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November 21, 1997

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Mr. Steve McLellan  
Washington Utilities and  
Transportation Commission  
Chandler Plaza Building  
1300 S. Evergreen Park Drive S.W.  
P.O. Box 47250  
Olympia, Washington 98504

Dear Mr. McLellan:

Subject: **GTE COMMENTS IN DOCKET NO. UT-970325 - ACCESS CHARGE  
REFORM AND THE COST OF UNIVERSAL SERVICE**

Attached are GTE's comments in the above-referenced docket. Please contact Joan Gage  
at 425/261-5238 if you have any questions.

Very truly yours,

Lida C. Tong  
State Director - External Affairs  
Washington

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Attachment

**DISK  
AVAILABLE**

**BEFORE THE  
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**Investigation of the Cost of Universal    )  
Service and Access Charge Reform        )        UT-970325**

**COMMENTS OF GTE NORTHWEST INCORPORATED ON  
THE PROPOSED RULEMAKING**

GTE Northwest Incorporated (GTE) submits its comments on the general topics of this proposed rulemaking and on the five issues set forth in the Commission's October 22, 1997, Preproposal Statement of Inquiry.

**INTRODUCTION**

**Replacing implicit support with sufficient explicit support is the key to preserving and enhancing universal service and to efficient advancement of Washington's telecommunications system.**

The Commission's acknowledgment in its Preproposal Statement of Inquiry that the implicit subsidies currently embedded in incumbent local exchange carrier (ILEC) rate structures must be replaced with sufficient explicit universal service subsidies is critical to putting in place a vital element of a new pro competitive, efficient, vibrant telecommunications system in Washington -- a system that will dynamically advance universal service goals through market forces, with targeted, competitively neutral support of high cost service areas. GTE encourages and supports the Commission in this effort. In the following responses to the issues posed by the Commission GTE outlines specific steps that need to be -- and can be -- taken to achieve these objectives.

This rulemaking docket can be utilized to establish policy goals and directions on a fairly expeditious basis. Once that effort is concluded, the Commission can then promptly move to the evidentiary proceedings necessary to implement a new universal support program by, for example, quantifying existing implicit subsidies and determining the amount of support needed by specific telecommunications providers in given service areas.

As the Federal Communications Commission (FCC) has recognized, any attempt to maintain the implicit subsidies embedded in current ILEC rate structures is antithetical to the competitive market that Congress -- and this Commission -- have decided will best serve the public. In the first place, economic laws and market forces will simply make it impossible to maintain such subsidies.

In a competitive market, a carrier that attempts to charge rates significantly above cost to a class of customers will lose many of those customers to a competitor. This incentive to entry by competitors in the lowest cost, highest profit market segments means that today's pillars of implicit subsidies -- high access charges, high prices for business services, and the averaging of rates over broad geographic areas -- will be under attack. New competitors can target service to more profitable customers without having to build into their rates the types of cross-subsidies that have been required of existing carriers who serve all customers.<sup>1</sup>

Moreover, maintaining implicit subsidies in ILEC rate structures would -- by sending incorrect price signals -- encourage inefficient competitive entry and discourage competitive entry, especially in high cost service areas and in the residential market.

[A]s competition develops, incumbent LECs may be forced to lower their access charges or lose market share, *in either case jeopardizing the source of revenue that, in the past, has permitted the incumbent LEC to offer service to other*

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<sup>1</sup> Universal Service Report and Order, CC Docket No. 96-45, released May 8, 1997, at paragraph 17.

*customers, particularly those in high-cost areas, at below-cost prices (emphasis added).*<sup>2</sup>

Under a system of implicit ILEC universal service subsidies, new firms will not have an incentive to enter and existing firms will have a disincentive to invest in the high cost service areas. Carriers that provide local service will not find it attractive to serve customers with higher costs and/or lower usage of the high-margin services. On the other hand, explicit universal service support can make serving many more high cost customers attractive to carriers. These customers can then benefit from competition because carriers will be interested in competing for their business. At the same time, the reduction of service rates containing implicit subsidies to more cost-based, market rates, which universal service funding would make possible, would reduce the margins for those services and send correct price signals to the marketplace. Such price reductions would obviously benefit a broad range of customers, and existing carriers and potential entrants would have economic incentives to adopt more broadly-based market strategies.

**The Telecommunications Act of 1996 requires this Commission to make explicit all implicit subsidies.**

Section 254 of the Telecommunications Act of 1996 (the Act) reflects Congress' recognition that implicit subsidies cannot be maintained in a competitive environment and therefore must be made explicit. The United States Court of Appeals for the Eighth Circuit in *Competitive Telecommunications Association v. Federal Communications Commission*, 117 F.3d 1068 (8th Cir. 1997) (hereinafter *CompTel*) noted the Act's "cost-based objectives," as well as its

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<sup>2</sup> FCC's First Report and Order in the Access Charge Reform Docket, released May 16, 1997, at paragraph 32.

mandate to make support for universal service “explicit.” Recognizing that “the subsidies necessary to achieve [the universal service] goal have been derived . . . from charges that are not cost-based,” *CompTel* at 1074, the *CompTel* court observed: “Clearly Congress did not intend that universal service should be adversely affected by the institution of cost-based rates . . . The Act requires the reform of universal service subsidies and not, significantly, abolishment of universal service, even temporarily.” *Id.* (emphasis added).

