



# Competition and Universal Service

Rural Task Force  
White Paper 5  
September 2000

<http://www.wutc.wa.gov/rtf>

The Rural Task Force is an independent advisory panel appointed by the Federal – State Joint Board on Universal Service to provide guidance on universal service issues affecting rural telephone companies. Opinions expressed in this White Paper are the collective view of the Rural Task Force membership and are not intended to represent the views of organizations to which each member is affiliated or those of the FCC or the Joint Board on Universal Service.

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**Rural Task Force**  
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**I. INTRODUCTION**

This White Paper addresses the components of a universal service system affecting competitive entry into rural and insular areas served by “rural telephone companies” (Rural Carriers).<sup>1</sup> The Rural Task Force (Task Force) has been appointed to make recommendations on a universal service support mechanism for areas served by Rural Carriers. The Task Force has previously recognized that a recommended support mechanism should be “consistent with extending the benefits of a competitive telecommunications market to rural or insular areas and with the principle of competitive neutrality.”<sup>2</sup> (*Footnote appears on following page*) This White Paper (1) reviews the provisions contained in the 1996 Act, Federal Communications Commission (FCC) orders and regulations, and court decisions governing the establishment of a competitive universal service system; (2) identifies the procedural and substantive requirements for competitive carriers to obtain designation as Eligible Telecommunications Carriers (ETCs)

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<sup>1</sup> “Rural telephone company” means a local exchange carrier operating entity to the extent that such entity— (A) provides common carrier service to any local exchange carrier study area that does not include either— (i) any incorporated place of 10,000 inhabitants or more, or any part thereof, based on the most recently available population statistics of the Bureau of the Census; or (ii) any territory, incorporated or unincorporated, included in an urbanized area, as defined by the Bureau of the Census as of August 10, 1993; (B) provides telephone exchange service, including exchange access, to fewer than 50,000 access lines; (C) provides telephone exchange service to any local exchange carrier study area with fewer than 100,000 access lines; or (D) has less than 15 percent of its access lines in communities of more than 50,000 on the date of enactment of the Telecommunications Act of 1996 (47 U.S.C. Section 153 (37)). The term “Rural Carrier” as used in this Recommendation is meant to include carriers serving insular areas and to incorporate the statutory definition of “rural telephone company” as applied in the FCC rules. See In re: Federal-State Joint Board on Universal Service, CC Docket No. 96-45, *Report and Order* (rel. May 8, 1997) at paragraph 96. See also *FCC Public Notice*, CC Docket No. 96-45, DA 98-1205 (rel. June 22, 1998) lists recognized self-certified “Rural Telephone Companies.” This list is updated periodically. See for example, *FCC Public Notice*, CC Docket No. 96-45, DA001705 (rel. Aug. 1, 2000).

for purposes of universal service support; and (3) examines the components of a universal service system that impact competitive entry into areas served by Rural Carriers eligible for universal service support.

## II. BACKGROUND

The FCC has historically implemented rules and policies to make telecommunications service affordable to all individuals through a combination of implicit and explicit subsidies available to incumbent local exchange carriers (ILECs). In the 1996 Act Congress directed the FCC to replace the existing universal service support mechanisms with “specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service.”<sup>3</sup> In response to this statutory mandate, the FCC adopted a series of orders, concluding that “universal service support will be sustainable in a competitive environment; this means both that the system of support must be competitively neutral and permanent, and that all support must be targeted as well as portable among eligible telecommunications carriers.”<sup>4</sup> Upon review of the FCC’s *Report and Order*, the Fifth Circuit Court of Appeals concluded:

For obvious reasons this system of implicit subsidies can work well only under regulated conditions. In a competitive environment, a carrier that tries to subsidize below-cost rates to rural customers with above-cost rates to urban customers is vulnerable to a competitor that offers at-cost rates to urban customers. Because opening local telephone markets to competition is a principal objective of the Act,

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<sup>2</sup> The Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996 Act). *See also Rural Task Force Mission and Purpose*, Rural Task Force, White Paper 1 at p. 7, September 1999, available on the Task Force Internet web site at [www.wutc.wa.gov/rtf](http://www.wutc.wa.gov/rtf). For any references to Task Force white papers hereinafter, please refer to the Task Force web page.

<sup>3</sup> *See* 47 U.S.C. § 254(b)(5).

