



**REPORT REVIEWING STATE TELECOMMUNICATIONS
POLICIES ON UNIVERSAL SERVICE**

Docket UT-100562

Prepared by:

Washington Utilities and Transportation Commission

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EXECUTIVE SUMMARY

The Washington Utilities and Transportation Commission (Commission) convened a proceeding to review state telecommunications policies concerning universal service at the request of certain members of the Washington Legislature. The Commission held three workshops on the issue and received written comments from a number of interested persons. After considering information received in the workshops and comments, the Commission identified the following five options for addressing the issue of universal service and preserving telecommunications network in this state:

- 1) Maintain the status quo;
- 2) Require flash-cut or phased-in reductions of intrastate access charges to interstate access charge levels;
- 3) Undertake selective examination of incumbent local exchange company earnings for potential reductions to intrastate access charges;
- 4) Subject to a thorough earnings review of the state's smaller telephone companies, create a targeted state universal service fund, with rigid funding criteria and of limited duration, for the transitional support of voice services; and
- 5) Create a broad state universal service fund that would support voice services for all ILECs serving rural areas of Washington, and which could be transitioned to support broadband services at some point in the future.

The Commission recommends pursuing Option 4, only after completion of a thorough examination of the financial condition of the state's smaller telephone companies to be completed by October 1, 2012. Legislation consistent with this recommendation could be considered during the 2013 legislative session.

INTRODUCTION

On April 7, 2010, the Commission initiated a proceeding to consider development of a policy statement and potential revisions to state universal service policies. The Commission initiated this proceeding in response to a request from six legislators dated March 2, 2010.¹ The letter requested that the Commission "adopt the schedule of workshops to begin in early

¹ The March 2, 2010, letter from Representatives McCoy and Crouse and Senators Rockefeller, Honeyford, Kastama and Zarelli to Chairman Goltz and Commissioners Oshie and Jones is attached to this report as Appendix 1.

April 2010, and ... report to us on the outcomes of those discussions, including any policy or legislative recommendations.”

To facilitate our inquiry into the state’s Universal Service policies the Commission conducted three workshops, solicited written comments on a number of policy questions posed to interested parties, and, through our Staff, gathered additional information. Collectively, more than ten interested parties provided input in varying degree reflecting the views of companies from all major sectors of the telecommunications industry including, but not limited to, incumbent local exchange carriers (ILECs) including representatives of the Washington Independent Telecommunications Association (WITA), wireless carriers, cable television companies, and various other competitive telecommunications carriers. The Commission was fortunate to have participation by the Public Counsel Section of the State Attorney General’s office which, like the Commission, provides input from the broader consumer perspective.

This report presents an overview of existing federal and state laws and policies relating to universal service (Part I); provides a summary of the evolution of the competitive telecommunications landscape in Washington in recent years and how it impacts the implementation of state and federal universal policies (Part II); summarizes the process the Commission undertook in this proceeding (Part III); and presents the Commission’s findings and recommendations for further action (Part IV).

I. Overview of Existing Federal and State Universal Service Law and Policy

Universal service is the long standing policy of the United States and the State of Washington to enable every American, regardless of location, to have access to affordable high-quality telecommunications and, more recently, information services. The policy encourages certain designated telecommunications carriers to invest in and operate telecommunications networks that enable the provision of telecommunications services in less dense and higher cost areas of the country at prices that are reasonably comparable to those offered in more dense and lower cost areas. As explained below, the policy has been accomplished through a variety of specific, and sometimes obscure, mechanisms that provide for significant financial transfers (in effect, subsidies) between various providers of telecommunications services and, therefore, to and from their customers.

Prior to the advent of local telephone service competition from other telecommunications carriers, and via new platforms such as wireless, Voice over Internet Protocol (VoIP), and broadband, universal service was advanced under a regulatory regime that relied upon a significant transfer of revenues from long distance (“LD”) carriers to local telephone companies. These transfers have been commonly known as interstate and intrastate access charges. Historically, these access charges have transferred a material portion of the revenues that long distance companies receive from their customers to local exchange companies, referred to as incumbent local exchange companies or ILECs. These charges are collected through the rates that ILECs apply to long distance carriers that use their networks to originate and terminate LD calls.

The access charge structure, and the federally-established subsidies created by it, were very successful in promoting the development and maintenance of local telephone infrastructure and universal service.² The system could be properly administered because most major service providers, be they local or long distance, were to a significant degree under the jurisdiction of both state and federal regulatory bodies that were, in turn, jointly responsible for, and focused on, the preservation and advancement of universal service. While successful in advancing universal service for voice services, the historical relationships between traditional telecommunications providers, their customers and state and federal regulatory policies have become increasingly challenged by the advent of new technologies and new service providers that offer end users competitive alternatives to traditional wireline services.

A. Federal Law and Policy

1. The Federal Telecommunications Act of 1996

Pursuant to the Telecommunications Act of 1996 (1996 Act),³ which materially amended the provisions of the Communications Act of 1934 (1934 Act), Congress sought to preserve and advance universal service while, at the same time, opening all telecommunications markets to competition. At the time of enactment, considerable competition existed in the interexchange (i.e., long distance) market as a result of certain pro-competitive policies

² While successful, the use of access charges in association with specific federal subsidy programs and objectives often resulted in disputes between local telephone companies and long distance providers.

³ *Telecommunications Act of 1996*, Pub. L. No. 104-104, 110 Stat. 56, 47 U.S.C. §§151 et seq.

adopted by the Federal Communications Commission (FCC); and, although competition was emerging in the local exchange marketplace, it was rather nascent.

In the 1996 Act, Congress sought to introduce competition into local telephone service that historically had been provided through regulated monopolies. The Act delegated authority to the FCC to establish the terms and conditions for breaking open the local exchange marketplace to competition while retaining those aspects of the legacy monopoly-based environment that, through various inter and intra-company transfer mechanisms, preserved and protected universal service. Recognizing that in introducing local telephone service competition it was threatening the implicit subsidy system that had traditionally supported universal service, the 1996 Act directed the FCC to reform its universal service rules to make support explicit and sustainable in the face of developing competition.⁴

Section 254(b) of the Act, directs the Federal-State Joint Board on Universal Service (Joint Board) and the FCC to base policies for the preservation and advancement of universal service on six general principles plus other principles that the FCC may establish. Among these policies are requirements that federal and state support mechanisms should be specific, predictable, and sufficient; that quality services should be available at just, reasonable, and affordable rates; and that consumers in all regions of the nation should have access to telecommunications services that are reasonably comparable to those services provided in

⁴ In large measure, Washington was ahead of the curve in promoting local exchange competition prior to enactment of the 1996 Act. The Washington Supreme Court ruled on a Commission decision regarding the registration and service offerings of a competitive local exchange carrier (Electric Lightwave, Inc.) and the extent to which the Commission's authority to establish service area boundaries of telecommunications carriers conveys certain exclusive rights to provide service within such areas. *Electric Lightwave, Inc v. Washington Utils. & Transp. Comm'n*, 123 Wn.2d 530, 869 P.2d 1045 (1994). A subsequent Commission proceeding established rules concerning interconnection by new entrants to existing telecommunications providers in Washington. *See Washington Utils. & Transp. Comm'n v. US West Communications, Inc.*, Docket UT 941464, 1995 WL 735315 (4th Supp. Order, Oct. 31, 1995). There, the Commission stated:

The record clearly establishes that unbundling of the local loop is essential to the rapid geographic dispersion of competitive benefits to consumers and is in the public interest. Unbundling allows customers greater opportunity to choose between a diversity of products, services, and companies. Unbundling also allows for efficient use of the public switched network, reduces the likelihood of inefficient network over-building, and ensures that competition is not held hostage by being bundled with bottleneck functions.

Id., 1995 WL 735315, at 30.

urban areas at reasonably comparable rates. Section 254(e) of the Act provides that only eligible telecommunications carriers (ETCs) designated by state commissions (or the FCC in the absence of state commission action) under section 214(e) shall be eligible to receive federal universal service support, and that any such support should be explicit and sufficient to achieve the purposes of that section.

2. The Federal Universal Service Fund

At the federal level, the universal service support is provided primarily through the Federal Universal Service Fund (FUSF), which directly supports construction and maintenance of extensive telecommunications infrastructure that provides nearly ubiquitous, high-quality local voice telecommunications service to some of the nation's most remote and difficult to serve areas. The provision of modern telecommunications infrastructure in these areas would never have been possible were it not for the nation's long-established policy of supporting universal service and the FUSF. The purpose of "high-cost" universal service support always has been to help ensure that consumers have access to telecommunications services in areas where the cost of providing such services would otherwise be prohibitively high.

