their own choosing?

Pricing Flexibility

- The Commission is focused on three types of pricing flexibility for RoR carriers
- Geographic deaveraging within a study area
- Volume and term discounts
- Contract pricing
- How do the unique characteristics of RoR carriers affect the benefits and risks with pricing flexibility?
- Are special rules needed to prevent anti-competitive behavior from inhibiting the development of competition in these markets?
- What impact would pricing flexibility have on the NECA pooling process?
- Should carriers be required to leave the NECA pools as a condition of obtaining pricing flexibility?
- What other forms of pricing flexibility would be appropriate for RoR carriers?
- Should pricing flexibility be granted to RoR carriers immediately, or should it be deferred until some appropriate level of competition has been established?
- Should competition metrics similar to those used for Price Cap carriers be used for RoR carriers?

All-or-Nothing Rule

- Do the all-or-nothing restrictions unreasonably and unfairly limit affiliated companies from selecting regulatory options that would enable them to operate more efficiently?
- What is different today from when the Commission previously considered this issue?
- Would customers be better off, or would competition be better served with or without the all-or-nothing rule?
- Are the rules working effectively since the waiver process allows the Commission to grant exceptions?
- What impact does an increasingly competitive environment have on whether these rules should be retained or eliminated?
- Are the "all-or-nothing" rules necessary to prevent cost shifting and gaming?
- How should RoR carriers that are required to convert, or choose to convert, to Price Cap regulation receive universal service support?
- Should they be allowed to retain ICLS and LTS?

Consolidation of ICLS and LTS

- The Commission has tentatively concluded that LTS will merge with ICLS as of 7/1/2003, after which participation in the NECA CL pool will not be required for receipt of universal service support. Their reasons for this conclusion include:
- LTS no longer will serve an independent purpose after the CCL charge is phased out.
- Restrictions to pooling carriers hampers the competitiveness of the incumbent LECs.
- The risk-sharing function will be reduced or eliminated by conversion of the CCL to explicit universal service support.
- The Commission seeks comment on these conclusions.

Editorial Comment

The combination of a new portable universal service mechanism that promises to open the barn door for rural LEC revenues to go to their competitors, and an FNPRM steeped in the rhetoric and competitive metrics of the 1990s Price Cap debates, makes for an odd pairing. In the earlier Price Cap debate, competition was in its infancy, was mostly urban, was predominantly landline, and competitors had to pay for the privilege of interconnecting. The rural competitive environment created by the RTF Order and the Order in the instant proceeding will be quite different. In addition to landline providers, competition can also involve established wireless carriers. Most significantly, if state PUCs grant CETC status, competitors will actually be paid for competing with the incumbent.

The competitive dynamics will be further complicated by the fact that the amount of support a competitor will receive will be determined not by their own costs and cost structure, but rather by the costs and structure of the wireline incumbent. Given the significant differences in the network architecture and cost structure between wireless and wireline carriers, opportunities for arbitrage of scarce public support dollars will certainly be present.

All of this suggests two things:

- Rural ILECs must fully understand their alternatives under the disaggregation options presented in the RTF Order, and
- Whatever incentive regulation plan emerges from the FNPRM must realize the fundamentally different dynamics of the rural competitive market.

USIA Disaggregation Tool

The MAG Order provides two additional reasons why RoR carriers need to understand and explore their disaggregation options and Path election. The Order provides carriers the opportunity to geographically deaverage the new ICLS mechanism in the same manner that the RTF Order provided the opportunity to disaggregate the traditional HCL and LTS universal service support mechanisms. The inclusion of ICLS in this mix will move more study areas into a position where disaggregation could provide positive benefits. The Order also provided limited ability to geographically deaverage SLC charges. It further extends until May 15, 2002 the date by which RoR carriers must make their filing Path decision.

To assist ILECs in analyzing their disaggregation alternatives, M&B has developed the Universal Service Impact Analysis (USIA) tool. USIA uses Census 2000 housing data at the Census Block level to construct subscriber density maps that allow the design of cost-based disaggregation zones. Subscriber density and distance from the central office are two of the primary drivers of the cost of telephone service. The major proxy models use this same Census Block housing data as the starting point in their design and costing of local telephone networks. By using this subscriber density data directly to design support zones, the USIA accomplishes this task more efficiently and economically.

M&B has recently added the ability to map wireless tower locations in the USIA process to assist in the analysis of vulnerability to wireless arbitrage. With the addition of ICLS to the portable support mechanisms, carriers need to understand their vulnerability to wireless arbitrage both in densely populated regions of their study area as well as in the more sparsely populated areas

USIA is being made available through a partnership of McLean & Brown and CCG Consulting. We are making USIA disaggregation studies available to rural companies, and we are also wholesaling the USIA functionality to other telecommunications consulting companies for use with their clients.

For more information on USIA, please visit the M&B web site at www.mcleanbrown.com.