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ACCESS CHARGES, UNIVERSAL SERVICE, AND COMPETITION

by

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I. Introduction

In this paper, we examine switched access charges and universal service policies from an historical perspective and describe the interrelated nature of those two policies with each other and with the larger regulatory, economic, and competitive context in which they are embedded. We describe how incumbent local exchange carriers' (ILECs') basic residential local rates have been set below competitive levels to promote universal service and more generally to ensure "affordable" local service. The economic justification for such pricing is to stimulate demand by low-income customers and those living in high-cost areas. Local telephone service rates also reflect political pressures.[1]

Historically, basic local rates have been subsidized by a complex set of implicit subsidies—from toll to local service, from business to residential service, and from urban to rural areas. However, such subsidies are more difficult to sustain in a competitive market, yet they cannot simply be eliminated without finding another source of revenue support. Eliminating the implicit subsidies without establishing explicit mechanisms to recoup the lost revenues would pressure the ILECs to raise basic rates, cut back on service quality, or limit network investment (or some combination of these measures) especially in their less densely populated areas.

In Section II of this report, we summarize how internal subsidies from AT&T toll services to the local Bell Operating Companies (BOCs) were used to lower local rates within the former Bell System. We look at how these subsidies were replaced in part by carrier access charges and explicit subsidies via universal service funds, especially at the federal level. We also describe how access charges were rebalanced—that is, how the Federal Communications Commission (FCC) gradually reduced carrier access charges and increased monthly subscriber line charges (SLCs)—in response to competitive and legislative developments. We show how the FCC's rate rebalancing process unfolded over more than two decades.

In Section III, we explain how carrier switched access and universal service policies fit into the larger regulatory and economic setting of the telecommunications industry, and why a holistic

approach is needed to promote economic efficiency and competition. We conclude by showing that reducing carrier access rates without making the existing implicit subsidies explicit would harm competition and consumers.

II. History of Universal Service and Switched Access Charge Policies

The 1934 Communications Act created the FCC in order to regulate "interstate … communications … to make available, so far as possible, to all the people of the United States, a rapid, efficient, Nation-wide, and world-wide wire and radio communication service with adequate facilities at reasonable charges ...."[2] However, the 1934 Act prescribed no mechanism for doing so.[3] What evolved over the years was a complex web of implicit subsidies from long distance to local service, from business to residential, and from urban and suburban to rural areas. The breakup of the former Bell System, growing competition, and the Telecommunications Act of 1996 (1996 Act) have prompted replacing these implicit subsidies with more explicit ones, including those embedded in carrier access charges.

Universal service has been defined as "the provision of some set of basic local services to all customers at an affordable price … [or] making local telephone service available to all consumers at a reasonable cost …."[4] Which services should be covered by universal service policies and what is meant by an "affordable" or "reasonable" price have been controversial subjects. For purposes of this paper, we assume that the set of services is limited to basic local exchange telephone service.

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[1] For example, it is not necessary to keep rates below competitive levels for higher-income customers in rural areas; however, it would be politically difficult to raise rates in rural areas.

[2] Section 151 of the Communications Act of 1934, 47 U.S.C. § 151.

[3] Indeed, according to a June 1984 Congressional Budget Office Study, "Although the goal of universal does not specifically in the language of the … 1934 [Act], it is widely accepted. In its [1982] access charge decision, the FCC decided that universal service had existed for several years and the commission was responsible for ensuring that such service continued." U.S. Congressional Budget Office, "The Changing Telephone Industry: Access Charges, Universal Service and Local Rates," June 1984, p. 27.

[4] See P.W. Huber, Michael K. Kellogg, and John Thorne, *Federal Telecommunications Law, Second Edition*, Aspen Law and Business, Gaithersburg, New York, 1999, pp. 541–543 (Huber, Kellogg, and Thorne).

The economics literature generally recognizes that one purpose of a universal service policy is to correct for "network externalities." That is, all users benefit when another user is added to the network because each subscriber will be able to communicate with the added customer. The potential new user, however, compares the price he is required to pay only to his private benefits, ignoring the external benefits his subscription confers on other users. This is the theoretical basis for providing subsidies to consumers (such as low-income customers or those living in high-cost areas) who would not subscribe to telephone service at cost-based rates.[5] Since the value of a network increases with the number of customers on the network, economic principles provide some support for keeping basic local service somewhat lower than the level that would be set in a competitive market.

A. Evolution of Long Distance Carrier Access Charges, Subscriber Access Charges, and Interstate Universal Service Funding

As stated by the FCC, "[l]ong distance companies rely on the loops, switches and transport facilities of local exchange companies for access to their customers. As a result, [LECs] recover a portion of their costs from long distance carriers accessing their networks."[6] In this section, we describe how current switched carrier access charge policies and related policies have evolved.

