Ad Hoc Working Group Proposal

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executive summary of proposal
written testimony

BIOGRAPHY

Joel B. Shifman

- Senior Advisor - Maine Public Utilities Commission
- Staff of 80-286 (Separations) Joint Board
- Lead Commenter for the "Rural States Group" in the § 254 Universal Service Joint Board Docket
- Leader of the Regulatory Methodologies Issue Group of the NARUC Staff Subcommittee on Communications
- Formally General Counsel of Maine Public Advocate
- Worked for 10 years as a Telecommunications Attorney with West Virginia Public Service Commission
- Bachelors Degree from Carnegie Mellon University - 1970 Pittsburgh, Pennsylvania
- Law Degree from West Virginia University - 1975 Morganstown, West Virginia

Hobbies: Telecomm History

Biographical Information on Peter Bluhm
May 28, 1998

Peter Bluhm holds a law degree from Albany Law School and a Master of Public Administration from S.U.N.Y. at Albany. For twenty years Peter has lived in Vermont and has worked for Vermont state government. For ten years he served as Legislative Draftsman and Committee Counsel to the Vermont Legislature. He also has worked as Vermont Assistant Attorney General for the Department of Mental Health, General Counsel to the Vermont State Board of Education, and as Vermont Deputy Secretary of Administration.

Currently Peter is employed as Director of Regulatory Policy at the Vermont Public Service Board where he directs the Board's legislative program and is the head of the Board's Telecommunications Team. He also serves as a hearing officer on cases from a variety of industries and is responsible for overseeing Vermont's Universal Service Fund for telecommunications.

Peter is also the Immediate Past-President of the Vermont School Boards Association.

AD HOC WORKING GROUP PROPOSAL

EXECUTIVE SUMMARY

Representatives of low and high cost states, local exchange carriers large and small, and other industry participants have worked since the summer of 1997 to develop an approach to funding for high cost areas that satisfies both the Telecommunications Act of 1996 (Telecom Act) and their legitimate and diverse interests. The resulting proposal is a reasoned compromise that, if adopted, will satisfy the goal of the Telecom Act to ensure reasonably comparable rates for high cost areas of the country without creating an unduly large burden on cost in low cost areas. The key elements in the proposal are:

1) that funds should flow from state to state only to the extent that a state is unable, by balancing high and low cost areas within its boundaries, to achieve average cost levels consistent with the national average;

2) that current support levels for rural companies are maintained to avoid near-term disruption for rural companies; and

3) that the impact of anomalies in cost data is moderated by basing support on the lesser of embedded or forward-looking state average costs, with a provision to accommodate states that require rapid replacement of older infrastructure.

These elements, taken together, require a fund of modest size (under $2 billion nationwide using current cost estimates) and provide sufficient additional support that high cost states can satisfy their obligations under the Telecom Act.

Perhaps the most important benefit of the proposal, however, is that, because it is the product of extensive negotiation and give and take, its adoption will minimize the degree to which litigation will dominate the Universal Service Fund landscape. High cost states supporting the proposal would give up the opportunity to claim that, under the Telecom Act, far greater federal funding is required; low cost states, for their part, would give up the opportunity to claim in court that any obligation is too great.

Numerous principles guided the design of the plan. These principles are endorsed by all the submitting states as a package, although some states may differ with some of the individual principles.

- The principal purpose of federal high cost support is to maintain reasonably comparable intrastate rates, and not to reduce interstate access charges.

- Consumers in rural, insular and high cost areas should have access to a similar spectrum of telecommunications services as consumers in urban areas, at rates that are reasonably comparable to rates charged for similar services in urban areas elsewhere in the country.

- The federal high cost support program should be as small as possible.

- Revenues for the federal high cost support program should be derived from a charge on only the interstate revenues of interstate carriers.

- Collection and distribution of high cost support should be competitively neutral.

- Federal support should create appropriate incentives for investment in the network.

- Federal support for high cost areas should be compatible with the method of separating costs and revenues between interstate and intrastate jurisdictions.

- Federal support for high cost areas should be distributed in a manner determined by state commissions and that is compatible with the state's decisions on related issues of rate deaveraging and establishing the size of service areas.

- Carrier earnings should be based upon success attracting customers in a competitive market, not based upon exploiting irregularities of state and federal regulatory policy.

- Federal support should be based upon cost, and should be based upon the differences among the states in the ability to provide reasonably comparable rates with internally generated explicit subsidies. Federal support should permit each state to have rates equal to the overall national average, which is an acceptable definition of rates "reasonably comparable" to urban rates.

- Both forward looking cost and embedded cost should set upper limits on federal support. This will ensure that any errors generated by forward-looking cost models do not have unduly harsh consequences.

- Federal support should consist of a single system. No distinction should be made between rural and non-rural carriers, nor between loop and switch costs.

- Carriers should be assured that federal support will not decrease until the reliability of forward looking models has been securely established.

To satisfy these principles, the proposal would calculate and distribute high cost fund support using the following sequence:

1. Using forward-looking cost models, calculate the difference between each state's average cost and the national average. Remove the 25% of these costs already covered by interstate revenues under separations.

2. Using reported embedded costs of incumbent carriers, calculate the difference between each state's average (embedded) cost and the national average. Remove the 25% already covered by interstate revenues under separations.

3. For each state, take the lesser of the amounts from step 1 and step 2. This is the minimum amount of federal support for each state.