<sup>4</sup> *See In re: Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, *Report and Order* (rel. May 8, 1997); as corrected by *Erratum*, FCC 97-157 (rel. June 4, 1997) at par. 19, *aff’d in part, rev’d in part, remanded in part sub. nom. Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393 (5<sup>th</sup> Cir. 1999). This case will be referred to hereinafter as “*Report and Order*.”

Congress recognized that the universal service system of implicit subsidies would have to be re-examined.<sup>5</sup>

As explained more fully below, the FCC and the courts have recognized that rural consumers will best realize the benefits of a competitive market by reforming the existing universal service system to achieve the objectives of the 1996 Act.

#### **A. The Act: Competition and Universal Service**

The 1996 Act's twin goals are to promote competition and preserve and advance universal service. To achieve these goals, Congress enacted Section 254 and 214(e) of the 1996 Act to establish a universal service system that would be sustainable in a competitive environment. Congress delegated to the FCC the responsibility to adopt rules to implement Sections 254 and 214(e) of the 1996 Act, based upon the recommendations of the Federal-State Joint Board on Universal Service (Joint Board).

Section 254(b) of the 1996 Act establishes the following universal service principles to guide the FCC in adopting rules and policies:

(1) **QUALITY AND RATES.** Quality services should be available at just, reasonable, and affordable rates.

(2) **ACCESS TO ADVANCED SERVICES.** Access to advanced telecommunications and information services should be provided in all regions of the Nation.

(3) **ACCESS IN RURAL AND HIGH COST AREAS.** 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 services in urban areas.

(4) **EQUITABLE AND NONDISCRIMINATORY CONTRIBUTIONS.** All providers of telecommunications services should make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service.

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<sup>5</sup> Texas Office of Public Utility Counsel v. FCC, 183 F.3rd 393 at 406. (5<sup>th</sup> Cir. 1999). This case will be referred to hereinafter as "TOPUC v. FCC."

(5) **SPECIFIC AND PREDICTABLE SUPPORT MECHANISMS.** There should be specific, predictable, and sufficient Federal and State mechanisms to preserve and advance universal service.

(6) **ACCESS TO ADVANCED TELECOMMUNICATIONS SERVICES FOR SCHOOLS, HEALTH CARE, AND LIBRARIES.** Elementary and secondary schools and classrooms, health care providers, and libraries should have access to advanced telecommunications services as described in subsection (h).

(7) **ADDITIONAL PRINCIPLES.** Such other principles as the Joint Board and the Commission determine are necessary and appropriate for the protection of the public interest, convenience, and necessity and are consistent with this Act.

Whereas Section 254(b) of the 1996 Act addresses the requirements of a universal service support mechanism, Section 214(e) of the 1996 Act addresses the eligibility requirements for common carriers to receive support for providing universal service. In particular, Section 214(e)(1) and (2) provide:

**Section 214(e) PROVISION OF UNIVERSAL SERVICE.**

(1) **ELIGIBLE TELECOMMUNICATIONS CARRIERS.** A common carrier designated as an eligible telecommunications carrier under paragraph (2), (3), or (6) shall be eligible to receive universal service support in accordance with section 254 and shall, throughout the service area for which the designation is received --

(A) offer the services that are supported by Federal universal service support mechanisms under section 254(c), either using its own facilities or a combination of its own facilities and resale of another carrier's services (including the services offered by another eligible telecommunications carrier); and

(B) advertise the availability of such services and the charges therefore using media of general distribution.

(2) **DESIGNATION OF ELIGIBLE TELECOMMUNICATIONS CARRIERS.** A State commission shall upon its own motion or upon request designate a common carrier that meets the requirements of paragraph (1) as an eligible telecommunications carrier for a service area designated by the State commission. Upon request and consistent with the public interest, convenience, and necessity, the State commission may, in the case of an area served by a rural telephone company, and shall, in the case of all other areas, designate more than one common carrier as an eligible telecommunications carrier for a service area designated by the State commission, so long as each additional requesting carrier meets the requirements of paragraph (1). Before designating an additional eligible telecommunications carrier for an area served

by a rural telephone company, the State commission shall find that the designation is in the public interest.

Together, Section 254(b) and 214(e) of the 1996 Act provide the statutory framework for a system that encourages competition while preserving and advancing universal service.

