

WRITTEN STATEMENT

of

**Paul W. Garnett
Director, Regulatory Policy
CTIA—The Wireless Association™**

on

**Reforming the Current High-cost Universal Service Support
Mechanism**

**Before the
Federal-State Joint Board on Universal Service
November 17, 2004**

Good afternoon. On behalf of CTIA – The Wireless Association,TM I want to thank the Joint Board for focusing its attention on the urgent need to reform the high-cost universal service mechanisms. CTIA is grateful for the opportunity to present its views, on behalf of the wireless industry, in this important area. As both a major contributor to universal service and a limited recipient of high-cost support, the wireless industry is uniquely positioned to comment on proposals to reform the rural high-cost support mechanisms.

Wireless carriers are significant net contributors to the federal universal service mechanisms. In 2003, CMRS providers were responsible for \$1.4 billion or 22% of federal universal service contributions, while receiving only \$175 million or 3% of all federal universal service subsidies. In contrast, local exchange carriers (LECs) were responsible for \$1.7 billion or 27% of federal universal service contributions, while receiving \$4.4 billion or 78% of all federal universal service subsidies.

From 2000 through 2003, the FCC's high-cost universal service mechanisms grew approximately 46%. In spite of alarmist rhetoric about increased support going to competitive eligible telecommunications carriers (ETCs), the vast majority of growth in the high-cost fund since its reformation in 1997 has flowed to incumbent LECs. In fact, from 2000 through 2003 incumbent LECs were responsible for 87% of the growth in the high-cost fund.

The wireless industry has strong incentives to curb growth in the size of the fund while ensuring that support for serving high-cost areas is available on a competitively neutral basis. Ultimately, consumers pay the increased costs associated with universal service and other regulatory mandates, and this suppresses demand for new and

innovative services. Wireless carriers and their customers, in particular, are disproportionately affected by these increases. In comparison with other market segments, wireless services are highly demand-elastic – meaning that relative to other market segments, a slight increase in price can significantly reduce demand for services. Excessive universal service subsidies also can distort markets by sending the wrong signals for investment and competitive entry.

The high-cost universal service mechanisms – particularly those supporting “rural telephone companies” – are one of the few remnants of a pre-divestiture regulatory structure that guaranteed profits to inefficient monopolies insulated from competition. Nearly nine years after passage of the Telecommunications Act, it is time for the Joint Board and the FCC to tackle necessary reforms to the rural high-cost universal service support mechanisms to make them more consistent with the Act’s universal service and pro-competition goals, and to control growth in the fund.

CTIA believes this can best be achieved through fundamental reforms to the FCC’s high-cost support universal service mechanisms. CTIA has developed short- and long-term proposals for achieving these goals. Under these proposals, the FCC would modify the existing high-cost mechanisms, while transitioning to a new high-cost mechanism for all eligible carriers. The ultimate result of such reform should be a simplified, unified support mechanism that replaces the five high-cost mechanisms currently in place. Under such a mechanism, support for all eligible carriers would be based purely on efficient, forward-looking economic costs of serving a geographic area.

Whatever changes are made to the underlying mechanisms, the FCC must ensure that universal service support continues to be distributed in both a competitively- and

technologically-neutral manner, as required by the Act. That way, the market, and not state or federal regulators, will determine who competes for and delivers services to rural consumers.

High-Cost Universal Service Mechanisms Are Enriching Rural ILECs at the Expense of Consumers.

There are numerous problems with the high-cost mechanisms, such as: (1) incentives for inefficiency; (2) funding of costs unrelated to universal service; and (3) impenetrable administrative complexity. Taken together, these problems result in a bloated fund that does not effectively target the appropriate levels of support to different high-cost areas. As a result, the high-cost support mechanisms do a poor job of ensuring that all Americans have access to high-quality, affordable telecommunications and information services. Moreover, the high-cost support mechanisms undermine the efficient development of competition as envisioned by the Act.