Moreover, the Federal Communications Commission in its First Report and Order in the Access Charge Reform Docket, released May 16, 1997, stated, at paragraph 32, that

as competition develops, incumbent LECs may be forced to lower their access charges or lose market share, *in either case jeopardizing the source of revenue that, in the past, has permitted the incumbent LEC to offer service to other customers, particularly those in high-cost areas, at below-cost prices* (emphasis added).

Thus, the FCC has acknowledged that competitive pricing will jeopardize the current universal service support flows implicit in ILEC rates.

Keeping in mind the shortfalls of the current ILECs’ rate structures, the necessity and benefit of an explicit support system, and the requirements of the Act in mind, GTE offers the following comments on the issues posed by the Commission.

**ISSUE ONE - HOW TO IDENTIFY THE EXISTENCE OF ANY IMPLICIT SUBSIDIES FOR UNIVERSAL SERVICE AND REMOVE THEM TO THE EXTENT POSSIBLE.**

**Implicit subsidies exist where rates are set too far above cost; they may be removed by setting rates on a cost and market basis and maintaining the affordability of universal service offerings by explicit funding.**

A rate contains an implicit subsidy when it is set too far above its costs -- when it is set at a level higher than could be maintained in a competitive market. In the current ILEC rate structures, these high, subsidy bearing rates exist in order that rates for "universal service" offerings may be set at levels below the service's costs -- below the level that would exist in a competitive market. Thus, the existence of implicit subsidies may be identified by estimating the cost-based, market rates that should exist for the ILECs' services. In particular, the magnitude of the current implicit subsidization of universal service offerings can be determined by estimating the cost-based market rate for such services and comparing it to the current tariffed rate.

The present implicit subsidies may be removed in ILEC rate structures by (1) providing ILECs support from an external Universal Service Fund (USF) in the amount of the current implicit subsidy and then (2) reducing the high rates that have contained the implicit subsidies by the amount of the new USF support.

In order to be sustainable, to send efficient price signals to telecommunications providers, and to recover GTE's costs, the price for each of the elements and services GTE offers must bear a reasonable relationship to its own cost. In an efficient, competitive market, market pressure maintains these relationships. However, relative to the underlying costs of providing service, GTE's current set of intrastate and interstate rates are disoriented. This is because the Commission has, in some instances, held the price for basic local service well below economic cost, averaged some rates across an ILEC's entire serving area and set lower rates in rural areas reflecting a value of service approach. Historically, it is through this system of implicit support, that GTE and other ILECs, have supported the provision of universal service in Washington.

This system of implicit support has resulted in margins for some basic local services that

are very low, or negative. To offset these low margins and to permit GTE's recovery of its total actual costs, the Commission has allowed prices to be set for other services, such as access, intraLATA toll, vertical services and some local business exchange services at levels that contain significant contributions over the economic cost.

In illustration of the order of magnitude of these implicit supports, Table 1 contains revenue and cost information (columns "a" and "b," respectively) for GTE's major service offerings. Column "c" presents the percentage contribution (defined as the difference between revenue and direct cost expressed as a percent of direct cost) for each service. As shown in Table 1, this system of implicit support has resulted in margins for some basic local services that are negative.

**Washington**

**Table 1**

**1995 Service Contribution Characteristics**

*Based on Cost Studies Filed in Dockets UT-960369, UT-960370, UT-960371*

Service	1995 Revenue (\$'000) (a)	Direct Cost* (b)	% Contribution (c) = ((a-b)/b)
Residence Local	\$85,356	\$244,780	-56%
plus EUCLs	\$21,695		
Business Local	\$82,596	\$97,574	-4%
Plus EUCLs	\$11,304		
Vertical	\$12,456	\$934	1234%
Toll	\$79,219	\$18,806	321%
State Access	\$56,578	\$5,203	987%
Interstate Access (Excl EUCLs)	\$87,498	\$9,511	820%
Other	\$105,352	\$78,615	34%

\*Column (b) does not include common costs.

The direct costs set forth in column "b" are derived from the studies GTE filed with this Commission in Dockets UT-960369, UT-960370, UT-960371 in March 1997. For purposes of this analysis, unbundled cost estimates were aggregated to produce estimates of service level costs (shown in column b) that are associated with the reported revenues (shown in column a). Table 1 demonstrates that GTE's current rate structure is significantly disoriented. Table 2 below extends the information from Table 1. Table 2 applies a fixed common cost allocator to direct



costs developed as explained in column b above to provide an estimate of the market based price for services. These statewide averages provide a conservative estimate of the level of the intrastate and interstate universal service support that is currently implicit in GTE's rates.

**Washington  
Table 2**

**Estimated USF Support Requirements (1995)**

*Based on Cost Studies Filed in Dockets UT-960369, UT-960370, UT-960371*

Service	1995 Revenue (\$000)  (a)	Total Rev @ Equal % Contribution (\$000)  (b)	Support Flow (\$000)  (c) = (a-b)
Residence Local  plus EUCLs	\$85,356  \$21,695	\$340,244	<b>(\$233,193)</b>
Business Local Plus EUCLs	\$82,596 \$11,304	\$135,628	(\$41,728)
Vertical	\$12,456	\$1,298	\$11,158
Toll	\$79,219	\$26,140	\$53,079
State Access	\$56,578	\$7,493	\$49,085
Interstate Access (Excl EUCLs)	\$87,498	\$13,695	\$73,803

Relative to this estimate of market prices, local residential service receives approximately \$233 million in intrastate and interstate support on an annual basis while local business service receives about \$41.7 million. These illustrative numbers should be regarded as conservative

estimates because the revenue and cost relationships are statewide averages. Again, as with Table 1, the costs set forth in Table 2 are derived from the cost studies GTE filed with this Commission in Dockets UT-960369, UT-960370, UT-960371. The level of intrastate universal service support should be the aggregate amount less the revised amount of interstate support that will be provided from the interstate universal service fund.