## **B. The FCC: Implementation of the Act's Universal Service Provisions**

The FCC has consistently held that universal service must be implemented in a competitively neutral manner.

A principal purpose of Section 254 is to create mechanisms that will sustain universal service as competition emerges. We expect that applying the policy of competitive neutrality will promote emerging technologies that, over time, may provide competitive alternatives in rural, insular, and high cost areas and thereby benefit rural consumers.<sup>6</sup>

To this end, pursuant to Section 254(b)(7) of the 1996 Act, the FCC adopted the principle of competitive neutrality to guide the establishment of universal service mechanisms and defined this principle as follows:

**COMPETITIVE NEUTRALITY** – Universal service support mechanisms and rules should be competitively neutral. In this context, competitive neutrality means that universal service support mechanisms and rules neither unfairly advantage nor disadvantage one provider over another, and neither unfairly favor nor disfavor one technology over another.<sup>7</sup>

The FCC explained the principle of technological neutrality in the following manner:

By following the principle of technological neutrality, we will avoid limiting providers of universal service to modes of delivering that service that are obsolete or not cost effective. The Joint Board correctly recognized that the concept of technological neutrality does not guarantee the success of any technology supported through universal service support mechanisms, but merely provides that universal service support should not be biased toward any particular technologies. We anticipate that a policy of technological neutrality will foster the development of competition and benefit certain providers, including wireless, cable, and small businesses that may have been excluded from participation in universal service mechanisms if we had interpreted universal service eligibility criteria so as to favor particular technologies. We also agree with the Joint Board's

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<sup>6</sup> *Report and Order* at para. 50.

<sup>7</sup> *Ibid*, at para. 47.

recommendation that the principle of competitive neutrality, including the concept of technological neutrality, should be considered in formulating universal service support mechanisms, regardless of size, status, or geographic location.<sup>8</sup>

The FCC concluded that a fully portable universal service system available to any state-designated ETCs should also apply in areas served by Rural Carriers, consistent with the principle of competitive neutrality and the 1996 Act's universal service requirements:

We adopt the Joint Board's recommendation to make rural carriers' support payments portable. As we discussed above regarding non-rural carriers, a CLEC that qualifies as an eligible telecommunications carrier shall receive universal service support to the extent that it captures subscribers formerly served by carriers receiving support based on the modified existing support mechanisms or adds new customers in the ILEC's study area. We conclude that paying the support to competitive eligible telecommunications carrier that wins the customer or adds a new subscriber would aid the entry of competition in rural study areas.<sup>9</sup>

### C. The Courts: Review of the FCC's Universal Service Orders

The Fifth Circuit Court of Appeals has issued two decisions addressing various aspects of the FCC's universal service orders. In TOPUC v. FCC, the court considered arguments challenging the FCC's *Report and Order* implementing Section 254 and 214 (e)(2) of the 1996 Act and largely affirmed the FCC's rules implementing the universal service provisions of the 1996 Act:

To attain the goal of local competition while preserving universal service, Congress directed the FCC to replace the patchwork of explicit and implicit subsidies with "specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service."<sup>10</sup>

In *Alenco Communications, Inc. v. FCC*,<sup>11</sup> (footnote appears on following page) the court addressed other aspects of the FCC's rules governing the establishment of a competitive universal service system. The court concluded that competition and universal service are twin

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<sup>8</sup> Ibid, at para. 49.

<sup>9</sup> Ibid, at para. 311.

<sup>10</sup> TOPUC v. FCC at 406.

goals of the 1996 Act and affirmed the challenged FCC's universal service rules. The following are some of the court's comments, analysis and conclusions on the issue of a universal service system in a competitive environment:

Alongside the universal service markets is the directive that local telephone markets be opened to competition.<sup>12</sup> The FCC must see to it that both universal service and local competition are realized; one cannot be sacrificed in favor of the other. The Commission therefore is responsible for making the changes necessary to its universal service program to ensure that it survives in the new world of competition.<sup>13</sup>

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Second, the old regime of implicit subsidies—that is, “the manipulation of rates for some customers to subsidize more affordable rates for others”—must be phased out and replaced with explicit universal service subsidies—government grants that cause no distortion to market prices—because a competitive market can only bear the latter.<sup>14</sup>

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Finally, the program must treat all market participants equally—for example, subsidies must be portable—so that the market, and not local or federal government regulators, determines who shall compete for and deliver services to customers.<sup>15</sup>