Incentives for Inefficiency. As the FCC correctly recognized in the *First Universal Service Order* in 1997, embedded cost-based high-cost universal service mechanisms reward inefficiency by creating incentives and opportunities for carriers to have higher embedded costs to receive more support. For example, between 2000 and 2003, the national average loop cost for rural incumbent LECs grew from approximately \$337 per loop per month to approximately \$378 per loop per month. This shows that, despite industry-wide efficiency gains, advances in technology, and amortization of depreciated equipment, high-cost universal service subsidies continue to increase rather than decrease over time.

In practice, the FCC's high-cost support mechanisms compound incentives for inefficiency inherent in embedded cost support mechanisms. For example, the high-cost

support mechanisms discourage carriers from taking advantage of economies of scale normally associated with combining operations. Under the high-cost loop support mechanism, smaller rural incumbent LECs are eligible for more high-cost loop support than larger carriers. In addition, the local switching support mechanism arbitrarily makes incumbent LECs with fewer than 50,000 access lines in a study area eligible for switching support. Incumbent LECs that increase their customer base risk reducing or eliminating their qualification for high-cost support. The embedded high-cost mechanisms' preference for small carriers also creates incentives for carriers to appear small when, in fact, they are much larger. Incumbent LECs do this by operating numerous "study areas" in a given state or by balkanizing their operations among the various states.

Guaranteed Profits and Reimbursement for Unrelated Expenses. As I noted at the outset, the FCC's high-cost universal service mechanisms are one of the few remnants of a pre-divestiture regulatory structure that guaranteed profits to inefficient monopolies insulated from competition. For example, the federal high-cost support mechanisms include a guaranteed rate of return of 11.25% for incumbent LECs. These elevated returns on equity do not translate to improved telecommunications services in high-cost areas. Instead, they simply enrich rural carriers and their investors, while increasing the overall size of the fund to the detriment of other carriers and consumers who end up paying higher universal service pass through charges.

In addition, rural incumbent LECs are permitted to recover Corporate Operations Expenses ("COE") through the high-cost loop support mechanism. These include everything from the salaries of rural ILEC executives, to their travel to conventions, to

lobbying fees. Such costs are not directly related to the provision of universal service, and should not be supported.

Impenetrable Administrative Complexity. The five separate high-cost support mechanisms, in conjunction with the waivers and other loopholes carriers use to enable themselves to receive additional high cost support, make the system an administrative and enforcement nightmare. Also, support calculations under the various federal high-cost support mechanisms rely on archaic and complicated cost accounting, jurisdictional separations, and reporting rules that have existed in one form or another since 1984.

The high-cost support mechanisms are so complicated that they have spawned a cottage industry of consultants who prepare and submit quarterly and annual cost reports on behalf of rural incumbent LECs. This administrative complexity also makes it exceedingly difficult for the Universal Service Administrative Company (“USAC”), the FCC’s independent universal service fund administrator, to audit incumbent LEC cost data submitted for purposes of calculating high-cost support. This is compounded by rules requiring incumbent LEC cost data to be submitted to the National Exchange Carrier Association (“NECA”), not USAC. The FCC’s rules provide for annual audits of USAC, not NECA. NECA has established its own cost reporting procedures outside FCC review, the Office of Management and Budget approval process, and most importantly, public scrutiny. NECA does not submit supporting documents for cost data to USAC. Rather, NECA processes such data and performs all support calculations prior to submitting them to USAC. Short of auditing NECA itself, there is no way for the FCC to know with certainty how NECA is interpreting and enforcing FCC cost reporting and

support calculation rules. These wasteful administrative costs are borne by consumers through higher rates for service, as well as higher universal service pass-through charges.

The Existing High-Cost Mechanisms Must Be Modified.

As I noted earlier, CTIA has developed both short-term and long-term proposals for improving the high-cost universal service support systems. The FCC and the Joint Board should modify the existing high-cost mechanisms, while transitioning to a new high-cost mechanism for all or some rural telephone companies. In the near term, only smaller incumbent LECs should continue qualifying for support based on embedded costs, and extraneous costs, such as risk-related profits and COE, should be removed from the support mechanisms. In the longer term, the five existing support mechanisms should be simplified and unified, and all incumbent LECs should be transitioned to a support mechanism based on forward-looking economic costs. These reforms will ensure that consumers in high-cost areas have better access to high-quality and affordable telecommunications and information services.