While this system of implicit subsidies worked well in a monopoly environment, it is wholly inconsistent with a competitive marketplace. Because of these disoriented rate structures, competitive local exchange carriers ("CLECs") can siphon off implicit universal service support flows by targeting ILECs' high margin customers. These rival suppliers -- free to enter and compete only in the most profitable markets (those markets where the ILECs currently generate universal service support contributions) -- enjoy a wholly artificial price advantage since they are not required to increase their prices to fund policies like universal service. This artificial price advantage allows even inefficient competitors, those without a cost or marketing advantage, to realize windfall gains by transforming implicit subsidies into profits.

**The Commission Must Make Explicit All Implicit Support - Implicit Support Mechanisms Cannot Be Sustained in a Competitive Environment**

Competition will undermine the universal service objective if a competitively neutral and explicit universal service mechanism is not adopted as required by the Act, because current price levels that generate support will not be sustainable. High margins on toll, access, some business and vertical services only invite competitive entry. Demand for these services is highly concentrated. As an example, on a nationwide basis, in GTE's territory only six percent of the

end-user locations generate almost half of the demand for interexchange access. Competitors can take a large market share and a corresponding significant portion of the contribution towards GTE's provision of universal service by simply targeting a relatively small number of high-volume, high-margin customers.

Concerns for the effect of competition on universal service resonate with the recent *Comptel* decision of the Eighth Circuit,<sup>3</sup> which recognized that "the subsidies necessary to achieve [the universal service] goal have been derived.... from charges that are not cost-based." *Id* at 1074. Recognizing the Act's "cost-based objectives," and the mandate to make support for universal service "explicit," the *CompTel* court observed:

[T]he Act required the reform of universal service subsidies and not, significantly, abolishment of universal service, even temporarily. *Id* at 1074.

The *CompTel* court continued,

Clearly Congress did not intend that universal service should be adversely affected by the institution of cost-based rates. But the...disparity between... implementation of cost-based service and the...reform of universal service raises the threat of serious disruption in universal service...if cost-based service is required before universal service is funded by competitively neutral means. *Id* at 1074.

The *Comptel* Court's concerns are not overblown. For example, consider this recent statement by current AT&T President and former General Counsel John Zeglis:

Let's look at the unbundled network element platform in...Pennsylvania. Admit it's a good state for us. We're going to go into a high density, low UNE price zone. We're going to buy all the elements, recombine them to make global service out of the elements, and assume we're doing this to a

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<sup>3</sup> *Competitive Telecommunications Association v. Federal Communications Commission*, 117 F.3d 1068 (8<sup>th</sup> Cir., 1997)

consumer that buys \$25 of long-distance and five dollars of local toll service per month....I improved my margin on a \$30 toll customer by \$10 because I don't have to pay access anymore outside the company. And Harry [Bennett] still has the distance between \$16 and \$23.50 to recover his further costs, which is a 32 percent discount in and of itself.  
[March 3, 1997, speech in Basking Ridge, New Jersey]

As John Zeglis highlights, competitive local exchange carrier ("CLECs") will reach customers via UNEs and set prices that are unconstrained by an obligation to contribute implicitly to universal service support. The targeted entry strategy described by John Zeglis underscores the need for permanent state universal service reform concurrent with local competition and in accordance with the *Act*. Pursuant to Section 254(f) of the *Act*, every telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, to a specific, predictable, and sufficient mechanism for the preservation and advancement of universal service. Until such time as the Commission meets its obligations under the Act, competitive local exchange carriers ("CLECs") can provide services by purchasing unbundled elements from GTE or by placing their own facilities and establishing prices that are unconstrained by any obligation to contribute implicitly to USF support. By engaging in rate arbitrage, CLECs reap as profits the funds previously used to support universal service without being required to make a corresponding contribution to support universal service.

Moreover, the current implicit method of supporting universal service undermines the development of competition by sending incorrect pricing signals: (1) extraordinarily high prices on services like access, toll, business and vertical services induce inefficient firms to enter those markets, and (2) extraordinarily low prices for basic local service inhibit efficient market entry and deter the introduction of new technologies and capital.

Most importantly, the Commission essentially will set the "price" of basic local service when it establishes the level of universal service support. While a local service subscriber pays the "tariff" rate approved by the Commission, the carrier sees that amount combined with an explicit universal service fund. To minimize distortions in the market, the combined amount must be as close as possible to the competitive market rate for the service that would prevail in the absence of the regulatory intervention to maintain universal service. This will provide the correct incentives for efficient new carriers to enter local markets and for incumbents to invest in service quality and new technologies.