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The purpose of universal service is to benefit the customer, not the carrier. “Sufficient” funding of the customer’s right to adequate telephone service can be achieved regardless of which carrier ultimately receives the subsidy.<sup>16</sup>

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To the extent petitioners argue that Congress recognized the precarious competitive positions of rural LEC’s, their concerns are addressed by 47 U.S.C. § 214(e), which empowers state commissions to regulate entry into rural markets. Furthermore, portability is not only consistent with predictability, but also is dictated by principles of competitive neutrality and the statutory command that

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<sup>11</sup> Alenco Communications, Inc., v. FCC, 3<sup>d</sup> 608 (5<sup>th</sup> Cir. 2000). This case will be referred to hereinafter as “Alenco v. FCC.”

<sup>12</sup> See 47 U.S.C. §§ 251-253; AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366, 371, 119 S. Ct. 721, 142 L.Ed.2d 835; TOPUC, 183 F.3d at 406, 412.

<sup>13</sup> Alenco v. FCC, at 615.

<sup>14</sup> Alenco v. FCC, at 616.

<sup>15</sup> Alenco v. FCC, at 616.

<sup>16</sup> Alenco v. FCC, at 621.

universal service support be spent “only for the provision, maintenance, and upgrading of facilities and services for which the [universal service] support is intended.”<sup>17</sup>

While the establishment of a competitively neutral universal service system will enable the emergence of competition in high-cost areas served by Rural Carriers, a competitive carrier is only able to obtain universal service support upon designation as an ETC.

### III. ETC STATUS

A service provider seeking to become eligible for universal service support must be designated as an ETC pursuant to requirements of Section 214(e)(1), (e)(2), and (e)(5) of the 1996 Act. Pursuant to the statute, in order to be designated an ETC, a provider must:

- Be a common carrier.
- Offer the services and functionalities, as defined by FCC, through its own facilities or through a combination of its own facilities and the resale of services offered by another carrier.
- Advertise the availability of the supported services and charges using media of general distribution.
- Make the services available throughout a designated service area, which in the case of ETCs that are Rural Carriers, has been defined as the Rural Carrier ETCs entire study area.
- Receive a finding from the state commission that the designation of an additional ETC in an area served by a Rural Carrier is in the public interest.

In addition to the statutory requirements, FCC rules require that all ETCs must advertise and make available Lifeline service to qualified customers.<sup>18</sup> Each of these requirements will be discussed below.

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<sup>17</sup> *Alenco v. FCC*, at 622.

<sup>18</sup> See 47 CFR § 54.405.

Common Carrier Requirement. A common carrier is generally defined as “any person engaged as a common carrier for-hire in interstate or foreign communications by wire or radio,”<sup>19</sup> and includes ILECs, CLECs, and Commercial Mobile Radio Service (CMRS) providers.

Offer The Supported Services. FCC rules set forth the nine (9) services or functionalities currently eligible to be supported by federal universal support mechanisms and required to be provided by an ETC.<sup>20</sup> These services and functionalities are currently defined as:

- Voice-Grade Access to public switched network, which is defined as the functionality that enables a user to transmit voice communications and to place or to receive calls within a bandwidth of approximately 2700 Hertz between 300 Hertz and 3000 Hertz frequency range;<sup>21</sup>
- Local usage;<sup>22</sup>
- Dual Tone Multi-Frequency (“DTMF”) Signaling or Functional Equivalent, which is a method of signaling that facilitates the transportation of signaling through a network to shorten call set-up time and provide call detail information;
- Single-Party Service or Functional Equivalent;
- Access to Emergency Services, which includes ability to reach a public emergency service provider and, to the extent required, access to E-911 with automatic numbering information (“ANI”) and automatic location information (“ALI”);
- Access to Operator Services, which is a consumer’s ability to access any automatic or live assistance to arrange for the billing and/or completion of a call;
- Access to Interexchange Service, which means the ability of a customer to make and receive toll or interexchange calls, but does not include equal access;

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<sup>19</sup> See 47 U.S.C. § 153(10).

<sup>20</sup> See 47 CFR § 54.101.

<sup>21</sup> In re: Federal State Joint Board on Universal Service, CC Docket No. 96-45, *Fourth Order on Reconsideration* FCC 97-420 (Dec. 30, 1997) at paragraphs 15 and 16.