4. Calculate hold-harmless support for each state. For most states, this consists of support under existing support systems (i.e., support for loops and switches). For states with above average embedded costs that currently make a net contribution to federal support, the hold-harmless amount is increased to ensure that the state will not have to increase its net contribution.

5. Federal support under the proposal is the greater of this "hold-harmless" amount and the minimum amount from step 3.

6. State commissions would assign federal support first to carriers who would receive support under existing systems, and distribute remaining support (if any) according to plans adopted by the states and approved by the FCC to ensure consistency with the Telecom Act. States could distribute federal support in accordance with one of several options, each of which would ensure that rates in rural areas are reasonably comparable to rates in urban areas.

Statement of the Ad Hoc Working Group

Mr. Chairman, members of the Commission, members of the Joint Board. I am Peter Bluhm, Policy Director for the Vermont Public Service Board. I appreciate being invited here to discuss with you how to satisfy the Telecommunications Act's requirement that rates for customers in rural areas be affordable and reasonably comparable to rates in urban areas. With me today is Joel Shifman of the Maine Public Utilities Commission, the other lead staff author of the Ad Hoc Plan who will be available to answer questions this afternoon.

I will focus on the two key tests of a successful universal service plan: The universal service plan must be sufficient and it must be efficient.

Sufficiency means that the system of support for high cost areas must allow affordable local telephone rates to be available to subscribers everywhere in the country. Rates do not have to be equal between downtown Los Angeles or Houston and rural Vermont, but they must be reasonably comparable. A sufficient universal service plan is essential for the benefits of competition to be realized by all Americans.

Efficiency is also necessary. Financial resources are limited, and regulators cannot federalize all high cost support objectives including all implicit subsidies existing in state rate structures. It is neither economically desirable nor politically possible to raise $10 or $15 billion dollars through a surcharge on interstate services. Universal service at the federal level must make do with a smaller budget, and should be limited to supporting the areas that are most closely connected with the comparability objectives of the Telecommunications Act.

The current system fails first because it is insufficient. It does not even pretend to support all rural and high cost areas equally, in that it discriminates against rural areas served by large companies. Vermont is by one definition the most rural state in the country, yet its major carrier serve 85% of our customers. Customers who live in the area served by this carrier receive substantially less support for high-cost loops and switching than do customers in other, equally rural areas. Furthermore, the current program totally ignores the high interoffice costs in many rural states. Thus the rate comparability requirements of the Act cannot be achieved unless the current system is substantially modified.

The current system also fails to comply with the Act because, by basing support in part on the size of the incumbent, the current system is incompatible with competition. Competition requires that subsidies be explicit and portable. A support system that links the amount of support available in an area to the identity of the incumbent clearly would destroy any effort to achieve meaningful portability.

The Commission's order of May 1997 establishing a 25/75 federal/state split likewise fails the test of sufficiency. The rule itself actually moves away from sufficiency by in effect repealing current high cost support.

Even if current support levels were maintained, however, the 25-75 plan is insufficient. Indeed, even if the Commission were to apply the full 25 percent support entirely to the state jurisdiction, the results still would not be sufficient to ensure that customers everywhere in the country have reasonably comparable rates.

Simply put, some states have low-cost urban areas from which they can draw support. Other states, however, have only small urban areas, and very limited ability to finance high costs. For these states, average costs are so high that it is impossible for them to obtain comparable rates, no matter what they do. In states with many high cost customers and few low-cost customers, the surcharges needed to achieve comparable rates would be so large that, when added to existing rates, the total cannot be comparable with low-average-cost states. These high average cost states would face the Hobson❼s choice of either imposing very high end user surcharges, thus destroying comparability, or imposing very high interexchange carrier access charges, thus impeding competition and economic development.

A universal service support system can be both sufficient and efficient. The Commission should set up an overall framework for support, but that framework can anticipate that the states will fill in some of the pieces. While the Act does not require any state to enact a high cost support program, the Commission can appropriately make some assumptions about state effort. The only alternative is raising $8 to $10 billion dollars, something that is politically unacceptable to the Congress, and frankly, something that is not necessary.

A sufficient fund of more modest size, however, requires regulators to be selective about how federal support will be distributed. If support is given to areas that can raise that support another way, such as from low-cost areas inside their own states, there will not be enough funds left over to finance affordable and comparable rates in other states.

The Ad Hoc Plan limits federal support to states to the amount by which that state's cost exceeds a national average. The plan assumes that if a state has average costs that are at or below the national average, the state can support its high cost areas from within its own borders by surcharging its own low-cost areas to support its own high-cost areas. This decision is appropriate since much of the anticipated support is implicit today in rates that are set by state commissions. There is no immediate need to replace these instate transfers with federal support.

The Ad Hoc mechanism also uses both forward-looking and embedded costs in calculating support. This feature has been controversial, but it serves important purposes beyond constraining the size of the interstate fund. First, there is much uncertainty about the accuracy of forward-looking models. I recommend that the Commission find a way to limit their applicability until there is more confidence that they predict costs accurately. The use of embedded costs also creates incentives for network upgrades in areas that have suffered from under-investment, and encourages competition by not overcompensating incumbents in areas where they have old and highly depreciated plant.

The AD Hoc Plan provides a sound framework to meet the requirements of the Telecommunications Act. Working together, the Commission and the states can ensure that all of their resources are used, fairly and evenly, to guarantee to customers everywhere in the country rates that are affordable and reasonably comparable.

I appreciate the opportunity to speak to you today. Mr. Shifman and I will be pleased to answer your questions at the appropriate time.