If the Commission holds the "price" for basic local service -- the tariff rate plus the support -- below market levels, the effects will be the same as those of artificial price controls in any market. While UNE rates are tethered directly to costs, resale service discounts depend on GTE's retail rate structure. As a result, any implicit support that the Commission allows to remain in GTE's rates will distort resale service rates relative to cost-based UNEs to the same degree that GTE's retail rates are not cost-based. The result is that new firms will not want to enter and existing firms will have a disincentive to invest. Further, carriers who provide local service will not find it attractive to serve customers with higher costs and/or lower usage of high-margin services. By establishing a local price that approximates the outcome of a competitive market, explicit universal service support can make many more customers attractive to carriers. These customers can then benefit from competition because carriers will be interested in competing for their business. At the same time, the reduction of service rates containing implicit subsidies to more cost-based, market rates, which universal service funding would make possible, would reduce the margins for those services and send correct price signals to the marketplace. Potential

entrants would have incentives to adopt more broadly-based market strategies.

Access reform must be closely linked to universal service. As such, the transfer of implicit support contained in access charges, as advocated by AT&T, cannot be accomplished in a vacuum; it is inextricably intertwined with the creation of a permanent, sufficient, and competitively neutral universal service fund ("USF"). Given these linkages, the preferred approach to meaningful access charge reform is to carefully integrate it with these other changes.

**Company Specific Long Run Incremental Cost Models and Estimates of Forward Looking Common Costs Can Be Used with Actual Cost Data to Identify and Quantify Implicit Subsidies.**

Financial realities and legal principles require that ILECs be afforded a realistic opportunity to recover their actual prudent costs of providing their services. Thus, quantification of subsidies and USF support must ultimately be grounded in ILEC specific actual costs. As the Commission knows from its "generic cost and price docket" [Dockets UT-960369, UT-960370, UT-960371] and other proceedings, actual cost data is not readily available on a service-by-service basis. Therefore, long run incremental cost models and common cost studies may be used in conjunction with companies' total actual cost data to estimate market rates for services necessary to cover costs and to quantify implicit -- and the replacement explicit -- subsidies.

GTE proposes that universal service support be made explicit through a calculation that compares (a) an estimate of the price the market would set for basic local service<sup>4</sup> in a particular

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<sup>4</sup> In this comparison, the "market price" is the ILEC's actual forward-looking direct costs plus a reasonable allocation of common costs for basic local service. It is necessary to include common costs as well as direct costs in sizing universal service requirements. Failure to do so would shift the recovery of the entire amount of GTE's common costs to the set of

Census Block Group (CBG) with (b) the rate that an ILEC is presently required to charge for basic local service (the "tariff" rate) in that CBG. To the extent that the estimated market rate exceeds the tariff rate, that difference would be the amount of universal service support, per customer, needed in a CBG.

**GTE's Integrated Cost Model (ICM) Should be Utilized to Develop the Price the Market Would Set for Basic Local Service**

GTE has developed a new company-specific engineering cost study model, ICM. GTE plans to submit ICM to support a calculation of GTE's cost of providing the services supported by a universal service mechanism as well as universal service support needed. GTE's own cost model, ICM, will best reflect its network architecture and service area characteristics and therefore should ultimately be used to establish GTE's cost of providing universal service. Therefore, the Commission should not adopt a cost proxy model as its ultimate instrument for determining the cost of providing universal service.

Should the Washington Commission move forward with costing universal service support before ICM adaptation for USF purposes is completed, GTE is proposing to populate BCPM 2.5 with company specific inputs to allow this Commission and GTE to evaluate whether the cost model with some of GTE's company-specific inputs provides a reasonable estimate of GTE's costs of providing the services included within a definition of universal service. GTE staff are

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unsupported services -- an outcome that would re-establish implicit subsidies and would not be competitively sustainable. This position is again consistent with the FCC's universal service framework.

currently evaluating the 2.5 version of the BCPM model.<sup>5</sup> Following evaluation of BCPM 2.5, GTE may propose that this version be used on an interim basis. In any event, the total universal service support set by this Commission, together with Commission-established retail rates and UNE prices, must be sufficient to compensate GTE for all the costs GTE incurs in providing service in Washington.

**Failing to Identify and Remove all Implicit Universal Service Support will Merely Shift ILEC's Cost of Meeting its Regulatory Obligation**

Under the Federal Telecommunications Act of 1996 ("Act"), GTE is entitled to recover all its costs. Interconnection prices and prices for GTE's other services -- together with any universal service and historical cost recovery mechanism -- must be sufficient to permit GTE the realistic opportunity to recover all its costs. GTE recognizes that it is the universal service costs that are the focus of this rulemaking. However, the Commission must consider the role of the proposed universal service fund as it relates to setting prices for all of GTE's offerings, including retail services, unbundled network elements (UNEs), and resold services.

For example, while GTE is not presenting an estimate of stranded costs in this rulemaking and does not advocate the recovery of stranded costs through a universal service mechanism, stranded costs are mentioned here simply to point out that the Commission's policy decisions relative to universal service, along with retail and wholesale pricing and rate rebalancing, will directly impact the level of ILEC stranded costs. Should the Commission fail to make explicit all

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<sup>5</sup> It is GTE's understanding that this version may approach the methodology and assumptions employed by ICM. We also understand that BCPM development continues. GTE will continue to monitor and evaluate each version as it becomes available.



implicit subsidies, stranded costs will be greater than would be the case if all subsidies were recovered explicitly through a universal service fund. Implicit subsidies in GTE's and other ILECs' rates would go unrecovered because of competition, while the obligation to provide universal service to all customers at below cost prices would remain with GTE and other ILECs. In effect, the costs of regulatory obligations would go unrecovered, or would be "stranded" to a greater extent in the absence of sufficient universal service reform.