One of the primary criticisms of the FUSF is the fact that support is generally provided to certain carriers depending on the size and regulatory classification of the carrier, not the characteristics of the area to which support is directed.⁵ Additionally, because only voice is a supported service, there is no requirement to provide broadband service to consumers, nor is there any mechanism to ensure that support is targeted toward extending service to unserved areas.⁶ Moreover, there are many critics of the FUSF that contend the program does not provide support in an economically efficient manner.⁷ For example, several components of the FUSF provide support based on an incumbent carrier's embedded costs, whether or not a

⁵Notice of Inquiry and Notice of Proposed Rulemaking, *In the Matter of Connect America Fund, A National Broadband Plan for Our Future, High-Cost Universal Service Support (NOI and NPRM Connect America Fund)*, WC Docket No. 10-90, GN Docket No. 09-51, WC Docket No. 05-337, released April 21, 2010.

⁶ However, many ILEC recipients of FUSF support in effect have used such funding to facilitate the offering of broadband service because the monies have been used to construct and maintain facilities that can be used by both narrowband voice and broadband services.

⁷ See, e.g., Comments of AT&T Corporation, Verizon and Verizon Wireless, Qwest Corporation, *NOI and NPRM Connect America Fund*, dated July 12, 2010.

competitor provides, or could provide, service at a lower cost. Despite these criticisms, however valid, it is indisputable that the current system of high-cost support has achieved considerable success in helping ensure there is widespread and affordable access to voice services in most regions of the nation. Currently, carriers designated by the Commission in Washington receive approximately \$100 million annually from the FUSF, and local telephone service is available to more than 99 percent of the residents of the state.⁸

Until recently, rural ILECs were the only providers of ubiquitous, high-quality, facilities-based service throughout their respective service areas. Over the past decade other carriers, particularly wireless carriers, have been receiving financial support from the FUSF, thereby extending significantly the reach of wireless technology into rural areas of the state, although not to the same ubiquitous level that has historically been achieved by their wireline-based competitors.⁹

As competition has developed, federal policy supporting universal service has been made increasingly difficult because the 1996 Act directs the FCC and states to achieve many important, but potentially conflicting, goals. All parties agree there is a compelling need to restructure the current universal service components of the FUSF and make them more sustainable and compatible with a competitive marketplace by wringing out implicit subsidies that, heretofore in a monopoly-based environment, helped to fund universal service. Additionally, there is enormous momentum towards redirecting support to more advanced services such as broadband.

The telecommunications landscape has undergone many fundamental changes that were scarcely anticipated when the 1996 Act was adopted. The Internet was only briefly mentioned in the 1996 Act, and even then not by name.¹⁰ However, now the Internet has come into widespread use, with broadband Internet access service increasingly viewed as a

⁸ See generally 2009 FCC Universal Service Monitoring Report, CC Docket 98-202.

⁹ Although subject to strong debate among interested parties, wireless carriers have also been able to extend the reach of their networks using, in part, certain “special access” services offered by ILECs pursuant to federal and state tariffs. The reach of wireless networks would not be as extensive but for the availability of such services from the ILECs.

¹⁰ Section 706(c)(1) of the 1996 Act states: “The term ‘advanced telecommunications capability’ is defined, without regard to any transmission media or technology, as high-speed, switched, broadband telecommunications capability that enables users to originate and receive high-quality voice, data, graphics, and video telecommunications using any technology.”

necessity. Consistent with this trend, carriers are converting from circuit-switched networks to Internet Protocol (IP)-based networks. These changes have benefited consumers and should be encouraged. Competition has resulted in lower prices for telephone service, and the introduction of innovative broadband products and services has fundamentally changed the way we communicate, work, and obtain our education, news, and entertainment.

At the same time, these developments have challenged the regulatory assumptions underlying the nation's universal service and intercarrier compensation regimes, forcing regulators to reassess existing approaches. The FUSF has seen unprecedented growth, driven in large part by increased support for competitive ETCs. Additionally, the growth of competition has eroded the universal service contribution base as the prices for interstate and international services have dropped. Finally, it appears that numerous competitors have been able to exploit arbitrage opportunities created by a patchwork of above-cost intercarrier compensation rates.¹¹

3. The National Broadband Plan

The American Recovery and Reinvestment Act (ARRA) enacted in February 2009¹² required the FCC to prepare a "National Broadband Plan" (NBP) to establish an ambitious agenda for shifting the nation's telecommunications policy towards support of robust deployment of broadband service. As a result of the broadband provisions of the ARRA, the FCC established a broadband task force that gathered information for the plan pursuant to 36 public workshops, 9 field hearings, and 31 public notices that produced more than 75,000 pages of public comment.

The FCC issued the NBP on March 16, 2010.¹³ Its primary goal is to put into place the necessary rules, resources, and support mechanisms to enable utilization and availability of broadband service in all corners of the nation. About half of the NBP's recommendations

¹¹ *Access Charge Reform*, 12 FCC Rcd 15982, ¶¶ 31-32 (1997); *Developing a Unified Intercarrier Compensation Regime*, Notice of Proposed Rulemaking, 16 FCC Rcd 9610, ¶¶ 11-18 (2001); *Developing a Unified Intercarrier Compensation Regime*, Further Notice of Proposed Rulemaking, 20 FCC Rcd 4685, ¶ 3 (2005).

¹² American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009) (Recovery Act). The Recovery Act was signed into law on February 17, 2009.

¹³ *Connecting America: The National Broadband Plan*, (National Broadband Plan), Staff of the Federal Communications Commission, Released March 16, 2010.

will be addressed directly by the FCC, while other recommendations will require action by Congress, the Executive Branch, and state and local governments working closely with private and nonprofit sectors.

The actions contemplated in the NBP reflect four strategic objectives intended to influence positively broadband availability and utilization:¹⁴

- a. Design policies to ensure robust competition and, as a result maximize consumer welfare, innovation and investment.
- b. Ensure efficient allocation and management of assets government controls or influences, such as spectrum, poles, and rights-of-way, to encourage network upgrades and competitive entry.
- c. Reform current universal service mechanisms to support deployment of broadband and voice in high-cost areas; and ensure that low-income Americans can afford broadband; and in addition, support efforts to boost adoption and utilization.
- d. Reform laws, policies, standards and incentives to maximize the benefits of broadband in sectors government influences significantly, such as public education, health care and government operations.

While each of the objectives will require significant effort by federal and state policymakers, it is the third objective, the reform of the FUSF, which has material long-term implications for federal and state universal service policies.

Although many of the contemplated changes are simply conceptual in nature and the process for altering federal rules applying to universal service is rather lengthy, some of the changes, if implemented, could significantly reduce or even eliminate the current FUSF support flowing to Washington ILECs. Specifically, three potential changes to FUSF support are (1) elimination of so-called “Interstate Access Support” (IAS), (2) freezing of “Interstate Common Line Support” (ICLS), and (3) phase out of interstate “High Cost Loop Support” (HCLS), which would greatly curtail existing FUSF support to Washington’s ILECs.¹⁵ Such

¹⁴ *Id.*, Executive Summary, at XI.

¹⁵ Interstate access support (IAS) is a FUSF support mechanism that was established in 2000 for price-cap carriers to replace the “implicit” support previously collected through interstate access charges with a direct federal subsidy. The purpose of this mechanism is to provide “explicit” support to ensure reasonably affordable interstate access charge rates. Interstate Common Line Support (ICLS) is another

support may eventually be phased out completely in favor of direct support to competitive broadband providers in rural areas through some form of competitive award process. Such an outcome may or may not result in continuing support to Washington ILECs as the nation's focus is shifted to broadband. In other words, although the contemplated changes could have significant impacts on the ILECs, it is not a foregone conclusion that future federal support would not be directed to such carriers. It is simply too soon to predict with any certainty the outcome of the federal proceedings intended to reform the FUSF.

Nevertheless, as a result of such changes, rural ILECs may lose the ability or incentive to continue investing in their networks. Insufficient funding also threatens these carriers' ongoing efforts to offer advanced services to greater numbers of consumers, as well as to schools, libraries and rural health care facilities. It is clear from the WITA companies' perspective, that their ability to sustain the availability of high-quality, modern service to rural consumers may be threatened by federal policy decisions that could place the future financial health of these companies at risk.