According to Kaserman and Mayo, as long distance costs declined relative to local service costs in the first half of the 1900s, public policy makers decided to take advantage of those cost reductions to "promote the social goal of universal service" by lowering local rates rather than fully flowing through long distance cost savings via lower long distance charges.[7] In order to do this, a complex set of internal subsidies known as the "separations and settlements" process was created. "Under this system, a portion of local company costs was 'separated' out and assigned

[5] See, for example, Robert D. Willig, "The Theory of Network Access Pricing" *Issues in Public Utility Regulation*, H. Trebing, editor, Michigan State University Press, East Lansing, 1979; Jean-Jacques Laffont and Jean Tirole, *Competition in Telecommunications*, MIT Press, 2000.

[6] FCC, "Trends in Telephone Service, 2007," 1-1.

[7] David L. Kaserman and John W. Mayo, *Government and Business: The Economics of Antitrust and Regulation*, The Dryden Press, Harcourt Brace College Publishers, 1995 (Kaserman and Mayo). Moreover, according to Kaserman and Mayo, "Before the 1930s, local companies recovered all of their costs of providing these services through the rates they charged. Similarly, long-distance rates were set to recover the costs of long-distance service…. But, … the costs of long distance transmission fell sharply. In a competitive industry, the rate structure would have been driven to mimic the changing costs: Long distance rates would have fallen relative to local rates. Instead, within the closed (regulated monopoly) system it was believed that cost reductions in long distance service

to long distance services to be recovered through per-minute charges in AT&T's long distance rates …. AT&T would use the inflated revenues from long distance calling to 'settle' (subsidize) the local exchange companies."[8]

With the advent of competition for long distance services and the breakup of AT&T, internal revenue sharing (via separations and settlements) was no longer sustainable. Thus, the mechanism was to be replaced by carrier access charges as specified in the Modification of Final Judgment:

> As part of its obligation to provide non-discriminatory access to interexchange carriers …, each BOC shall begin to offer all interexchange carriers exchange access on an unbundled, tariffed basis … equal in type and quality to that provided to that provided … to AT&T and its affiliates.[9]
>
> ... Such tariffs shall replace the division of revenues process used to allocate revenues to a BOC for exchange access provided for the interexchange telecommunications of BOCs or AT&T.[10]

Accordingly, between 1982 and 1984 the FCC worked with a Federal-State Joint Board to replace the "historic method of sharing revenues … with a new system of access charges for [LECs] to charge long distance carriers for origination and termination of interstate traffic … [and] subscriber line charges (SLCs) …."[11]

The FCC's original decision would have greatly reduced cross-subsidies from interstate carrier access to local service by raising monthly end-user charges for telephone lines by about $1.00 each year over a five- to seven-year transition period. The reasoning behind the policy was that high-volume-business-long distance users were finding ways to avoid paying carrier access fees by bypassing the local switched network and connecting directly to the long distance companies' switches. However, "that decision evoked violent opposition from consumer advocacy groups,

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could best promote the social goal of universal service by shifting at least some of the savings to local telephone services."

[8] See Kaserman and Mayo, p. 597. As the authors point out, the separations process relied on a fully allocated cost process, which economists have shown to produce inefficient prices.

[9] Modification of Final Judgment (MFJ), Appendix B, Section A.1, August 24, 1982.

[10] MFJ, Appendix B, Section B.1.

[11] See FCC, "Trends in Telephone Service, 2007," pp. 1-2.

state regulators, and Congress, which forced the FCC to compromise."[12] The FCC agreed to a smaller SLC for residential customers and a slower reduction of carrier access charges. It also put into place a detailed monitoring plan that tracked telephone subscription rates in order to identify the possible effects of the SLC on the proportion of households subscribing to service. The reduction of carrier access charges and the subsidies implicit in those charges were linked with increases in the SLC. In addition, the policy was accompanied by the introduction and expansion of explicit universal service funding.

> Since local telephone companies were required to reduce their charges to long distance carriers—dollar for dollar—as SLCs were introduced, the pricing changes reduced the implicit subsidy from long distance use to local service.[13]

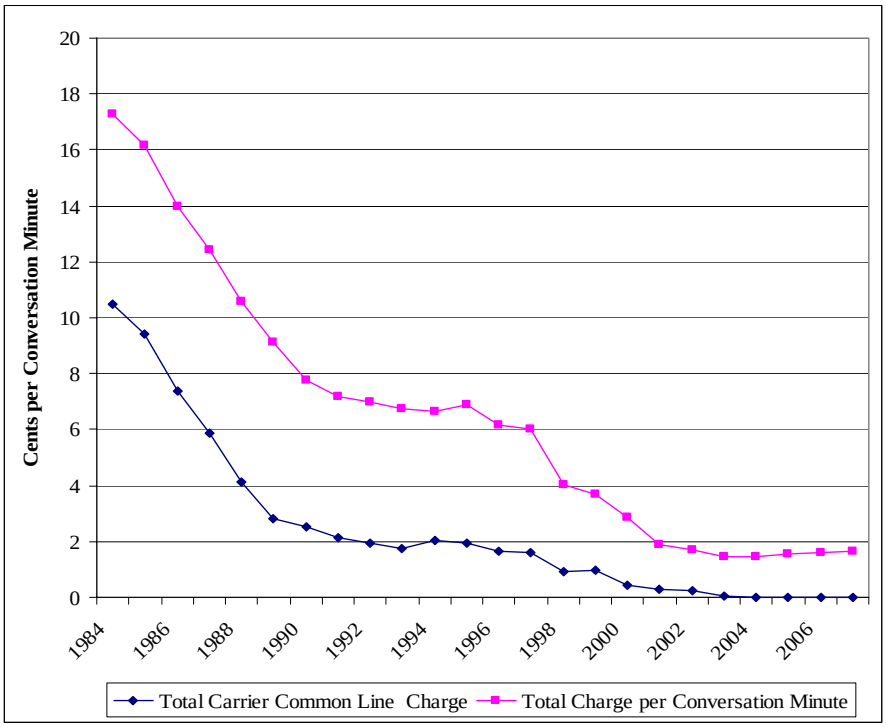
The process of rebalancing interstate rates—that is, reducing interstate carrier access charges and increasing subscriber line charges—took place over more than two decades.[14] This is illustrated in Figures 1 and 2 below.