A Forward-Looking Support Mechanism Will Reward Efficiency and Reduce the Need For Support Over Time.

If properly designed, a forward-looking methodology for calculating high-cost universal service will do a far better job than an embedded cost system at directing appropriate levels of high-cost support to eligible carriers serving high-cost areas. Because a forward-looking mechanism provides an objective measure of efficient costs, it also will provide the appropriate incentives for investment, innovation, and entry into the marketplace. As the FCC observed in the *Universal Service First Report and Order*, in comparison to embedded cost support, “a forward-looking economic cost methodology creates the incentives for carriers to operate efficiently and does not give carriers any

incentives to inflate their costs or to refrain from efficient cost-cutting.” Moreover, “in the long run, forward-looking economic cost best approximates the costs that would be incurred by an efficient carrier in the market.”

A forward-looking mechanism such as that currently used for non-rural incumbent LECs also targets support to small geographic areas, thereby ensuring that “sufficient” support is available in high-cost areas. A forward-looking mechanism, therefore, will better ensure that consumers in high-cost areas have access to telecommunications services that are comparable to those available in urban areas, in terms of both rates and quality. Over time, a high-cost support system based on forward-looking costs also will reduce the need for support.

On several occasions, the FCC has rightly rejected arguments that the FCC indefinitely should maintain embedded cost support mechanisms for rural carriers. In the *Rural Task Force Order*, the FCC described numerous flaws with the Rural Task Force’s conclusion that forward-looking support was not suitable for rural telephone companies. Indeed, the FCC concluded that all of the Rural Task Force’s complaints about forward-looking support could be addressed by updating model inputs and using different benchmarks and averaging conventions.

The fact that some eligible carriers would receive less support under a new system is not a valid reason to reject reforms that would enable the FCC to better satisfy the requirements of the Act. The United States Court of Appeals for the Fifth Circuit previously agreed, stating that “[t]he Act does *not* guarantee all local telephone service providers a sufficient return on investment. . . . So long as there is sufficient and competitively-neutral funding to enable all customers to receive basic

telecommunications services, the FCC has satisfied the Act and is not further required to ensure sufficient funding of every local telephone provider as well.” The FCC, therefore, must move forward with necessary reforms to the high-cost universal service mechanisms.

Now is the Time to Begin the High-Cost Reform Process.

On July 1, 2006, upon expiration of the five-year plan adopted in the *Rural Task Force Order*, incumbent LECs that, along with their affiliates, have 50,000 or more access lines in a state, or 2.5 million access lines nationally, should begin receiving support, if any, based on forward-looking economic costs. The Rural Task Force acknowledged that, with modest changes to the forward-looking mechanism, carriers with operations of this scope have no need to remain on an embedded-cost mechanism. Moving larger carriers to the model would affect a small percentage of rural incumbent LEC study areas, but would cover approximately 14 million or 65% of the total lines served by rural carriers.

“Rural telephone companies” in non-contiguous states and territories (*e.g.*, Alaska and Hawaii) and those that have fewer than 50,000 access lines in a state would remain under embedded cost support, but would be required to combine their study areas in any given state or territory.

The Joint Board and the FCC also should consider changes to the local switching support mechanism, which is premised on the idea that smaller carriers with less than 50,000 access lines in a study area have higher average switching costs. One idea would be to consider requiring incumbent LECs with fewer than 50,000 lines to prove that they in fact have higher average switching costs to continue receiving support. The Joint

Board and the Commission also could explore the possibility of reducing the threshold number of lines to reflect how economies of scale have changed over the last decade such that small carriers can now purchase cost-effective digital switches or even soft switches designed to meet their needs.

These changes would eliminate arbitrary distinctions made under the current mechanisms between “rural” and “non-rural” carriers. Instead, during an interim period, the rules would determine which carriers continue to receive embedded cost-based support solely based on the number of lines served.