In the next month or two, the FCC is expected to release two important Notices of Proposed Rulemakings (NPRMs) on these subjects: the first dealing with comprehensive USF reform and the retargeting of federal USF support through the proposed "Connect America Fund" and the second addressing the unresolved issues of intercarrier compensation reform. Both rulemakings are expected to be difficult and contentious. The FCC is expected to propose a menu of "carrots" and "sticks" to urge states to adopt such reforms, including potentially incentives or credits for states that have already acted to reform intrastate access rates or establish a state-based USF program. If this proves to be true and we judge federal reforms to be likely, we may recommend a more accelerated schedule in order to take advantage of such proposals by the FCC.

FUSF support mechanism. In November 2001, the Commission created the ICLS mechanism for rate-of-return carriers to convert another level of "implicit" support in carrier's interstate access rate structure to "explicit," portable support. ICLS recovers any shortfall between the allowed federal common line revenues of rate-of-return carriers and their subscriber line charge revenues and gradually replaces the carrier common line charge. Finally, embedded High-Cost Loop Support (HCLS) is provided to all rural ILECs based on their embedded costs. Such federal support provides assistance for non-traffic sensitive (NTS) local loop costs -- a term that refers to the costs of outside telephone wires, poles, and other facilities that link each telephone customer's premises to the public switched telephone network. NTS costs are allocated between the state and interstate jurisdictions because all local loops can be used for making and receiving both intrastate and interstate telephone calls. Historically, the interstate allocation was made using the Subscriber Plant Factor (SPF), which is now 25 percent for all companies.

B. State Law and Policy

1. State Statutory Framework

Two sets of provisions of state law address universal service. First, RCW 80.36.300 establishes the preservation of affordable universal telecommunications service as the official policy of the State of Washington. It states:

The legislature declares it is the policy of the state to:

- (1) Preserve affordable universal telecommunications service;
- (2) Maintain and advance the efficiency and availability of telecommunications service;
- (3) Ensure that customers pay only reasonable charges for telecommunications service;
- (4) Ensure that rates for noncompetitive telecommunications services do not subsidize the competitive ventures of regulated telecommunications companies;
- (5) Promote diversity in the supply of telecommunications services and products in telecommunications markets throughout the state; and
- (6) Permit flexible regulation of competitive telecommunications companies and services.

Second, RCW 80.36.600 and RCW 80.36.610 require the Commission to plan and prepare to implement a program for the preservation and advancement of universal telecommunications service which shall not take effect until the Legislature approves the program.¹⁶ RCW 80.36.600(1) states:

The commission shall plan and prepare to implement a program for the preservation and advancement of universal telecommunications service which shall not take effect until the legislature approves the program. The purpose of the universal service program is to benefit telecommunications ratepayers in the state by minimizing implicit sources of support and maximizing explicit sources of support that are specific, sufficient, competitively neutral, and technologically neutral to support basic telecommunications services for

¹⁶ RCW 80.36.600 was adopted in 1998 pursuant to Engrossed Substitute Senate Bill 6622 (ESSB 6622).

customers of telecommunications companies in high-cost locations.

Subsequent subsections of RCW 80.36.600 and RCW 80.36.610(2) detail what should be in a universal service program.¹⁷

2. State Policy – Access Charges

To date, Washington has not established a specific universal service fund as contemplated by the state statutes identified above.¹⁸ Nevertheless, in addition to various elements of the FUSF discussed previously, there are certain non-fund subsidy mechanisms that the Commission has established to provide support to ILECs or directly to their customers.

Over time, by virtue of a number of tariff proceedings and specific rulemakings, the Commission has established the rates, terms and conditions regarding intrastate access charges that enable ILECs to assess and collect a variety of rate elements applied to LD carriers for the origination and termination of intrastate LD calls.¹⁹ As a consequence of these proceedings, there are four specific components of the Washington ILEC's intrastate access charge rate structure that provide direct or indirect subsidization of the local telephone services provided by the ILECs;

- (1) universal service fund rate,
- (2) non-traffic sensitive interim terminating access charge rate (NTS ITAC),
- (3) traffic sensitive interim terminating access charge rate (TS ITAC), and

¹⁷ The provisions of RCW 80.36.300, RCW 80.36.600, and RCW 80.36.610 are set forth in Appendix 2 to this report.

¹⁸ In 1991, the Commission established a “community calling fund” (CCF) administratively that was intended to provide financial support to certain ILECs for conversion of a number of long distance calling routes to local calling capability (commonly referred to as extended area service or EAS). The CCF would have compensated ILECs for any direct revenue shortfalls associated with the financial effects of the conversions. However, the Washington Court of Appeals invalidated that effort as being without statutory authority. *Washington Independent Telephone Ass’n v. Telecommunications Ratepayers Ass’n for Cost-Based and Equitable Rates*, 75 Wn. App. 356, 880 P.2d 50 (1994).

¹⁹ The state also has a subsidy mechanism, the Washington Telephone Assistance Plan (WTAP), which provides indirect financial assistance to low income telephone consumers in tandem with a federal funding mechanism known as the Federal Lifeline Assistance Program. Together these programs provide a discount to wireline telephone consumers for a reduction to the prices assessed on their monthly telephone bills.

(4) carrier common line charge (CCLC).

Billed on a per minute of use basis, these “subsidy” components of intrastate access charges are used in part by each ILEC to offset the cost of providing local telephone service within their designated franchised service areas in Washington. In 2008, for example, such charges generated \$41 million.²⁰

The NTS ITAC and TS ITAC rates were established as “interim” measures pursuant to a rulemaking under which the Commission required that terminating intrastate access charges not exceed the rate charged for comparable local termination service rates or the actual cost of termination based upon the total service long-run incremental cost (TSLRIC) costing methodology, plus reasonable common or overhead costs (WAC 480-120-540). This rule does not set rates directly, but instead establishes the methodology that ILECs must use in setting terminating intrastate access rates. After it was adopted, WITA challenged the Commission’s authority to impose the rule on its members but, ultimately, the Washington Supreme Court ruled that the Commission did not exceed its statutory authority when promulgating the rule.²¹

3. Prior Commission Review of Universal Service Funding

Beginning in 1998, in compliance with RCW 80.36.600, the Commission undertook an examination of state universal service funding conditions,²² wherein it developed an assessment of the annual cost of supporting universal service.²³ At that time, the cost of universal service was estimated to be approximately \$125 million per year, an amount many interested parties found both financially untenable and politically objectionable.

²⁰ An excellent overview of these state subsidy mechanisms is contained in the presentation of Mark Vasconi of Commission Staff (see Appendix 3 to this report).

²¹ *Washington Independent Telephone Ass’n v. Washington Utils. & Transp. Comm’n*, 148 Wn.2d 887, 64 P.3d 606 (2003). The court’s ruling is important in light of the previous action involving the CCF where the Commission was found to have exceeded its statutory authority in establishing a fund to compensate ILECs for lost revenues associated with changes to long distance calling routes.

²² See Docket UT-980311. The documents in this docket are available on the Commission’s web site www.utc.wa.gov.

²³ The Commission’s methodology compared the estimated cost of providing telephone service in rural areas with the revenues available to support universal service.

In its final report, entitled *State Telecommunications Policy and Federal Requirements – Promoting Competition and Reforming Universal Service* (1998 USF Report),²⁴ the Commission proffered a series of recommendations, including the establishment of an explicit state universal service fund for all telephone lines in high-cost rural areas of the state. In support, the Commission drafted request legislation and proposed rules, which the Commission was prepared to implement had the Legislature authorized doing so. It also recommended adoption of a revenue bench-mark as a targeted offset to such costs and a proposal to require contributions to a new state universal service support mechanism supported by all providers of telecommunications services in the state, including wireless carriers and those entities using newly emerging technologies as a means to compete with traditional wireline carriers. Although legislation was introduced,²⁵ none of the Commission’s recommendations or the “Model Universal Service Legislation” incorporated as Appendix H to the 1998 USF Report were adopted by the Washington Legislature.

II Evolution of the Competitive Telecommunications Landscape in Washington - Factors Affecting Universal Service

A. Market Structure Changes

The telecommunications landscape has changed dramatically since the Commission issued its 1998 USF Report. What once was expected to be a fierce competitive battle for local telephone customers between long distance carriers such as AT&T and MCI, on the one hand, and the traditional Bell companies and larger independent telephone companies on the other, has not come to pass. Instead, it is robust and well-funded competition from wireless, cable companies, and new technology providers such as those using voice over internet protocol (VoIP) platforms that have made significant and demonstrable inroads to the ILECs’ traditional wireline service offerings.

New telecommunications providers, be they wireless companies, cable TV providers, or VoIP companies, typically offer end users compelling service alternatives at affordable prices that are often broader in scope than the services typically offered by local telephone

²⁴ A copy of the report in Docket UT-980311 is available on the Commission’s website at www.utc.wa.gov.