**ISSUE TWO - HOW TO ESTABLISH A NEW UNIVERSAL SERVICE FUNDING SYSTEM AND REPLACE THE EXISTING SYSTEM WITH AN EXPLICIT, SPECIFIC, PREDICTABLE, AND SUFFICIENT FUNDING MECHANISM FOR UNIVERSAL SERVICE THAT IS COMPETITIVELY NEUTRAL.**

**A Retail Surcharge Should Be Employed to Fund a New Universal Support Program**

GTE believes that the best recovery mechanism would be a mandatory surcharge on all retail telecommunications services. This would most effectively ensure that the burden of funding universal service is borne equitably by all retail customers. It would also ensure competitive neutrality, because customers would know that they could not alter their contribution to universal service by changing the mix of services they buy, or by switching from one carrier to another. Thus, the surcharge would not create artificial incentives for customers to make different choices among services or providers than they would have made in the absence of the surcharge. If carriers are allowed to exercise discretion as to how the surcharge is applied, then this essential

competitive neutrality will be lost because the relative recovery across services and carriers will differ and customers will be given an incentive to alter their purchase decisions to avoid the surcharge. An automatic end-user percentage surcharge will ensure that each carrier's fund obligations are recovered from all services, and all end-users, in an even-handed, competitively neutral fashion. This surcharge would meet the "specific and predictable" requirement of the Act §254(b)(5), and the non-discrimination requirement of the Act 254(b)(4), and Washington Code RCW 80.36.180, while mirroring the FCC's requirement for explicit disclosure of contribution pass-through information to end-users (CC Docket No. 96-45 ¶855).

**An Interim Surcharge on ILEC Unbundled Element and Resale Offerings Should Be Implemented Until the New USF is Effective**

This Commission is in the process of implementing various provisions of the Act, including universal service reform and implementation of local competition through the sale of UNEs and resold services. However, as the Eighth Circuit in *CompTel* has recognized, the Act requires preservation of universal service support concurrent with institution of the competitive provisions of the Act. The *CompTel* court stated that the Act ". . . requires the reform of universal service subsidies and not, significantly, abolishment of universal service, *even temporarily.*" *CompTel, supra*, at 1074 (emphasis added). Accordingly, as this Commission requires GTE to provide UNEs or allows CLECs to engage in facilities-based competition prior to adoption of a sufficient and explicit universal service mechanism, GTE will seek an interim universal service support surcharge to preserve the existing universal service support levels. Such an interim surcharge was recognized by the *CompTel* court to comply with the mandate of the

Act to preserve and advance universal service. The *CompTel* Court observed that if the FCC “ . . . had not instituted an interim access charge of some sort in order to subsidize universal service for the nine months before universal service reforms are complete, we think it apparent that universal service soon would be nothing more than a memory.” *Id.*

Without a surcharge, CLECs will compete in such a way as to avoid contributing to the support of universal service. For example, a CLEC can purchase UNEs at cost-based rates and rebundle them to replicate GTE's retail services, thus avoiding their statutory requirement to support universal service. The same is true if a CLEC engages in facilities-based competition. The CLECs will then engage in so-called “cream-skimming” by targeting high margin customers with these rebundled UNEs or their own facilities and either pocket the price support that historically has been used to pay for universal service or reduce prices to unfairly take market share. In addition, by using rebundled UNEs in this fashion, the CLECs will pay interconnection rates that do not include a universal service support component in lieu of paying access rates, which have been specifically designed to contribute to universal service support. Similarly, in the context of resale, a CLEC that chooses to self-provision toll will siphon off revenues that were specifically designed to contribute to universal service support. The interim universal service support surcharge would be adjusted to reflect only the interstate contribution as soon as the Commission implements a permanent intrastate universal service fund.

Section 252(d)(1)(A) of the act supports the implementation of GTE's interim universal service support surcharge plan. It provides that “just and reasonable” rates for interconnection and elements are to be based on “cost.” The implicit supports contained in GTE's historical retail rates will result in very real costs to GTE in the developing competitive environment. Those costs

will start to accrue as soon as CLEC enters the local market. Accordingly, a recovery mechanism for those costs, such as GTE's interim universal service support surcharge plan, is necessary.

There are additional negative consequences of implementing rates without an interim universal service support surcharge. First, if UNEs are purchased (and sold) without an interim universal service support surcharge mechanism, followed by an adjustment when a permanent USF charge is implemented, customers will be confused. Second, this situation will send incorrect economic signals to both consumers and new entrants. Third, incumbents like GTE will be unable to respond in kind and because of this unfair competition, will inevitably lose more market share than otherwise should have occurred. It will be very costly for GTE to win back these lost customers when a more "normal" market is restored. Finally, the intent of Congress, that all telecommunications providers support USF objectives, will be defeated. In sum, the Commission must ensure that there is competitive neutrality from the very onset of competition.

The justification for the interim surcharges rests on the simple fact that implicit support exists in the current set of ILEC rates. Until a permanent and explicit fund is established, the current levels of implicit funding are exposed and vulnerable. The proposed surcharge simply requires the average level of support to be maintained whether the customer is served by GTE at current retail rates or by a CLEC using some combination of unbundled elements or resale. Arguments that competition has not progressed to a level that warrants action by this Commission is irrelevant. By their design, if no retail market share is lost to CLECs utilizing UNEs or resale no universal service support will be recovered through the proposed surcharges. The mere availability of alternatives to ILEC retail rates is sufficient justification for interim protections until a permanent fund is established. The surcharges simply eliminate the cream-skimming

opportunities enjoyed by CLECs through the transition to a permanent universal service fund and rebalanced retail rates.