[12] See Alfred E. Kahn and William B. Shew, "Current Issues in Telecommunications Regulation: Pricing," *Yale Journal on Regulation*, Yale Journal on Regulation, Vol. 4, Number 2, Spring 1987, pp. 196–197 (Kahn and Shew).

[13] See FCC, "Trends in Telephone Service," February 2007, pp. 1-2.

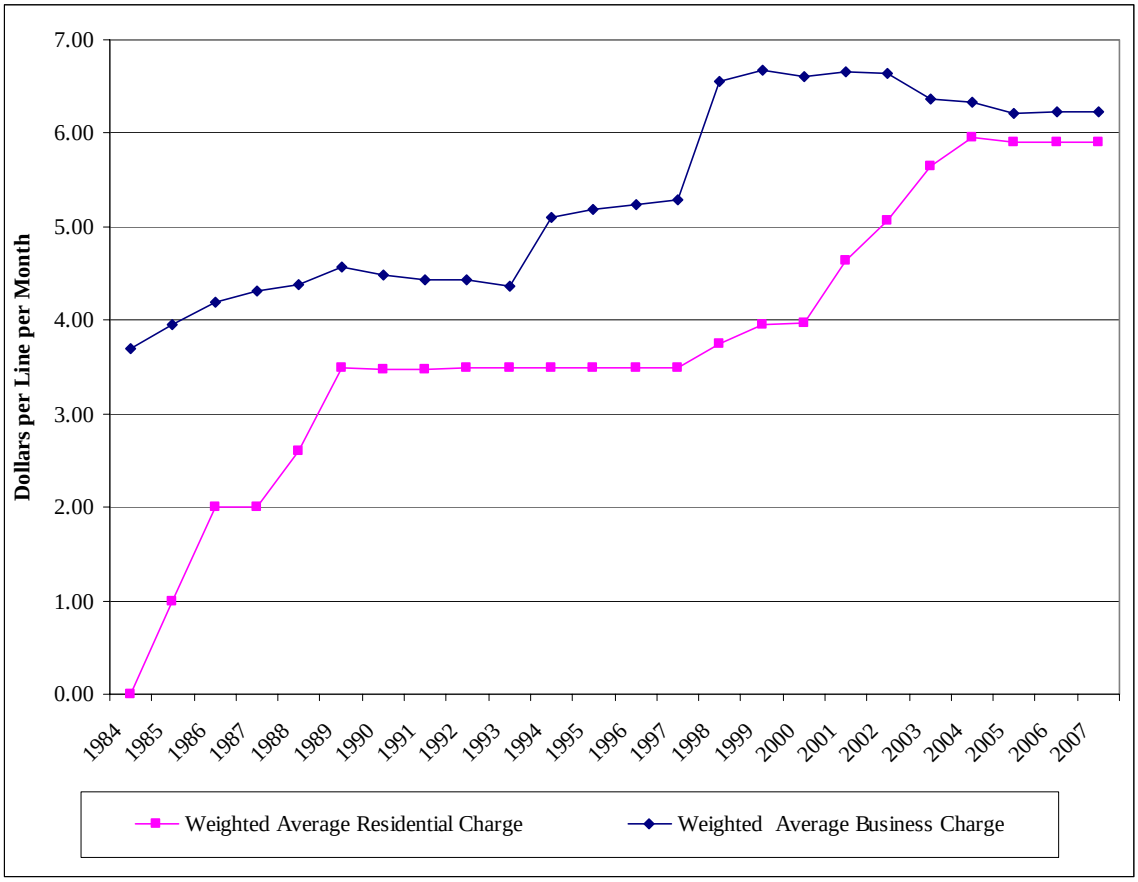
[14] This discussion and the data are based on FCC, "Trends in Telephone Service," February 2007, Tables 1.1 through 1.6.

Figure 1
Interstate Per-Minute Switched Carrier Access Charges
(1984 to 2001)[15]



[15] FCC, "Trends In Telephone Service," February 2007, Table 1.2.