²⁵ Senate Bill 5811, 56th Legislature, 1999 Regular Session.

companies. Additionally, wireless service providers offer voice and data communications services using advanced networking technologies that provide mobility to Washington consumers. Cable TV providers offer end users a suite of services that add voice service and broadband internet service on top of highly valued video entertainment services that, in many respects, “glue” an end user to a bundle of services.

While these competing services are distinct end user alternatives from those typically offered by traditional telephone companies, they rely, in varying degree, on the infrastructure that has been historically provided and managed by traditional local telephone providers. As an example, when a wireless customer places a call using a cellular phone, that call uses not only the cell tower and wireless antennas provided by the cellular company, but also high capacity circuits and possibly switching resources owned and maintained by traditional incumbent telephone companies. When a cable company’s customer places a voice call, if that call is destined for an end user who subscribes to a traditional telephone company, the call must traverse assets owned by the cable provider and then be interconnected to assets owned and maintained by a traditional wireline telephone company. Therefore, while companies offering communications services over newer technologies compete vigorously with traditional telecom providers for end user revenues, they must, at some level and in varying degrees, purchase services from an underlying local telephone company to provide reliable service to their end users. And while new service providers either lease or interconnect with assets owned by traditional phone companies, the relationships between these new providers and traditional wireline companies are not governed or regulated in the same manner as the relationship between local and traditional long distance providers. These marketplace changes pose significant competitive challenges for the WITA companies, particularly its smaller members that do not have the economies of scale and scope of operations associated with Washington’s larger carriers to respond effectively to the new service providers and their bundled service offerings.

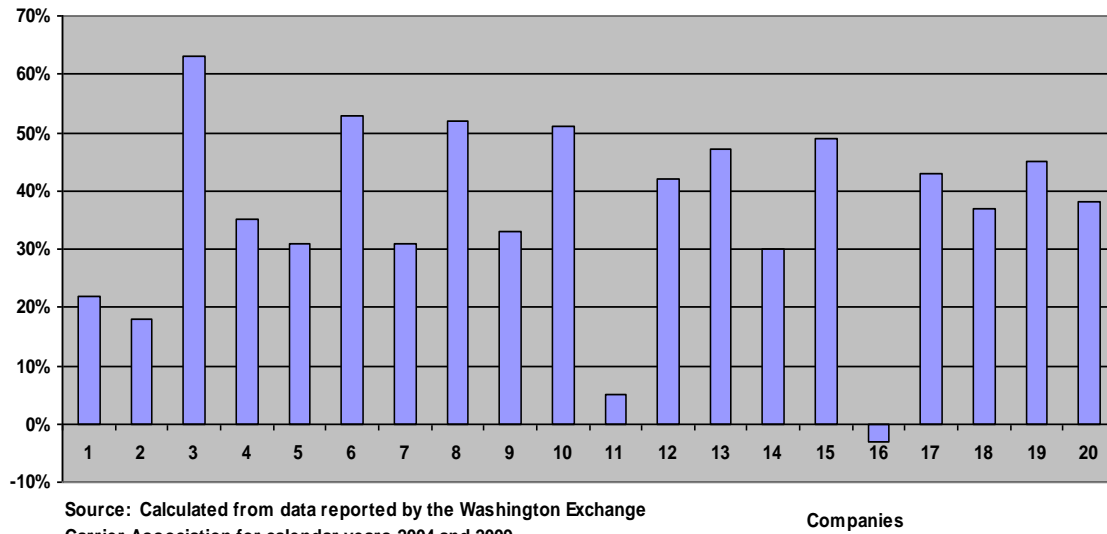
B. Weakening Revenue Streams

The narrowband voice services that ILECs provide in rural areas of Washington have been and continue to be supported by three principal revenue streams: (1) the local revenues derived directly from telephone consumers within their respective service areas, (2) interstate and intrastate access charge revenues, and (3) significant federal subsidy support from the FUSF.²⁶ All three “legs of the stool” are atrophying in varying degree. Access lines, the basic element of the carrier’s local revenue stream are declining, as consumers “cut the cord” and go wireless, eliminate second lines, or even switch to the competitive offerings of other wireline carriers such as the cable companies. Similarly, access revenues are declining as minutes, and the corresponding revenues associated with them, are shifted to other carriers and technological platforms. As traditional long distance services have shifted from conventional telecommunications technologies to new platforms such as VoIP, the access charge revenues that ILECs have historically enjoyed have declined. In fact, during the course of our proceeding, WITA companies provided tangible evidence surrounding the challenges facing their businesses, particularly the substantial declines in intercarrier compensation that its member companies are experiencing as a consequence of intercarrier compensation arbitrage, access avoidance (often referred to as phantom traffic), and dramatic declines in intrastate access charge usage as a result of minutes shifting to other technological platforms. Finally, the FCC may adopt measures that curtail the level of FUSF support historically enjoyed by rural ILECs.

Indeed, as demonstrated in Table 1 below, which was produced by WITA, it appears that the decline in intrastate access minutes – the basis upon which access charge revenues flow to the companies and are used to support their rural operations – is the most pressing issue facing these companies. Intrastate minutes have declined approximately 42 percent over the six year period (2004 – 2009).

²⁶ In addition, all but one of the ILECs in Washington receive revenue derived from intrastate access charge rate elements, including subsidy elements, approved by the Commission.

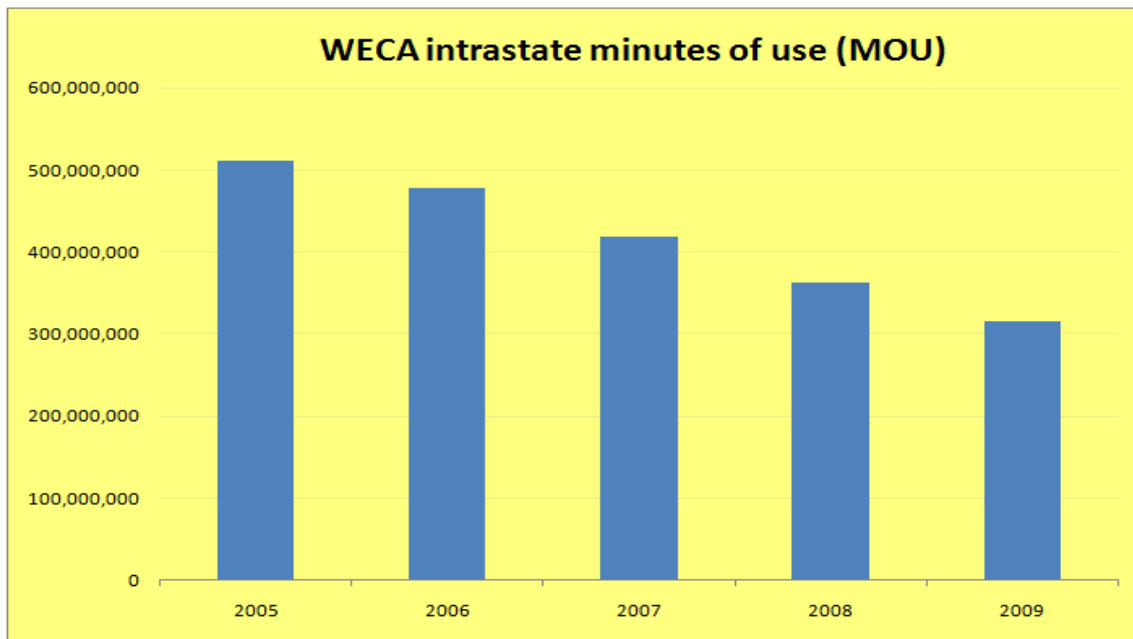
Table 1
 WECA Member Companies²⁷
 Percentage Intrastate Access Minute Loss
 Total Minutes (2004-2009)
 Average (All Companies): 42%



As Table 1 demonstrates, virtually all of the ILECs in Washington are experiencing declines in intrastate access usage, a result illustrated collectively in Table 2 below, which shows the overall decline in usage between 2005 and 2009 for all members of the Washington Exchange Carrier Association (WECA).

²⁷ All members of WITA, except for the company formerly known as Embarq, now part of Century Link, are members of the Washington Exchange Carrier Association (WECA). WECA members include all ILECs in Washington except Qwest, Frontier, and Embarq. For reasons of confidentiality, WITA assigned numbers to each company rather than providing the company's name.

Table 2
Total Intrastate Access Minutes of Use
WECA Members



Source: WECA annual filings.

Although there are a variety of factors that are challenging the ILEC’s business models, it is the substantial and accelerating reduction to their intrastate access charge revenue streams that became the focus of discussion during our workshops.