The surcharge applies to the provision of unbundled loops or ports, as well as to facilities-based providers. In this manner, the current level of universal service support for an average business customer is preserved.

**Once Washington's USF is Effective, a Reduced Interim Surcharge May Be Necessary Until the FCC Implements a Sufficient Universal Support Mechanism**

Until the interstate universal service fund is implemented, a portion of the interim surcharge would still be necessary to preserve the level of implicit support that is implicit in current interstate access rates. This is due to the FCC's order which does not protect the current levels of interstate universal service support. In its recent Access Charge Reform Order at paragraphs 337-340, the FCC stated that ILECs may not recover interstate access charges when UNEs are sold. The FCC plans to shift some of these implicit subsidies from usage-based charges to flat-rate charges, but this shift does not address the problem -- the subsidies are still lost when GTE sells UNEs. Thus, existing support for residential rates in Washington will vanish.

The FCC in its recent Universal Service Order affirmed its prior position that UNEs would not utilize interstate switched access charge rates. This decision eliminates substantial interstate universal service support and shifts the responsibility for continued recovery of that support to the states. The FCC made no alternative arrangements to recoup this lost contribution. As CLECs siphon off the implicit subsidies contained in the interstate rates by competitors serving customers via unbundled network elements, this Commission will have no choice but to either raise local

residential rates or establish an appropriate surcharge on all loops sold as UNEs to recover the shortfall.

The Act provides that the state commissions have exclusive jurisdiction over the rates and charges pertaining to UNEs. The Act further provides that Congress expressly intended to eliminate and identify implicit subsidies and in their place to establish sufficient and predictable and explicit USF flows. Since the FCC has failed to account for the implicit USF flows that went directly to residential rates when it mandated that interstate switched access charges would not be applicable when UNEs are utilized, this Commission must account for this cost as a cost of the UNEs. Since this Commission is responsible for pricing UNEs, it is appropriate for the Commission to impose a surcharge per line to make up the shortfall created by the FCC's rules.

**ISSUE THREE - HOW TO REVIEW PRICING PRINCIPLES TO ENSURE RECOVERY OF ECONOMICALLY EFFICIENT COSTS, AND TO ENSURE THAT APPROPRIATE RATE LEVELS AND RATE DESIGN ARE ESTABLISHED IN PROPER RELATIONSHIP TO THE COSTS AND MARKET POWER OF EACH PROVIDER.**

The method of determining market rates (i.e. tariff rates plus universal service support) that GTE described herein will ensure that rates are set in proper relationship to costs. When ILECs' rates are set in this fashion, "market power" is not a concern. In addition, when ILEC rate structures are appropriately cost-based and free of implicit subsidies, correct price signals will be sent to other telecommunications providers, resulting in economically efficient market entry.

**Each ILEC'S Actual Costs Should Form the Basis for Developing the Cost of Universal Service**

The Commission should develop the cost of providing universal service using company-specific cost studies. Only company-specific cost studies recognize both the inputs and methods that reflect the actual serving areas and production technologies used by the given company. Thus, a company-specific model is more likely to be accurate and better able to be validated. Moreover, the alternative to company-specific cost studies, i.e., cost proxy models, such as the Hatfield cost model proposed by AT&T, utilize default inputs, will likely deny ILECs the opportunity to recover their costs in violation of the Act and constitutional property rights. Such models rely largely on public data that is not company-specific, and do not take into account the specific operating circumstances of the given company.

#### **A Cost Model Must Be Accurate**

Only company-specific cost studies recognize both the inputs and methods that reflect the actual serving areas and production technologies used by each ILEC. Because cost proxy models often rely largely on public data that is not company specific and utilize default inputs, the output they produce may deny ILECs the opportunity to recover their prudently incurred costs. Only actual company-specific costs can be validated by checking them against real records. In evaluating cost models, this Commission should reject a process whereby the modeler "data shops" (i.e., picks and chooses amongst various costing sources to produce a desired result) as is the case with the other publicly available cost proxy model - the Hatfield Model. Furthermore, cost inputs cannot be based solely on the "opinions" of paid outside experts, where the support for such opinions is not disclosed, does not exist, or is totally at odds with reality.

Moreover, the company-specific costs of an ILEC must be used to identify and quantify universal service support because ILECs are currently the only carriers obligated to provide basic universal service on a “stand-ready” carrier of last resort basis in a defined geographic area. ILEC facilities are in place and will continue to be used, at least initially, to provide universal service to customers and underlying facilities to other carriers under the UNE and resale provisions of the Act. As such, ILEC company-specific costs represent an estimate of the price (including a reasonable profit) at which they would be willing to offer services in their defined exchange areas in a competitive market. In any competitive market, the price depends on the costs of the firms actually supplying that market. This is the appropriate price to which potential entrants would compare their own costs when deciding whether to enter, and when choosing whether to “construct” their own facilities or “buy” them from the ILEC. Moreover, ILECs invested in their existing networks pursuant to their historical regulatory obligations. In regulating ILECs, commissions have ensured that ILECs’ investment is reasonable, prudent, and necessary to provide an appropriate level of service.

**Proxy Models Likely Will Deny ILEC the Opportunity to Recover Its Costs**

Using a cost proxy model likely will deny ILECs the opportunity to recover their costs because a cost proxy model will provide a less accurate measure of universal service costs and support requirements in Washington. It is possible that a proxy model would result in cost estimates that equal, or even exceed, some ILECs’ costs. However, proxy models do not reflect the production technologies, input prices, and other company-specific circumstances of any ILEC.