Figure 2
Weighed Average Residential and Business Interstate Subscriber Line Charges
(1984 to 2007)[16]



The above graphs reflect the following changes in interstate access charges:

- Switched interstate carrier access charges per conversation minute were gradually reduced from about 17 cents in mid 1984 to about 8 cents in 1990 to 6 cents in 1997 to about 2 cents per-conversation minute in 2001 and remained at about that level through 2007.

- Multi-line business subscriber line charges of about $5 per line per month were initiated in 1984 and stayed within $0.50 cents of that level until 1996, then increased to about $7 per line per month in 1998, and gradually declined to about $6.30 in 2007.

- Residential and single-line business subscriber line charges were initiated at $1 in 1985, grew to about $3.50 per month in 1989, and stayed at that level through 2000; they gradually

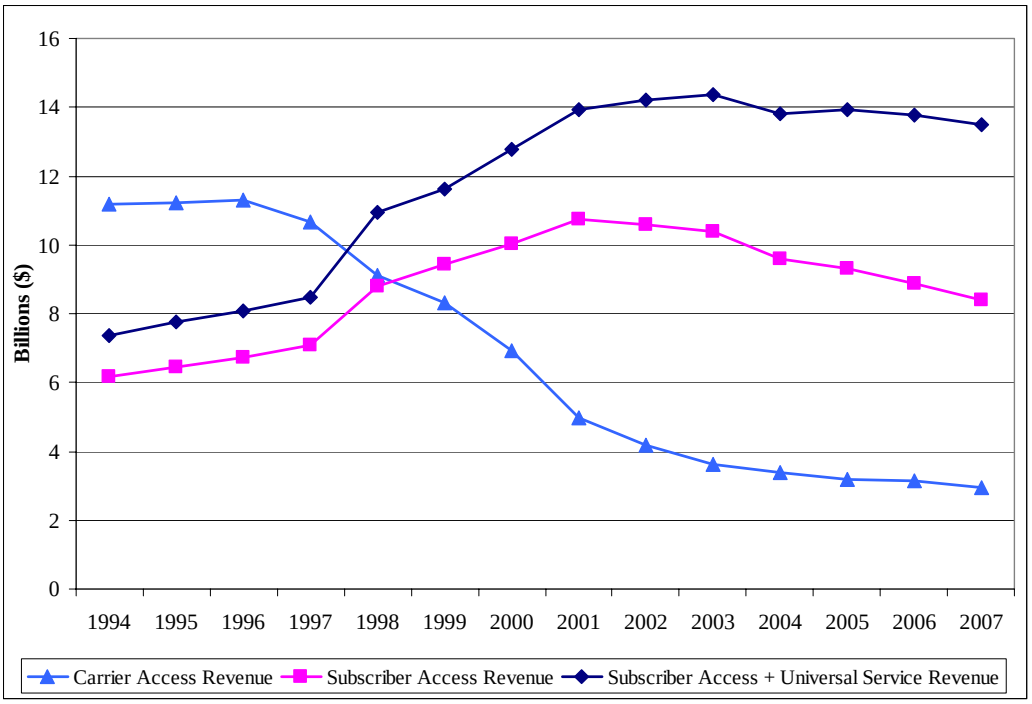
[16] See FCC, "Trends in Telephone Service," February 2007, Tables 1.1 and 7.4; FCC ARMIS Report 43-08, Table III. Note: The charge for a given year is as of June 30 of that year. Weights for residential lines (1984–1987) are estimated using an average from 1988–1990. Weights for business lines (1984–1990) are estimated using an average from 1991–1993.

increased to about $5 in 2002 and about $6 by mid 2007. Nonprimary line charges were initiated at about $5 per line in 1998 and rose to about $6 per line per month in1999 and stayed at about that level through 2007.

- As part of the process required by the 1996 Act to replace implicit subsidies with explicit subsidies for universal service, "[p]resubscribed interexchange carrier charges (PICCs) were created in order to allow local carriers to recover the remaining portion of their fixed loop costs from long distance carriers on a per-line, instead of a per-minute, basis."[17] The PICCs were implemented in 1998, but were phased out in 2000 since the SLC was increased from 2000 through 2005.

Figure 3 depicts trends in the revenues produced by the FCC's decisions to rebalance interstate switched carrier access and subscriber line charges and to enhance universal service funding pursuant to the 1996 Act.

Figure 3
Effects of FCC Access Charge Rebalancing and Universal Service Policies (1994 to 2007)[18]