At the same time, non-loop costs such as risk-related profits and COE should be removed from the high-cost loop support mechanism. The rate of return currently employed reflects the RBOCs’ cost of capital 13 years ago; it also fails to recognize the lower degree of risk associated with a government-subsidized business. COE should be removed from the high-cost mechanism because, to encourage efficiency, companies should be required to recover these expenses from their own customers rather than subsidy mechanisms.

Finally, a freeze should be placed on further growth in the embedded cost support mechanisms while the Joint Board and the Commission consider long-term reforms. The local switching and interstate common line support funds would be frozen at current levels, and the overall size of the high-cost loop fund could go no higher than the funding year 2005 cap, based on 2003 cost data. Alternatively, growth in these funds could be tied to industry revenue growth (or reductions), as was proposed by the Oregon Public Utility Commission in the Competitive Eligible Telecommunications Carrier proceeding.

More Fundamental Reforms Are Necessary in the Long Term

The reforms I just outlined will be merely first steps towards the long-term goal of transitioning all carriers to a single, unified federal support mechanism based on forward-looking economic costs. A single forward-looking mechanism will reduce unnecessary costs and burdens associated with managing multiple mechanisms. A high-cost support mechanism based on a forward-looking cost model also would eliminate the current need for detailed cost reporting. In contrast to the multiple cost elements requirement under Part 36 of the FCC's rules, a forward-looking mechanism would only require carriers to report wire center line counts on a quarterly basis, and wire centers locations and customer locations less frequently. These filings could be further reduced if USAC were to obtain the customer location data from an independent vendor.

The FCC also should eliminate unnecessary and costly administrative layers by centralizing administration of the high-cost support mechanisms in USAC. For high-cost universal service support, this would, for example, mean that USAC should replace NECA as the recipient of all necessary data for calculation of high-cost support. USAC also should take over responsibility from FCC staff for managing the day-to-day operations of the forward-looking model. USAC is better suited to perform these administrative functions than the FCC. This would aid in the administration and enforcement of the mechanisms.

The FCC first should transition all incumbent LECs to a unified forward-looking high-cost mechanism that would replace the existing high-cost loop support, local switching support, and (the current) forward-looking mechanism. Significant work would need to be done to prepare and modify the model to accommodate smaller carriers.

Under the current forward-looking high-cost support mechanism, support is only available to 10 states due to the operation of the benchmark and statewide averaging. In order to ensure that support is more widely available, while maintaining or reducing the overall high-cost fund size, the FCC could eliminate statewide averaging and increase the benchmark from two standard deviations above the national average to a higher number. The FCC should make sure the benchmarks chosen do not result in an increase to the overall size of the high-cost support mechanisms.

The next step would be for the FCC to eliminate arbitrary interstate and intrastate cost separations and fold interstate common line support and interstate access support into the unified forward-looking high-cost support mechanism. The high-cost universal service support mechanisms should be agnostic to interstate and intrastate distinctions, which are becoming increasingly irrelevant. Moreover, since the federal universal service mechanisms already subsidize both intrastate and interstate costs, nothing precludes the FCC from combining these separate mechanisms. This step would significantly simplify support calculations.

Any incumbent LEC USF revenue losses resulting from the transition to forward-looking support should only be recovered through end-user charges (*e.g.*, SLC and other end-user charges), not through access and other carrier charges (which would result in illegal implicit subsidies). If an eligible carrier is thereby forced to increase its end user rates to “unaffordable” levels (*i.e.*, rates that are not comparable to those charged in urban areas), it would have the option of petitioning the FCC for additional high-cost universal service support. To the extent that a carrier is able to charge close to or, in some cases,

less than an “affordable” rate for service, there is no justification or basis in the Act for requiring other carriers and customers to subsidize that service.

In order to ensure that high-cost support mechanisms decrease, rather than increase, over time, the Joint Board should recommend that the FCC amend its rules to require regular (*i.e.*, annual or biennial) updates to the forward-looking mechanism to reflect the introduction of more efficient technologies. This will be extremely important over the next several years as circuit-switched networks are replaced with packet-based technology. The Joint Board and the FCC also could consider reducing support over time for both the incumbent and competitors in those markets where consumers have multiple facilities-based competitive alternatives.