C. Potential Impact of the National Broadband Plan on the FUSF

As discussed above, the FCC contemplates a substantial overhaul for the FUSF as a consequence of the nation’s shifting priority to support of broadband services and implementation of the NBP. On April 21, 2010, the FCC released a Notice of Inquiry (NOI) and companion Notice of Proposed Rulemaking (NPRM) regarding use of an elaborate computer model to help determine universal service support levels in areas where there is no private sector business case to provide broadband and voice services. The NOI also seeks comment on the best way to create an accelerated process to target funding toward new deployment of broadband networks in unserved areas as the FCC considers development of new rules to implement fully a new Connect America Fund (CAF) funding mechanism that

would be aimed at ensuring universal access to broadband and voice services. The accompanying NPRM seeks comment on specific reforms to cap growth and cut inefficient funding in the FUSF and to shift certain savings associated with the revisions toward support of broadband service. The Commission understands that other FCC initiatives, in the form of additional NOIs and NPRMs aimed at reform of the FUSF, may be issued prior to the end of this year.

III. Overview of Commission Inquiry and Workshop Process

In response to the request from legislators, the Commission convened three workshops to address the issues we were requested to address.

A. First Workshop

The first workshop took place on May 5, 2010, at the Commission's office in Olympia, Washington. Three panels were convened consisting of senior-level representatives from small or predominantly rural ILECs, larger ILECs, and wireline-based competitors that have significant telecommunications operations in Washington.²⁸ The panels and their participants were:

Universal Service – Rural Company Perspective

- Bob Debroux, Director Federal Affairs and Public Policy – TDS Telecom
- John Jones, Vice President State Government Affairs – CenturyLink
- Robert Smith, Director of Government Relations and Regulatory Affairs – Kalama and Tenino Telecom

Universal Service – Large Provider Perspective

- Joel Lubin, Vice President – Public Policy, AT&T
- Steve Davis, Senior Vice President, Public Policy and Government Relations, Qwest Communications

²⁸ The presentations by panel participants are available from the Commission's website at www.utc.wa.gov/100562.

Universal Service – Wireline Competitor Perspective

- Michael Pelcovits, Industry Consultant Comcast
- Greg Kopta, Attorney, Davis Wright Tremaine – Competitive Local Exchange Carriers
- Doug Denney, Director Costs and Policy – Integra Telecom

Additionally, the Commission was fortunate to receive a comprehensive presentation from Ms. Carol Matthey, Deputy Chief, Wireline Competition Bureau of the FCC. Her presentation provided a sweeping overview of the FCC's National Broadband Plan including likely proceedings and issues her agency will be dealing with over the next few years as federal policy shifts from narrowband voice services to a broadband environment.

Finally, Mark Vasconi of the Commission Staff provided a detailed overview of existing state universal service mechanisms.²⁹

B. Written Comments – Questions Concerning Appropriate Universal Service Policies in Washington

At the close of the first workshop, interested parties were informed that the Commission would be releasing a set of questions regarding the various issues raised by presenters. On May 26, 2010, the Commission issued a notice inviting responses to 16 policy questions and providing for two rounds of written comments (direct and reply) prior to the second workshop. The questions posed by the Commission are included as Appendix 4. The Commission made available to workshop participants a summary of the direct and reply comments provided by interested parties.³⁰ Not surprisingly, the responding parties did not agree on the need for and potential structure of a state universal service fund. Those likely to be able to receive financial support encouraged the Commission to recommend a fund. On the other hand, those likely to be required to pay into a fund were generally opposed or would only support a fund as a last resort. Even then, their support was conditioned upon a finding by the Commission that potential recipients of fund dollars were of actual need of such support. Such need would have to be determined only after significantly scrutiny had

²⁹ A copy of Mr. Vasconi's presentation is attached to this report as Appendix 3.

³⁰ This summary is available on the Commission's web site at www.utc.wa.gov/100562.

been applied to the financial conditions of the fund's potential recipients, including an analysis of other funding avenues.³¹

C. Second Workshop

The Commission conducted a second workshop on July 27, 2010, at which a panel of the following representatives for wireless carriers presented their views on state universal service policies:

Universal Service – Wireless Carrier Perspective

- Dave Conn, National Director – State Regulatory, T-Mobile USA
- Pete Sywenki, Director – Government Affairs, Sprint Nextel Corporation
- Milt Doumit, Vice President – NW Governmental Affairs, Verizon Communications

The second workshop also focused on a specific proposal offered by representatives of WITA. That proposal, which eventually came to be known as the WITA Concept Paper (Concept Paper), reflected the establishment of a state universal service fund offering two funding approaches based on the relative size of the carrier seeking support.³²

The first funding approach would provide state universal service support to those ILECs serving fewer than 2 percent of the access lines in Washington. State funding would be available to them for the financial effect of reducing their intrastate access charges to interstate levels minus the calculated difference between their existing local rates and a statewide benchmark local rate the Commission would be authorized to proscribe at some point in the future.³³ To establish the financial need of these smaller carriers, WITA proposed a simplified earnings review³⁴ the Commission would conduct to determine eligibility for state funding.

³¹ Such funding sources could include: contributions from the federal universal service fund, wholesale revenues (if any), and increased local telephone service rates.

³² A copy of the Concept Paper is attached as Appendix 5.

³³ The Commission has not established such a benchmark for companies now receiving support. The benchmark's purpose is to set a price for basic telephone service for rural regulated telecommunications companies that is reasonably comparable to that paid by non-rural companies operating within the state.

³⁴ The term "simplified earnings review" was the subject of extensive discussion among interested parties and the Commission. Despite such discussions, at this time, there is no consensus regarding the scope of

WITA proposed a two-step approach for carriers serving more than 2 percent of the access lines in the state. Step 1 would require the Commission, presumably with the assistance of interested parties, to develop a “forward-looking cost model” to estimate the cost of providing service in high cost areas of the state. The total modeled cost amount would be offset by all revenues derived from “supported services” to determine an initial level of available state universal service funding. Step 2 is essentially the same as the approach proposed for the smaller carriers (i.e., those serving less than 2 percent of the access lines in the state). Carriers serving more than 2 percent of the access lines in the state would calculate the financial effect of eliminating the difference between intrastate and interstate access rates minus a local rate benchmark. Once determined, this amount would serve as a cap on any eligible amount determined pursuant to Step 1.

WITA also proposed, for both methods, a widening of the base of contributors that would be required to pay into any state universal service mechanism; relief from, or determination of continued carrier of last resort responsibilities, depending on whether the company received funds; establishment of certain narrowband and broadband service commitments; and formation of specific Commission rules to establish eligibility requirements, funding procedures, and enforcement abilities.

At the close of the second workshop, the Commission asked WITA to consider the feedback it received from interested parties and make adjustments to its Concept Paper, and submit a revised version, if any, to be subject to written comment prior to our third and final workshop.³⁵

the process and the manner in which it would be conducted. As discussed in Section IV. B. 4, the Commission believes that eligibility for any state fund, should one be established at some point in the future, would require considerable examination of a number of financial matters of the companies seeking to participate in the fund.

³⁵ As noted above, the latest version of the Concept Paper is attached to this report as Appendix 5. A complete description of the WITA Concept Paper is presented in Appendix 6 and a summary of the written comments of interested parties on the proposal is attached as Appendix 7.

D. Third Workshop

The Commission scheduled a third workshop to focus less on details of WITA's Concept Paper and more on possible areas of consensus. The purpose was to allow the Commissioners and interested parties to engage in a frank discussion regarding any possible conditions under which a new state universal service mechanism could be embraced. The result was such a frank exchange of views, but no consensus was reached, with interested parties generally holding fast to their initial positions either for or against establishment of a state universal service fund.

IV. Policy Options and Recommendations

A. Initial Commission Observations

The substantial and accelerating reduction to ILECs' intrastate access charge revenue streams became the primary focus of the universal service discussions that occurred during the Commission's workshops. The issue served as the focal point for WITA and AT&T's contention that immediate action is required to address the declining financial condition of rural ILECs. During the course of our proceeding, WITA provided a specific proposal to shore up the revenues associated with intrastate access so that recipients of state funding could better maintain and operate the telecommunications network facilities through which they meet their carrier of last resort responsibilities, an approach they contend embodies the preservation of universal service. In essence, the proponents of change advocated reducing intrastate access charges, creating a state universal fund to make up the difference (offset by a statewide local service rate benchmark), and passing potential savings to Washington consumers in the form of lower long distance rates. Before assessing the WITA proposal or the range of policy options available to us, we believe several preliminary observations are warranted.