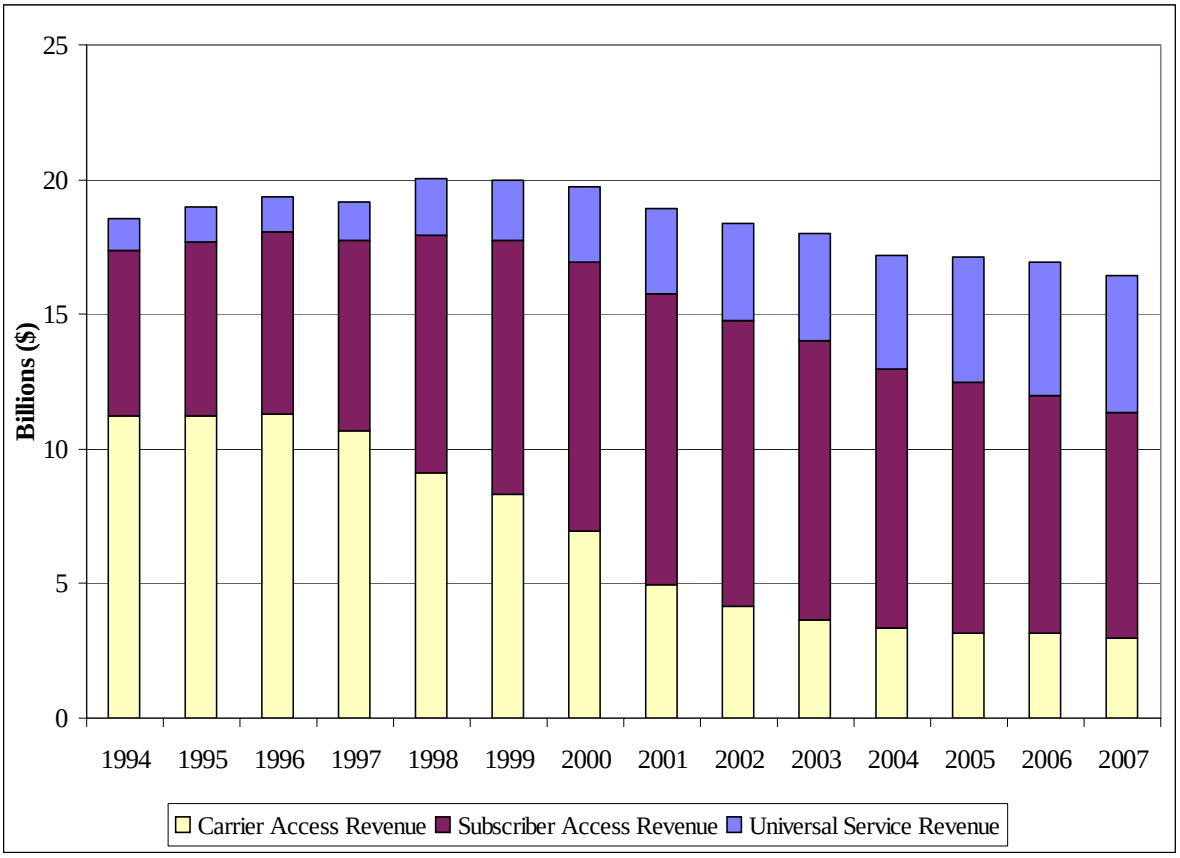


Source: FCC, "Trends in Telephone Service," February 2007, Tables 19.3 and 19.10.; FCC ARMIS Report 43-04, Table I, Rows 4010 and 4011 (Interstate).

[17] See FCC, "Trends in Telephone Service," February 2007, pp. 1-2.
[18] See FCC, "Trends in Telephone Service," February 2007, Tables 19.3 and 19.10.; FCC ARMIS Report 43-04, Table I, Rows 4010 and 4011 (Interstate).

Figure 4 shows that the reductions in switched carrier access charges received by ILECs were roughly offset by the subscriber access charge gains and universal service funding until subscriber line charge revenues began to decline in 2001 as the ILECs' line losses to intermodal competition began to intensify.

Figure 4
Effects of FCC Access Charge Rebalancing and Universal Service Policies
1994–2007[19]



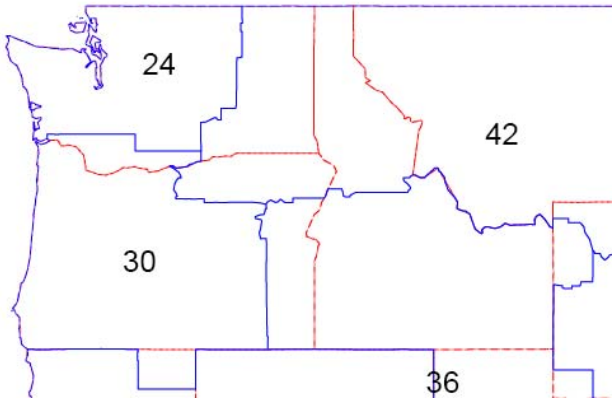
B. Interconnection Charges for Wireless Carriers

With one important exception, wireless carriers face the same rules as interexchange carriers (IXCs) for originating and terminating toll calls. The exception is that wireless carriers can avoid access charges on calls that would be toll calls on a wireline network because the FCC has

[19] Source: Universal Service Funding from FCC, "Trends in Telephone Service," February 2007, Tables 19.3 and 19.10; Access Revenues from FCC ARMIS Report 43-04, Table I, Rows 4010 and 4011 (Interstate). Note that access revenues reported in ARMIS exclude revenues of the smaller ILECs. Thus, the relative size of universal service funding is somewhat smaller than implied in this figure.

determined that wireless carriers are subject to the reciprocal compensation rules for calls within major trading areas (MTAs). "In the *Local Competition First Report and Order*, the Commission stated that traffic to or from a CMRS network that originates and terminates within the same Major Trading Area (MTA) is subject to reciprocal compensation obligations under section 251(b)(5), rather than interstate or intrastate access charges."[20] This is an important distinction because MTAs are quite large. For example, all of Washington is within the Seattle, Portland and Spokane-Billings MTAs (MTAs 24, 30 and 42) as shown in the following map.