Since there is more than one ILEC in Washington, each with different serving-area characteristics, it is unlikely that this circumstance would occur for all of the ILECs, and it is therefore likely that prudently incurred costs would not be recovered. Moreover, it is GTE's opinion that the Hatfield model, in particular, significantly underestimates GTE's costs -- use of Hatfield as a statewide proxy would almost certainly mean that GTE's costs would not be recovered.

Additionally, the proxy models rely on thousands of inputs, not all of which are completely understood or available. Even if some of the default values are made company-specific, there will be a vast majority of inputs that remain unchanged in the proxy model. Moreover, GTE does not necessarily maintain data that can be easily translated into input values for a proxy model. By comparison, the inputs of a company-specific model must necessarily be understood by and available for the given ILEC as well as more easily translated to input values for a company-specific model.

### **Use of Proxy Models Will Violate the Act**

Generally, cost proxy models fail to consider an ILEC's actual operations and its actual costs. Instead, cost proxy models estimate the perceived costs of a hypothetical new entrant. Reliance on a hypothetical entrant's "costs" to establish rates for UNE's would violate the Act because none of these hypothetical "entrants" will ever actually provide network elements. Section 252(d)(1) of the Act provides that "[d]eterminations . . . of the just and reasonable rate" for interconnection and network elements "shall be . . . based on the cost . . . of providing the interconnection or network element." 47 U.S.C. § 252(d)(1). Moreover, section 252(d)(1)

provides that prices for unbundled elements “may include a reasonable profit.” ILEC’s cannot earn a profit, however, unless they first recover all of their costs. See Iowa Utilities Commission v. FCC, Nos. 96-3321, et al., 1997 U.S. App. LEXIS 18183, at \*92 n.35 (8th Cir. July 18, 1997); FCC First Report and Order ¶ 699 (stating that there can be no “profit” unless the firm earns at least “the total revenue required to cover all the costs of the firm”) (emphasis added). This includes the cost of providing universal service. An ILEC cannot recover the cost of providing universal service if universal service support is based on cost proxy models that fail to measure the cost associated with an ILEC’s actual network.

#### **The Use of Cost Proxy Models Could Result in an Unconstitutional Taking**

Using a cost proxy model to determine costs is precluded not only by the plain terms and overall design of the Act, but by constitutional requirements as well. Should this Commission determine costs of universal service based on anything other than an ILEC’s actual costs, it could result in an unconstitutional taking of an ILEC’s property.

The Fifth Amendment requires a utility to be permitted a rate that will allow it to “maintain its financial integrity, to attract capital, and to compensate its investors for the risk [they have] assumed.” Duquesne Light Co. v. Barasch, 488 U.S. 299, 310 (1989) (quoting FPC v. Hope Natural Gas Co., 320 U.S. 591, 605 (1944)). Under that standard, “it is important that there be enough revenue not only for operating expenses, but also for . . . capital costs,” which “include service on the debt and dividends on the stock.” Hope, 320 U.S. at 603. Thus, “[o]ne of the elements always relevant to setting the rate . . . is the return investors expect.” Duquesne, 488

U.S. at 314 (emphasis added). But there can be no return to investors if a company cannot recover its actual capital outlays. See Tenoco Oil Co. v. Department of Consumer Affs., 876 F.2d 1013, 1020 (1st Cir. 1989) (to meet constitutional standards "rates must provide not only for a company's costs, but also for a fair return on investment"). Duquesne and Hope thus require that compensation be sufficient to cover an ILEC's operating costs and service on the debt and equity used to finance investment.

The Eighth Circuit acknowledged that compensatory prices were required in order to avoid a taking. Iowa Utilities Board, 1997 U.S. App. LEXIS 18183, at \*99-100. Moreover, the court concluded that an ILEC need not provide a CLEC with a network "superior" to the ILEC's existing network. Id. at \*80 (stating that the Act "implicitly requires unbundled access only to an incumbent LECs existing network -- not a yet unbuilt superior one").

The application of these taking principles requires that GTE be permitted to fully recover its costs. If proxy models fail to adequately account for these costs, this jeopardizes the ILECs' ability to continue attracting capital, does not afford investors a return commensurate with the risk of similar investments, and does not place ILEC's in the position they would have been had their property not been taken through confiscatory pricing. Constitutional requirements thus require that cost proxy models be rejected by this Commission.

#### **ISSUE FOUR - HOW TO ALLOW THE MARKETPLACE TO FUNCTION, WHILE PROTECTING CAPTIVE RATEPAYERS.**

The marketplace will function only if efficient price signals are communicated so as to

allow neither ILECs nor CLECs an artificial price advantage. If this Commission sets the universal support at the correct level, efficient competitors (i.e. those with a cost or marketing advantage) will be motivated to enter the market and provide alternatives. In any event the elimination of implicit subsidies from ILEC rate structures and the institution of an explicit universal service support program will appropriately protect any "captive customers".

**Comparison Of Average Revenue Per Line To Forward-looking Cost Would Fail To Achieve The Requirement To Be Sufficient and Predictable**

The universal service support amount should not be determined by comparing the (a) forward-looking economic cost of providing universal service, plus the cost of providing toll, access, and discretionary services, to (b) a statewide average revenue benchmark<sup>6</sup> (either company-specific or multi-company) that includes revenues generated by basic and discretionary local services, as well as revenues from toll and access services. Even assuming an accurate calculation of GTE's, and other ILEC's, cost of providing universal service support, the proposed calculation necessarily understates the amount of universal service support by using a statewide average as well as using revenues based on year-end revenues.