First, the policy approach we support here must recognize that lower rates are in the public interest and that rates in remote and rural areas should be reasonably comparable to those assessed on consumers in more dense urban areas of the state. Furthermore, we must strive to balance the inherent tension between the rates telecommunications carriers impose on each other for transporting and terminating calls and the rates that each carrier imposes on its own

end users.³⁶ It is this balance that has been challenged by the dramatic emergence of local exchange competition across multiple market segments. Furthermore, the goal of universal service has, by and large, become a reality, and our success in achieving this result has irreversibly affected the policy objectives we see for the future. The relationship between local rates and intercarrier access charges was originally defined by the financial support required to achieve the expansive goals of universal service. As telecommunication services are available to over 99 percent of the state's population,³⁷ we now face the task of maintaining the existing network while keeping local telephone rates affordable for customers.

Yet, high intercarrier compensation rates, such as intrastate access charges that have traditionally supported and promoted lower local telephone rates, particularly in the more rural and remote operating areas served by the WITA companies, are no longer sustainable. If we were to lower, or even eliminate intercarrier compensation rates, it would become necessary to require carriers to recover more of their ongoing investment and operating costs from their own end users, a condition that is clearly necessary in an increasingly competitive market. Thus, as competition supplants traditional monopoly-based delivery of telecommunication services there is a compelling need to revisit this balance, particularly the intercarrier compensation rates that competing companies impose on each other.

Second, given the genuine erosion in revenues associated with traditional local phone service and intrastate access charges, the Commission is sensitive to the ILECs' claim that if left unaddressed, a number of traditional telephone companies will, at some time in the future, be placed under financial duress which will likely limit their ability to maintain and invest in their telecommunications networks.

However, a number of stakeholders have argued that before the Commission recommends any specific course of action to the Legislature, the proposal must first involve a detailed examination concerning the true financial condition of each ILEC subject to our jurisdiction. They argue that such an examination should take into account new revenue streams primarily associated with high speed internet and video services which are not directly regulated by the Commission, and not just revenues associated with basic voice service. The extent to which

³⁶ We also appreciate the historical context in which some intrastate access rate elements were established as "interim" support mechanisms intended directly to support state universal service objectives.

³⁷ 2009 FCC Universal Service Monitoring Report, CC Docket 98-202, Table 6.9.

these additional revenues have offset, in whole or in part, the weakening condition of their basic business is unclear at this point in time. Although WITA has presented the Commission with a snapshot of its member's revenue streams and overall financial condition, only certain aspects of their members' revenue streams and costs were represented in WITA's disclosures. As discussed in Subsection B.4 below, the Commission believes the process for determining actual financial need entails a thorough and comprehensive review of a company's revenues and costs in some fashion. The Commission is prepared to devote its resources to accomplish this task in a transparent and deliberate manner. Until this objective is accomplished, the Commission is reluctant to recommend a state universal service fund. Moreover, recognizing that telecommunications consumers already face a myriad of fees, taxes, and other surcharges on their monthly bills, we would not endorse yet another potential line item that is difficult to explain or even justify to consumers. Accordingly, as articulated below in the discussion of various options, the Commission concurs that, for several of the options discussed, a more detailed review of the companies' books and records (including all revenues and costs) would be warranted.³⁸

Third, from the Commission's perspective, potential state universal service policy options range from maintaining the "regulatory" status quo to developing an explicit Washington Universal Service Fund (WUSF). The latter is an approach which could, at its extreme, compensate incumbent telephone companies for revenues lost due to further reductions in access charges as well as for the more extensive revenue reductions associated with competition from new providers using newer technology platforms. Regardless of which option is embraced, it is indisputable that significant marketplace developments are challenging the existing environment in which Washington's incumbent telephone companies operate. However, the Commission strongly believes that any changes to state universal service policy that we embrace must take into account such evolving conditions. Furthermore, any specific actions we would recommend must seek to minimize possible marketplace distortions that could occur if users of one relatively new technology platform (e.g., wireless or VoIP) are required to assist another technology platform such as wireline service offered through traditional telecom providers.

³⁸ As part of our proceeding, WITA provided some general financial information to Commission Staff regarding the apparent financial condition of each of its members as a means to demonstrate, from their perspective, the deteriorating revenue streams to their companies.

Finally, we note that although the changes taking place in the telecommunications market have affected all incumbent telecommunications providers in Washington, the highest risk to universal service is borne by those smaller rural telephone companies that have experienced dramatic declines in access charge revenue. While Washington's larger telecom companies that serve both urban and rural locations are not immune to this risk, their deeper financial resources and more varied customer base and range of service offerings mitigates the risks posed to such companies by marketplace developments.

B. The Range of State Universal Service Policy Options

Given all these considerations, we turn to the policy options that we see as arising from our workshops. They are:

- 1) Maintain the status quo;
- 2) Require flash-cut or phased-in reductions of intrastate access charges to interstate access charge levels;
- 3) Undertake selective examination of ILEC earnings for potential reductions to intrastate access charges;
- 4) Create a targeted state universal service fund, with rigid funding criteria and of limited duration, for the transitional support of voice services; and
- 5) Create a broad state universal service fund that would support voice services for all ILECs serving rural areas of Washington, and which could be transitioned to support broadband services at some point in the future.

1. Maintain Status Quo

In maintaining the status quo, no state universal service fund would be established, intrastate access charges would not be reduced to interstate levels, and WITA's member companies likely would continue to experience declining intrastate access charge revenues as intrastate long distance minutes continue the pattern of erosion. As is true today, any WITA company would have the option of petitioning the Commission to establish a new revenue objective (i.e., intrastate access charge revenue target) based upon its current costs and intrastate access minute volumes. If a company were to proceed down this path, the Commission would continue its practice of conducting moderate earnings examinations including, a review of the ILECs' jurisdictional financial condition in order to determine their proper intrastate revenue objective and resulting intrastate access rates. Given that intrastate minute volumes

have declined by approximately 42 percent since 2004, it is likely that intrastate access rates would increase above current levels, which would, in turn, increase interexchange carriers costs, and could lead to an increase in intrastate long distance rates. In today's competitive telecommunications environment, a company subjects itself to increased competitive pressures when it raises rates. Loathe to provide such an advantage to its competitors, companies have not sought increases to basic rates in order to minimize the current trend of consumers to migrate from the ILEC to competitive alternatives to place intrastate long distance calls. The WITA companies' collective failure to address access charge declines by increasing their customers' rates is one of the chief criticisms expressed by other parties.

The WITA companies have known for a considerable time that the dynamics of an increasingly competitive local telephone exchange marketplace could jeopardize their historical role in delivering rural telecommunications services. Despite this, none of the WITA members has filed tariff revisions, or initiated a proceeding before the Commission, to address specifically the imbalance that exists in their intrastate rate structures (i.e., by seeking to decrease intrastate access charge rates and increase local rates to statewide or more market-based levels).³⁹ This apparent hesitancy or disinterest in proactively addressing some of the financial challenges associated with their businesses may imply that company revenues were sufficient to meet costs, plus provide a sufficient return on investment. Said another way, one can surmise that the benefits of maintaining the status quo outweighed the risks associated with seeking rate relief. At least for some companies, this calculation today leads them to propose a new course of action.

³⁹ In this vein we also note that, other than Qwest, no Washington ILEC has availed itself of existing opportunities under state law to pursue and establish an alternative form of regulation (AFOR) plan according to RCW 80.36.135, or sought to obtain competitive classification for its telecommunications operations or services pursuant to RCW 80.36.310 – 330. The Qwest proceedings involving these provisions of state law are:

- (1) Docket UT-000883, Competitive Classification of Business Services,
- (2) Docket UT-021257, Competitive Classification of Digital Switched Service, Integrated Digital Switched Network Services, and Uniform Access Solution,
- (3) Docket UT-030614, Competitive Classification of Basic Business Exchange Telecommunications Services,
- (4) Docket UT-050258, Competitive Classification of Digital Business Switched and Private Line Services,
- (5) Docket UT-061625, Petition of Qwest Corporation For an Alternative Form of Regulation Pursuant to RCW 80.36.135.