Figure 5
Seattle, Portland and Spokane-Billings — MTAs 24, 30 and 42[21]



Furthermore, since mobile wireless carriers terminate calls to their subscribers on their own network, they are entitled to collect carrier compensation charges. In fact, for calls subject to reciprocal compensation, the FCC has found:

> … a CMRS carrier is entitled to receive reciprocal compensation for the additional costs of terminating traffic on its network at a rate exceeding the

[20] FCC, In the Matter of Developing a Unified Intercarrier Compensation Regime, *Further Notice of Proposed Rulemaking*, CC Docket No. 01-92, FCC 05-33, ¶ 134 (FNPRM Unified Carrier Comp.). See also note 36 where the Commission notes, "In the Local Competition First Report and Order, the Commission also concluded that 'the new transport and termination rules should be applied to LECs and CMRS providers.'" FCC, Local Competition First Report and Order, 11 FCC Rcd at 16016-17,¶ 1043," and ¶ 134, where the Commission states, "… section 51.701(b)(2) of the Commission's rules defines telecommunications traffic exchanged between a LEC and a CMRS provider that is subject to reciprocal compensation as traffic 'that, at the beginning of the call, originates and terminates within the same Major Trading Area.'"

[21] Figure 5 is from http://wireless.fcc.gov/auctions/data/maps/mta.pdf. State borders appear as dashed lines when this map is printed in black and white.

> incumbent LEC rate if it can demonstrate that its termination costs exceed those of the incumbent LEC and that those costs are traffic-sensitive.[22]

The FCC also pointed out that:

> According to one analyst's report in 2003, wireless carriers assign numbers so as to minimize the access charges paid to local wireline companies.… "For wireless operators, the standard practice is to aggregate phone numbers within the same area code onto the same or several rate centers, whose physical locations would result in the least amount of access charges paid to ILECs. Therefore, in each market, wireless operators are present in only a small number of rate centers. According to our industry sources, this percentage is probably below 20%, and could be meaningfully lower than 20 %."[23]

C. Overview of State Universal Service and Switched Carrier Access Policies

The desire to keep local rates low and avoid rate shock has been a key goal of state policy makers. For example, state regulators were among those opposing the FCC's effort to use higher subscriber charges to offset reductions in carrier switched access charges when the FCC first proposed this policy.[24] The state regulators have sought to keep rates low using a variety of implicit subsidy mechanisms for basic residential services. This includes charging higher (above-cost) rates for business services; allowing LECs to charge above-cost prices for intrastate toll calls, intrastate access charges, and vertical features, such as call forwarding and call waiting; allowing, and more recently requiring, geographic rate averaging and value of service pricing to provide subsidies from high-density (urban) to low-density (rural) areas.[25]

States have been slower than the FCC to implement explicit universal service mechanisms to replace traditional subsidies. This remains true although the 1996 Act states that there "… should be specific, predictable and sufficient Federal and state mechanisms to preserve and advance universal service." However, in defining the states' authority with regard to universal service, the Act states that "[e]very telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, to the preservation and

[22] See FNPRM Unified Carrier Comp., note 41.
[23] Twelfth CMRS Report, note 566, citing Linda Mutschler et al., "Wireless Number Portability," Merrill Lynch, Equity Research, Jan 9, 2003, p. 8
[24] See Kahn and Shew, pp. 196-197.
[25] See Huber, Kellogg, and Thorne, p. 552, note 45.

enhancement of universal service in that state."[26] Thus, to the extent that a state commission decides that it is appropriate to fund universal service using carrier access charges and above-cost intrastate toll rates, it can do so. In other words, states can continue to use carrier switched access charges as a way of ensuring that providers of intrastate long distance services provide an "equitable and nondiscriminatory" contribution to fund universal service because the LECs also have to contribute to universal service funding via subsidies implicit in their rates for toll and other services. It is important to note that the FCC did not "attempt to identify state-level implicit universal service support …, nor did it try to convert such implicit mechanisms to explicit federal universal service support."[27]

States have been slower than the FCC to implement rate rebalancing—that is, to increase residential rates and reduce charges for other services. This observation is evidenced by the fact that the interstate SLC increased by 200 percent from about $2.00 to about $6.00 per line per month from 1986 through 2006, while the "representative" (intrastate) local rates increased by only about 19 percent from about $12.60 to about $15.00 according the FCC's most recent rate report.[28]

III. The Need for a Holistic Approach

ILECs face four interrelated issues. First, their networks are characterized by a variety of common costs associated with resources used to provide a variety of services to different classes of customers.[29] Therefore, the incremental costs of individual services are relatively low when compared to the total costs the company must recover in its prices. Second, they are subject to pricing constraints designed to promote universal service by keeping prices "affordable." Third, they are required to serve customers throughout their service territory, including high-cost, low-