Once these steps have been taken, the Commission should consider additional reforms that would better serve the underlying statutory goals for universal service. For example, the Joint Board and the FCC could consider developing a high-cost mechanism that directs equal per-line support to both incumbent and competitive ETCs based on the most efficient technology in a selected area. Such a mechanism could determine whether universal service is best achieved in an area using wireline packet or circuit-switched technology, or wireless technology.

In the very long term, the Joint Board and the Commission should continue to study the possibility of abandoning cost-based support altogether in favor of a system of competitive bidding that would determine high-cost support levels for both competitors and incumbents. Another creative idea would be to investigate the feasibility of directing a consumer subsidy based on a combination of the cost of service and the consumer’s income, thereby merging the high-cost and low-income support mechanisms.

The FCC Must Reject Proposals to Discriminate Against Wireless Carriers.

Whatever steps the FCC takes to reform the high-cost support mechanisms, the Act demands that such support must be available on a technologically- and competitively-neutral basis. The Joint Board therefore should reject proposals to give the incumbent and competitive ETCs in a particular market unequal per-line support amounts.

Specifically, the Joint Board should reject blatantly discriminatory proposals to give competitive ETCs support based on their own embedded or forward-looking costs when those costs are less than the incumbent carrier's costs (but not when competitive ETC costs are the same or more than the incumbent's costs). Instituting a system that always gives competitive ETCs the short end of the universal service stick will significantly handicap competitive ETCs in the competitive marketplace – in some cases, literally requiring a wireless carrier to be two to three times more efficient than the wireline incumbent when competing for the same customer.

Wireless deployment in rural areas has occurred, in part, because of competitively neutral access to high-cost and low-income universal service support. Deployment of wireless services in rural markets is more costly on a per-customer basis than serving a more densely populated area. As with wireline networks, factors such as lower population densities, topography, and geographic isolation make the average cost of providing mobile wireless services in rural areas significantly higher than in urban areas. Western Wireless, for example, is reported to be spending five times as much capital and is building nine times as many cell sites in North and South Dakota, where it has been designated an ETC, than in Montana, where it has not been designated.

In some cases, wireless ETCs have brought universal service to rural and insular areas that traditionally have been underserved or unserved by incumbent LECs. The FCC has recognized, for example, that certain regions of the country, such as Appalachia, the Mississippi Delta, and Tribal Areas, have lower telephone penetration rates than other regions in the country and that the wireless industry can be a key player in deploying services to these areas.

The goal of competitive neutrality in the distribution of universal service funds is not just a worthwhile policy goal. It is required by statute. The FCC recognized this statutory mandate in its *First Report and Order* on universal service, stating that the universal service mechanisms rules should neither unfairly advantage nor disadvantage one provider or technology over another.

The courts also have ruled in support of nondiscrimination in the universal service context. In *Alenco Communications, Inc. v. FCC*, the United States Court of Appeals for the Fifth Circuit stated that the universal service program must treat all market participants equally (by making subsidies portable) so that the market, and not local or federal regulators, determines who competes for and delivers services to customers.

Conclusion.

Almost nine years after passage of the Telecommunications Act, it is time for the Joint Board and the FCC to complete necessary reforms to the high-cost universal service support mechanisms to make them more consistent with the Act's universal service and pro-competition goals, while curbing growth in the fund. To achieve the goals of universal service, the FCC should develop a simplified, unified, forward-looking high-cost support mechanism that replaces the five existing high-cost support mechanisms.

Whatever changes are made to the high-cost mechanisms, the Joint Board and the FCC must ensure that universal service support continues to be distributed in both a competitively and technologically neutral manner, as required by the Act. These steps will ensure that consumers, the intended beneficiaries of universal service, have more uniform access to high-quality and affordable telecommunications and information services, as the statute requires.

Thank you for your time and attention.