On a related point, the prospect of the status quo would encourage existing long distance providers to continue to file formal complaints against one or more ILECs to reduce intrastate access charges. Interestingly, successful complaints would likely result in increases to consumer rates – a form of “rate rebalancing” we describe below. This type of action was used recently and aggressively by Verizon in a formal complaint filed against Embarq in 2008.⁴⁰ That matter was resolved pursuant to Commission approval of a settlement agreement among Verizon, Embarq, and other interested parties under which Embarq agreed to a phased-in reduction of its intrastate access rates through 2012. Embarq, subject to a rate freeze expressly negotiated in its merger settlement, did not seek to rebalance its consumer rates to recover its access revenue shortfall. In an earlier proceeding, AT&T brought a similar action against Verizon, which resulted in a \$32 million decrease in Verizon’s intrastate access revenues. This decision was followed by a rate case filed by Verizon to recover in part the lost revenues. This case eventually settled for \$39 million, with customer rates increasing by \$3.90 per month for most residential and business customers according to a two-year phase in period.⁴¹ While a case-by-case review of access charges would eventually result in access charge reform, the process would take much longer to accomplish, is less straightforward from a policy standpoint, and would not provide the timely resolution of the imbalance issues facing the smallest companies most likely in need of assistance.

2. Lower Intrastate Access Charge Rates to Interstate Levels

This option would require all WITA companies to reduce their intrastate access charges to interstate levels, either immediately or over a prescribed period in order to phase in the effects of the reductions. The Commission possesses the statutory authority to order such a result.⁴² To make up for lost access revenues, the Commission would establish a

⁴⁰ See *Verizon Select Services, Inc.; MCIMetro Access Transmission Services, LLC; MCI Communications Services, Inc.; Teleconnect Long Distance Services and Systems Co. D/B/A Telecom USA; and TTI National, Inc. v. United Telephone Company of the Northwest*, Docket UT-081393, Complaint to Reduce Intrastate Switched Access Charges, filed July 25, 2008.

⁴¹ See *AT&T Communications of the Pacific Northwest, Inc. v. Verizon Northwest Inc.*, Docket UT-020406, Eleventh Supplemental Order, Order Sustaining Complaint, Directing Filing of Revised Access Charge Rates (Aug. 12, 2003).

⁴² See RCW 80.04.110, which empowers the Commission to review and set rates charged by telecommunications companies not classified as competitive carriers. Also, pursuant to RCW 80.36.140, the Commission has full authority to proceed on the basis that any particular company's practices

“benchmark” local exchange rate, along the lines of the benchmark proposal set forth in the WITA Concept Paper, and order those WITA companies whose local service rates are below the “benchmark” to increase their local rates to recover part of the revenues lost through the reduction in intrastate access rates. While this type of two-part movement, lowering intrastate access rates and increasing rates on local lines, could equalize intrastate and interstate access charges and require that local service customers in rural areas shoulder more of the costs associated with local exchange service, it could still result in a “gap” relative to revenues currently received through the combination of intrastate access charges and local rates. Recovery of any remaining revenue gap would be left to each ILEC through further expansion into new non-regulated lines of business or through further price increases on regulated and/or non-regulated services already offered by the ILECs.

To accomplish the rate revisions contemplated by this policy option, the Commission has two procedural alternatives. First, it could adopt revisions to the rule governing terminating access charges, WAC 480-120-540, or otherwise promulgate new rules in furtherance of the pro-competitive goals of the state telecommunications act of 1985⁴³ and the 1996 Act by setting industry-wide requirements applying to intrastate access charges, particularly terminating access charges. This result would be consistent with the authority the Commission exercised, and that the courts upheld, when the Commission initially adopted WAC 480-120-540.⁴⁴ Second, the Commission could effect the same result by filing complaints against the WITA companies, individually or collectively, to reset any excessive access charges even if they had been established in accordance with our existing rules.

3. Selective Examination of Certain ILECs for Potential Reductions of Intrastate Access Charges to Interstate Levels

As with Policy Option 2 above, using existing authority pursuant to RCW 80.36.140, and without the need for further legislative authority, under Option 3 the Commission would selectively initiate earnings investigations of each rural ILEC, and, upon a showing of need, reduce intrastate access rates while increasing local service rates to compensate for all or part

affecting rates, including intrastate access rates, are unjust, unreasonable, discriminatory, preferential or in violation of law

⁴³ Chapter 450, Laws of 1985.

⁴⁴ WITA, 148 Wn.2d 887 (2003).

of the access revenue reduction. This type of action would, effectively, be a targeted variant of Policy Option 2 above that would focus only on specific companies, examined independently from one another and performed sequentially, such that once the examination of one company is completed, examination of another could begin. The Commission believes that under this approach, intrastate access charges could be reduced to interstate levels on a company-by-company basis over a three to five year period.⁴⁵

4. Targeted Washington Universal Service Fund

Under this policy option, the Commission would oversee a limited universal service fund to be created by the Legislature⁴⁶ that would be targeted to those ILECs currently serving less than 2 percent of the total number of lines in the state and which are deemed to be earning less than their authorized revenue requirement. The fund would compensate the ILEC for reduced access revenues after increasing local service rates to a “benchmark” but would not make the ILEC “whole” relative to its overall shortfall relative to its total intrastate revenue requirement.

The fund would be directed solely to support existing voice services currently offered by qualifying ILECs in order to give such companies and their customers a reasonable period of time to embrace the impending transition to a broadband era. It would serve as a transitional mechanism during which ILECs could make the investments and operational adjustments necessary to further develop their networks and pursue business objectives and opportunities. From its inception, the funding mechanism should expire in no more than five years. To determine the appropriate level of support, the Commission would conduct a detailed earnings examination, including a review of the financial impact of reducing intrastate access rates to interstate levels. If a “qualifying condition” regarding insufficiency of earnings is met, funding would be available. However, support would be limited to the revenue gap resulting from lowering intrastate access rates to interstate levels, so long as the funding recipient has increased local service rates to a Commission-determined statewide local service “benchmark” rate. In other words, if a small ILEC is not achieving its revenue

⁴⁵ We note that existing Commission Staff workload issues on other proceedings as well as current budgetary restraints including scheduled mandatory layoffs of Commission employees could affect the pace at which individual company reviews could be conducted.

⁴⁶ This approach would trigger the provisions of RCW 80.36.600 and RCW 80.36.610 requiring legislative approval before it could be implemented.

requirement after reducing intrastate access rates and increasing local service rates to the prescribed benchmark, then that company would be eligible to receive an amount sufficient to recover the revenue lost from reducing its access charges. It could not, however, use the fund to recover the total deficiency relative to its overall revenue requirement.⁴⁷

The fund would be financed through an explicit surcharge assessed on each retail customer's monthly telephone bill, regardless of the type of provider. The surcharge could represent a percentage of intrastate revenues or an assessment per line. Should the assessable base expand from wireline telephone customers to include every working telephone number in use in Washington regardless of technology (i.e., wireline, wireless, and VoIP), the assessment per retail customer would drop considerably.⁴⁸

At this juncture, it is premature to state definitively the total funding requirement for this option.⁴⁹ To make this determination, the Commission would have to establish a benchmark for local service rates and determine the scope of the surcharge (i.e., wireline users or all telephone numbers in use for wireline, wireless and VoIP services). However, written comments submitted by AT&T on September 17, 2010, provide a useful estimate on the size of such a fund depending on the local service rate "benchmark" adopted by the Commission. Specifically, AT&T estimates the fund size to range between \$2 million per year, using a local rate benchmark of \$22.00 per line, to \$5.6 million per year using a benchmark rate of

⁴⁷ As an example, if a small ILEC (i.e., a company that serves less than 2 percent of the access lines in Washington) was under earning its revenue requirement by \$1,000,000 prior reducing access charges, the ILEC would be eligible for WUSF payments. However, the payment from the WUSF would not be \$1,000,000. Instead, the payment to the ILEC from the WUSF would be the amount of revenue lost as a consequence of lowering its intrastate access rates to interstate levels while also increasing local service rates. Regardless of the fact that an ILEC was earning below its intrastate revenue requirement by \$1,000,000, if the reduction in access rates to interstate levels forced a drop in revenues of \$800,000 while its increase in local service rates generated \$200,000, this option would only entitle the ILEC to seek recovery of the net revenue "gap" of \$600,000, not the overall deficiency of \$1,000,000.

⁴⁸ The FCC recently adopted a Declaratory Ruling allowing state commissions to require providers of nomadic VoIP services to contribute to state universal service funds so long as any state requirements are consistent with federal law and policy. *In the Matter of Universal Service Contribution Methodology, Petition of Nebraska Public Service Commission and Kansas Corporation Commission for Declaratory Ruling or, in the Alternative, Adoption of Rule Declaring that State Universal Service Funds May Assess Nomadic VoIP Intrastate Revenues*, WC Docket No. 06-122, Released November 5, 2010.

⁴⁹ Without knowing the actual size of the fund, the Commission cannot state the customer surcharge necessary to finance the fund.