[26] Telecommunications Act of 1996, Pub. LA. No. 104-104, 110 Stat. 56 (1996).
[27] Huber, Kellogg, and Thorne, p. 589.
[28] See FCC, *Reference Book of Rates, Price Indices, and Household Expenditures for Telephone Service*, August 2007, Table 1.2, "Average Residential Rates for Local Service in Urban Areas, 1986-2006." The percentage increase is lower than the general inflation rate over the time period.
[29] Common costs are costs incurred in connection with the production of multiple products or services that remain unchanged as the relative proportion of those products or services varies (*e.g.*, the salaries of corporate managers). Such costs may be common to all services provided by the firm or common to only a subset of those services or elements.

density rural areas—that is, they must meet the carrier-of-last-resort obligation—and they are subject to service quality requirements or standards set by state regulators.[30] Fourth, they confront growing competition for a widening array of their services from competitors who are free to focus on the most lucrative customers and areas. Accordingly, regulators must consider all of these factors.

A key part of the historical balance that regulators and the industry reached was to set long distance rates and carrier access charges above their incremental cost to recover both some of the nontraffic sensitive (NTS) costs of the network (i.e., subscriber line costs) and possibly some of the joint and common costs of the network (e.g., shared switching costs). Thus, as explained above, absent long distance competition, "the phone company" could use revenues from long distance services, priced above incremental cost, to recover NTS costs, thus making it possible to set below-cost rates in some areas and/or to recover less than an optimal level of common network costs. Once long distance competition was permitted, regulators set access charges to contribute towards recovering NTS costs (i.e., subsidizing basic rates) and possibly to help recover some joint and common costs. Thus, both the ILECs own long distance services and the long distance services of other carriers accessing the ILEC networks contribute to recovering NTS costs and joint and common costs.

A. Telecommunications Cost Structures Imply that Services Must Be Priced Above Incremental Cost

Telecommunications networks have substantial amounts of joint and common costs. Consider, for example, an ILEC switching center. The costs of the land, building, air conditioning, and much of the equipment are not unique to any particular service provided by an ILEC. For instance, from the perspective of the customers served by that switching center, all of the services they receive require the switching center and have some shared responsibility for those costs. However, the added costs for making and receiving long distance calls in addition to the other services provided by the switching center are quite low, and the same can be said for any of the numerous other services provided via that unique network facility. Thus, to recover those

[30] This is not to say that such cost recovery concepts as construction charges and contribution in aid to construction are not accepted mechanisms for sharing cost recovery risks with end-user customers and developers in high-cost areas.

costs, it is necessary to charge more than the incremental costs of the individual services. To determine how much to recover, economists recommend some form of market-based pricing, such as economically efficient markups over long-run incremental cost. Regulators, on the other hand, have traditionally resisted such pricing and have chosen to focus on other considerations—keeping basic rates affordable and promoting universal service.

B. ILECs Face Unique Obligations and Constraints

ILECs face unique obligations including universal service obligations and carrier-of-last-resort obligations. The carrier-of-last-resort obligation has been carried over from the time when the ILECs had monopoly franchises in their operating territories in exchange for agreeing to provide service to all customers with access to their networks.[31] Under most state regulations, the ILECs are required by law (as they have been designated the carrier-of-last-resort) to serve all customers, even those in high-cost areas that require significant subsidies to recover the costs of providing service.

The ILECs' basic rates are also generally restricted by regulation. In contrast, competitors can set their prices as they see fit, and they can also avoid serving less lucrative customers, especially those in high-cost areas.

C. ILECs Face Strong and Growing Competition

ILECs are facing strong and growing competition from intermodal competitors, such as wireless, cable, and VoIP in many parts of the country. This competition is particularly strong in nonrural areas and has led to significant line losses by the ILECs. The State of Washington is no exception in this trend. The Washington ILECs have seen a decrease in their access lines, carrier access MOUs, and long distance traffic, particularly in nonrural areas.[32] In light of these competitive forces, the ILECs' ability to recover any decrease in carrier switched access revenue by increasing retail prices is constrained by market forces, as well as by price regulation.

[31] See Dennis L. Weisman, "Designing carrier of last resort obligations," *Information Economics and Policy*, 6 (1994), pp. 97–119

[32] Declines in access lines are shown by data for Washington from the FCC Local Competition Report as of June 30, 2007, Table 10; carrier access minutes have declined according to the NECA Network Usage by Carrier Reports; long distance traffic has declined according to the ARMIS Report 43-08, Table IV, row (EF)

D. The Need for a Balanced Approach

The following chart shows the rough balance of obligations and offsetting regulatory policies and benefits of being an ILEC.