First, the use of a statewide average revenue from toll, access, and discretionary local services perpetuates the system of implicit subsidies because it forces the carrier to recover its

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<sup>6</sup> GTE also opposes the use of arbitrarily selected state-wide average revenues to calculate the benchmark to which costs will be compared to determine the per-line universal service support. The use of multi-company statewide revenue averages fails to adequately recognize rate disparities between companies and ignores the current supports provided between geographic areas.

costs from something other than a combination of the tariff price for basic local service and the explicit amount of universal service. A customer may generate no revenue from toll, access, or discretionary local service, or less than the statewide average amount of revenue. In this situation, the calculation under the proposed rules results in an insufficient amount of universal service support. The ILEC, who cannot refuse service to this customer, and who cannot charge more than the tariff rate, is forced either to provide universal service without a sufficient universal service recovery mechanism or is forced to subsidize the below-cost basic local service through prices for other services. Not only is this type of implicit support prohibited under the Act, the ILEC lacks the pricing flexibility to adjust its prices to ensure sufficient recovery when its customers generate less than the average amount of revenues from toll, access, or vertical services. Customers who generate higher than average amounts of revenue from toll, access, and vertical services are the likely targets of competitors who enjoy pricing flexibility without the obligation to provide universal service support at the tariff rates.

Second, comparing statewide average revenues to costs generated at the census block group level exacerbates the existing reliance on inter-customer and inter-service cross-subsidies. The support flow disparities of urban/rural rates and toll and discretionary service usage among customers is essentially institutionalized by comparing these statewide average revenues streams to small geographic area costs. This averaging of rates biases the benchmark away from reflecting the actual rate subsidies in particular CBGs. If the revenue benchmark is inflated relative to costs due to averaging or the inclusion of revenue streams not currently reflected in the cost models (*e.g.*, toll and access), the fund will be undersized resulting in a continuation of implicit support which is contrary to the intent of the Act as interpreted by the FCC (*In the Matter*

*of Federal-State Joint Board on Universal Service CC Docket No. 96-45, paras. 9-14).* Third, it is inappropriate to include a revenue stream that currently supports local rate suppression in the calculation attempting to identify and remove these implicit supports. The inclusion of current supports in the revenue benchmark when compared to a relatively small average cost structure will artificially suppress the fund and undermine universal service goals by disincenting companies from providing competitive universal service to customers whose margins, when coupled with their universal service support, fail to meet market levels.

In addition, if the forward-looking economic cost models included the non-basic costs for universal service purposes, the underlying costing methodology will then be at variance with the costing methodology used to calculate wholesale rates in other proceedings (i.e. UNE costs).

GTE supports the use of company-specific tariffed rates which have already been deemed affordable by this Commission for determining the per-line revenue amount above which universal service fund support will be provided. To work properly, a universal service plan must compare company-specific costs to company-specific rates charged in each CBG. The rates included in the calculation should be only those which the customer would pay as a direct result of the customer's decision to subscribe to basic local service. This would include the monthly recurring rate, the subscriber line charge, and any other mandatory charges such as non-optional EAS. Including any other revenues in the calculation amounts to asking the other services that produce those revenues to generate additional contribution, above what market-level rates would provide, in order to support basic local service. This flow of support simply cannot be sustained in a competitive environment — especially not one in which competitors can buy from the ILEC, at cost-based rates, the elements they need to assemble any ILEC service. If a given ILEC customer

winds up paying more than the cost of his or her basic local service because that customer also uses large amounts of toll or vertical services, then another provider can offer service to that customer which does not include the excess contribution built into the ILEC's rates for toll or vertical services. The competitor can do this either using its own facilities, or by buying UNEs from the ILEC at rates which also do not include artificial contributions toward universal service. Therefore, any system of universal service that relies on other service revenues cannot be sufficient and predictable.

**ISSUE FIVE - HOW TO ENSURE THAT SERVICE TO RURAL AND HIGH COST AREA CUSTOMERS IS ADEQUATE AND AFFORDABLE, AS SPECIFIED IN 47 U.S.C. 254(b)(3).**

Section 254(b)(3) of the Act provides the following universal service principle:

**Consumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas.**

For the reasons related above, the institution of sufficient explicit universal support funding for rural, insular and high cost areas will provide market incentives for ILECs and other carriers alike to make "universal service" offerings in those areas. In addition, if the implicit subsidies that GTE believes exist in switched access charges and toll rates are removed, then it will be more attractive for carriers to provide interexchange services in those areas at the averaged rates mandated by

Section 254(g). As these economic incentives work to bring modern local and interexchange services to these areas, customers will thereby also be assured of “access to...information services,” e.g., the Internet, at rates reasonably comparable to urban area rates. Similarly, the carriers’ infrastructure will be available to support the provision of “advanced” services.

In order to ensure that service to rural and high cost area customers is adequate and affordable, as specified in 47 U.S.C. 254(b)(3), the Commission must minimize distortions in the market by adopting a methodology whereby the combined amount is as close as possible to the market rate for the service that would prevail in the absence of regulatory constraint. Only then will price signals provide the correct incentives for efficient new carriers to enter local markets and for incumbents to invest in service quality and new technologies.