\$16.00 per line per month.⁵⁰ As there are approximately 2 million wireline telephone customers in Washington, the annual surcharge could range from \$1.00 - \$2.80 per customer. Rounded up, the monthly charge could range from \$.10 and \$.25 per customer. While AT&T's estimates are helpful, the approximate size of the fund and the related customer surcharge will require significantly more analysis by Commission Staff and industry participants.

Should the Legislature direct the Commission to pursue this policy option, the Commission would engage in one or more rulemakings to define the mechanics for determining the size of the fund, the type and amount of a retail customer surcharge, and the specific procedures necessary for full and impartial administration of the fund. Further, the Legislature could direct the Commission to pursue one of two possible approaches. First, the Legislature could authorize a fund of no more than a predetermined size, reflecting a maximum level that would be available to eligible companies after satisfaction of the access charge and local rate change procedures set forth above. Alternatively, rather than creating the fund immediately, the Legislature could require the Commission to conduct the detailed analysis to determine the appropriate size of the potential fund before it is created. The Legislature could enact legislation that would direct those companies with fewer than two percent of the access lines in the state to provide all relevant financial and operational information the Commission deems necessary in order to review their earnings for the specific purpose of determining which companies would be eligible to receive monies from a state fund and to determine the overall size of a fund. The Commission would then present that information, and a proposal for a specific size of fund, for approval in a subsequent legislative session. Assuming full cooperation of the companies subject to the earnings examinations, the Commission believes that sizing of the fund could be completed no later than October 1, 2012, followed by a concrete fund proposal during a subsequent legislative session.

⁵⁰ See, AT&T Comments on Washington Independent Telecommunications Association USF Concept Paper, Docket UT-100562, at 6-7 (September 17, 2010).

5. Comprehensive State Universal Service Fund

Unlike the targeted universal fund discussed in Option 4 that would be used solely to support voice services offered by small ILECs, a more comprehensive state universal service fund could be established to support the services offered not just by the small rural ILECs, but also by larger ILECs and their competitors, including the delivery of broadband service.

Currently, expanding wireline-based broadband services in rural Washington is challenging because of low population density, high development costs and relatively low adoption or “take” rates. When combined, these factors effectively limit broadband services to those areas of the state where broadband investments provide an opportunity for cost recovery plus a reasonable return on invested capital. As broadband is a competitive service not subject to economic regulation, it is apparent that market forces have operated to exclude customers located in remote regions of the state or even those who live some distance from towns in rural Washington. The Commission’s experience with expanding the broadband services of certain ILECs⁵¹ provides a glimpse into the significant capital necessary to build broadband capacity in rural Washington.⁵² Although the cost and subsidy issues are significant, perhaps

⁵¹ See *In the Matter of the Joint Application of Embarq Corporation and CenturyTel, Inc. for Approval of Transfer of Control of United Telephone Company of the Northwest d/b/a Embarq and Embarq Communications, Inc.*, Docket UT-082119, Order 05, Final Order Approving and Adopting Settlement Agreement (May 28, 2009) (approving a settlement agreement requiring Joint Applicants (CenturyTel and Embarq) to expand broadband to an additional 2,200 households within the Embarq service area over a three year period following the close of the merger); *In the Matter of the Joint Application of Verizon Communications, Inc., and Frontier Communications Corporation for an Order Declining to Assert Jurisdiction Over, or, in the Alternative, Approving the Indirect Transfer of Control of Verizon Northwest, Inc.*, Docket UT-090842, Order 06, Final Order Approving and Adopting, Subject to Conditions, Multiparty Settlement Agreements and Authorizing Transaction (April 16, 2010) (approving a settlement agreement requiring Frontier Corporation to spend at least \$40 million on broadband deployment in Washington in order to deploy broadband service to no less than 95 percent of its Washington wire centers within two years of closing of the transaction and to approximately 89 percent of the households within the existing footprint of the Verizon NW service area by December 31, 2014).

⁵² The Commission is not aware of any estimates of cost to build broadband capacity throughout the state, however the FCC recently estimated that the cost of addressing the broadband “availability gap” (defined as the difference between the capital and operational costs of expanding the reach of broadband service to all Americans minus the available broadband revenues is approximately \$24 billion nationwide. See National Broadband Plan, *supra* note 13 at 137.

the most complicated and controversial challenge would be deciding which companies would be permitted to draw from such a fund. The questions raised in our proceeding include:

- Would any carrier interested in serving the high cost area in question be allowed to tap the fund?
- Should access to the fund be restricted to existing ILECs, no matter what size?
- What if two or more providers seek funding for the same area?
- Is it good public policy to promote competition in areas that the free market has selected to ignore?
- Is it good public policy to encourage significant investment (cost) to reach a few customers in a certain area?
- What technology (e.g., wireless, satellite, wireline, cable) should be favored or disfavored?
- Should a preference be given to the speed of service?
- Should a preference be given to the functionality inherent in the technology?
- Should the fund subsidize the subscriber's monthly charges, either explicitly (lower monthly bill) or implicitly (by providing support to a service provider for operation and maintenance costs)?

All of these issues and more would need to be addressed and settled before the Commission could recommend the Legislature implement this course of action.

Finally, as with Policy Option 4 above, establishing a comprehensive fund would require legislative approval for implementation. Similarly, payments into such a fund would be accomplished through an explicit surcharge assessed on each Washington retail customer's monthly telephone bill and the surcharge itself could be a percentage of intrastate revenues, an assessment per line, or an assessment to each wireline, cable, wireless and VoIP telephone number in use in Washington. For this policy option, the Commission believes the best approach would be to require those that seek to draw from the fund to pay into the fund.

C. Commission Recommendation

The Commission recognizes the need for a small and targeted universal service funding mechanism of a limited duration and subject to phase-out. From the materials provided by WITA, we can assume that the financial condition of some WITA companies is deteriorating and new funding would be necessary to support the provision of local telephone service in

the state's more rural and high cost areas. It appears particularly true for the smallest WITA companies (i.e., those companies that provide service to fewer than 2 percent of the total number of access lines in the state). However, given the paucity of information presently made available by WITA, the scope and scale of such a fund cannot be accurately determined. Therefore, the prudent course is to undertake a series of detailed earnings investigations of the fund's recipients to determine its approximate size before recommending that the Legislature authorize a specific state universal service program in accordance with RCW 80.36.600 and RCW 80.36.610. In essence our approach is a blended one reflecting aspects of Policy Options 3 and 4 above.⁵³

As to a state fund supporting broadband service, the Commission observes that while the National Broadband Plan is a comprehensive examination of the nation's broadband infrastructure and broadband needs, it reflects a dramatic shift in federal policy that has only just begun. Among other things discussed in the plan is the estimated nationwide cost of achieving universal availability of broadband service which, using public information and a complex cost model, an FCC task force estimated would cost approximately \$24 billion, net of the estimated broadband revenues that would be derived in such areas.⁵⁴ We certainly support the nation's shifting focus towards support for broadband service and recognize there will be significant challenges and opportunities for providers of broadband service, including those ILECs that currently serve rural and high cost areas of Washington. There may well be sources for substantial financial assistance for Washington rural telecommunications carriers as federal support mechanisms are revised.⁵⁵

Given the aspirations of the NBP, activities at the FCC, and the lack of information on Washington-specific broadband development costs in rural parts of the state, the Commission

⁵³ We do not recommend the approach set forth in the WITA Concept Paper. We recognize it was merely a "straw-man" proposal, and we appreciate the effort that WITA put in to that Paper. It was intended as a means to generate a meaningful discussion of an appropriate way forward, and, to this end, it was successful. Nevertheless, we do not support an approach that simply shifts the financial effect of access charge rate decreases to a state fund under the guise of supporting universal service. While we agree that intrastate access charges must be reduced significantly we are not persuaded a fund is absolutely necessary to achieve such reductions over the near term.

⁵⁴ We note that the FCC is now engaged in issuing various rulemaking proceedings that will eventually establish regulations and procedures that will support the goal of universal availability and the means to fund it; however, the process of adopting and implementing such rules is likely to be lengthy and involve numerous procedural and legal challenges before implementation.

⁵⁵ See note 15, supra.

believes it is prudent essentially to adopt a “wait-and-see” approach and move slowly with consideration of any comprehensive state universal service mechanism what would include support for broadband deployment as one of its objectives. Federal efforts may supplant or obviate any measures that the Legislature is asked to consider and may ultimately substantially fund broadband expansion through revised national funding mechanisms. Therefore, until there is more definition around the NBP and related FCC efforts, the Commission believes it is premature to establish a Washington fund intended to directly support broadband development in the state.