ILEC Obligations and Constraints	Offsetting Factors/Advantages
Carrier-of-last-resort obligation—must provide service to all of its territory, including high-cost areas	Economies of scale and scope—may be able to offer new services at low incremental costs
Universal Service—must provide service at subsidized rates to: ▪ High-cost areas ▪ Low-income customers	Allowed to set prices for toll, long distance and other retail services high enough to recover some common costs and partially offset universal service obligations (As discussed above competition increasingly constrains ILEC pricing.) Allowed to include Carrier Common Line Charges in switched carrier access service prices
Asymmetric regulation: ▪ ILECs have limited pricing flexibility ▪ Must allow competitors to resell or purchase at cost essential network elements and services ▪ Competitors are free to focus on most lucrative customers and geographic areas – Do not have provider-of-last-resort obligation—need not serve high-cost areas – Face few if any pricing constraints	Incentive Regulation—allows carriers to retain gains in profits achieved by improving efficiency and offering innovative services

The above offsetting factors have themselves been the product of regulators trying to balance the demands of consumer advocates seeking the lowest possible rates, investors for a regulatory regime that allows them a reasonable opportunity to earn an economic return on their investment, and incumbents and competitors seeking to gain as much advantage as they can via the regulatory process.

The need for a balanced approach has been reflected in the implementation of competition policies and the reform of universal service policies. Regulators have recognized the need to balance a host of factors when they weigh the need to change rate structures. In fact, the FCC in phasing in universal service reform as required by the 1996 Act was concerned that "drastically cutting access charges to bring them to cost-based levels could prove disruptive to business operations."[33] Thus, the FCC "declined to implement any dramatic changes to its access charge regime, ruling that "the existing system of largely implicit subsidies," would have to "continue to serve its purpose."[34] The linkage between intercarrier compensation and universal service funding for high-cost rural areas was explicitly recognized by the FCC in its 2005 Further Notice of Proposed Rulemaking on intercarrier compensation reform:

> Preservation of universal service is another priority under the Act and we recognize that fulfillment of this mandate must be a consideration in the development of any intercarrier compensation regime.…and we are particularly sensitive to the interests of rural and high-cost communities. Given the relationship between intercarrier compensation and universal service support, we recognize that reforms to the intercarrier compensation regime may warrant changes to universal service support mechanisms. Any proposal that would result in significant reductions in intercarrier payments should include a proposal to address the universal service implications, if any, of such reductions. In particular, many rural LECs collect a significant percentage of their revenue from interstate and intrastate access charges. Because of the high costs associated with serving rural areas, we must be certain that any reform of compensation mechanisms does not jeopardize the ability of rural consumers to receive service at reasonable rates.[35]

This concern is appropriate because ILECs have unique obligations—carrier-of-last-resort obligations and constraints on their ability to change rates. Thus, drastic, unbalanced decreases in a revenue stream such as carrier switched access charges could dramatically affect the ability of a company to meet its obligations.

Efforts to lower intrastate carrier switched access prices with no offsetting means of replacing the revenues used to cover network costs ignore crucial economic and regulatory considerations. The resulting unbalanced policy would not only defy a fundamental objective of the access

[33] Huber, Kellogg, and Thorne, p. 584, citing *Access Charge Reform Order*, 12 F.C.C. Rec. at 16,002, ¶ 46.
[34] Huber, Kellogg, and Thorne, p. 584, citing *Universal Service Order*, 12 F.C.C. Rec. at 8786–8787, ¶ 17.
[35] See FNPRM Unified Carrier Comp., ¶ 32.

charge regime (i.e., affordable basic service), but also have extremely deleterious economic consequences. The current state regulatory balance was reached with the expectation that the ILECs could count on carrier switched access revenues or some replacement for carrier switched access revenues as one of the ways to meet their regulatory and financial obligations.

The implications of unbalanced access charge policies are at least twofold and should not be underestimated. First, this will have a detrimental effect on the ILEC's ability to finance investment in its service area because shareholders will not be willing to invest their money in maintaining the network, let alone deploying new services.[36] Failing to recognize this could have severe consequences not only for the ILEC directly affected, but for other companies regulated by the Commission because the ILEC and those companies would receive a signal that state regulators cannot resist the temptation to short-change investors for the sake of the short-term interest of some customers and competitors. Second, without the necessary funding to serve rural areas, ILECs will be forced to raise prices in these areas and/or reduce the quality of service. This response, however, would directly undermine a fundamental objective of the current access charge regime as it could diminish the quality and/or the affordability of basic telephone service to rural and low-income customers.

Hence, if state regulators decide to reduce carrier switched access charges, then such a reduction must be implemented fairly and efficiently by replacing current carrier switched access contributions to common costs and universal service with an explicit recovery mechanism. In practice, this means that regulators must allow the ILECs to raise basic residential rates (where possible), develop a competitively neutral state universal service fund to replace any lost carrier switched access revenues, or some combination of the two.

[36] See Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation* (1998), p. 108. *See also* William J. Baumol and J. Gregory Sidak, *Transmission Pricing and Stranded Costs in the Electric Power Industry* (1995), p. 103 ("a fundamental precept of the competitive market model for regulation [is] that the regulator never take any step that *precludes* investors in the regulated firm from the *ex ante* expectation that earning will be sufficient in the long run to return the investors' capital plus a competitive rate of return on that investment").