<sup>22</sup> See In re: Federal-State Joint Board on Universal Service, CC Docket No. 96-45 *Memorandum, Opinion, and Order and Further Notice of Proposed Rulemaking*, (rel. Oct. 26, 1998) at paras. 1-4, wherein the FCC seeks comment on the definition of basic service packages that carriers must offer in order to be eligible to receive federal universal service support, specifically addressing how much local usage an ETC must offer.

- Access to Directory Assistance, which means access to a service that includes making available to customers information contained in directory listings, but does not include white pages directories and directory listings;
- Toll Limitation for Qualifying Low-Income Consumers, which means the ability to provide a blocking service to Lifeline customers to elect not to allow outgoing toll calls; lifeline service consists of the FCC mandated services under 54.101(a)(1)-(9) that is available only to qualifying low-income consumers who are eligible for a discount on their monthly rates.<sup>23</sup>

Advertising the Availability of Services. An ETC must advertise the availability of supported services and charges for such universal service offerings using media of general distribution. The FCC has not adopted any particular standards regarding the advertising requirements under Section 214(e)(1)(B) of the 1996 Act, but has recommended that States establish guidelines and monitor ETCs advertising on an ongoing basis.

Offering the Supported Services Throughout Designated Service Areas. An ETC must provide all of the FCC's supported services throughout its designated service areas. "Service area" is generally defined as a geographic area established by a state commission for the purpose of determining universal service obligations and support mechanisms. For an area served by a Rural Carrier, the term "service area" means the Rural Carrier's "study area," unless the FCC and the state commission establish a different definition for such a company under the procedures set forth in FCC rules.<sup>24</sup> (*Footnote is on the next page*) A "study area" is generally considered to be all of the certificated exchange service areas within a given state. An ETC must provide supported services over its own facilities, at least in part. Resale of the ILECs services may be used in areas located outside of an area served by an ETC with its own facilities.

Public Interest Determination in RTC Areas. In areas served by Rural Carriers the 1996 Act imposes an important additional condition on a competitive carrier seeking ETC designation. Under Section 214(e) of the 1996 Act, state commissions are required to make a finding that the

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<sup>23</sup> All ETCs must make Lifeline service available to qualifying low-income customers. See 47 CFR § 54.405.

designation of an additional ETC in areas served by Rural Carriers is in the public interest. To date, several state commissions have made public interest findings. There are several other petitions for ETC designation in Rural Carrier areas pending before state commissions.

#### **IV. ISSUES IN DESIGNING A UNIVERSAL SERVICE SYSTEM TO ENABLE COMPETITIVE ENTRY INTO AREAS SERVED BY RURAL CARRIERS**

##### **A. Competitive Carriers' Entry Into Markets Served by Rural Carriers**

Local telecommunications service competition exists in many urban areas where carriers compete based both on service capabilities and on rates charged to customers. Competitive entry in high-cost areas served by Rural Carriers is less widespread than in urban areas, but is also growing. Competition in these areas is also based both on rates charged to customers and the level and type of services provided. Competitive carriers are unlikely to enter high-cost areas served by Rural Carriers and provide service if they are not able to recover their costs of providing service. To the extent that incumbents receive universal service support, such support should be extended to competitors willing to take on the responsibilities of an ETC.

**Essential attributes of a competitively neutral universal service system include the following:**

1. Universal service support should be explicit and based upon the cost (actual or estimated) of providing service within the designated area;
2. Explicit universal service support should be portable. Potential competitors should have ready access to the amount of support available for serving a consumer within a defined high-cost geographic area;

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<sup>24</sup> See 47 CFR § 54.207(c) and (d).

3. The universal service support mechanism should be implemented in a non-discriminatory manner; and
4. Regulatory requirements that significantly influence cost should be implemented in a competitively neutral manner.

#### **B. Identification of High-Cost Areas Eligible for Universal Service Support**

Eligibility for universal service support for areas served by Rural Carriers must be determined on the basis of competitive and technological neutrality — that is, without regard to the recipient's corporate identity or the technology used by the recipient. A competitive carrier's decision to enter the universal service market depends, in part, on two key factors: (1) an identification of the geographic area for which universal service support is available; and (2) the identification of the amount of explicit support per line within the geographic area.

Disaggregation of a Rural Carrier's universal service support may be necessary to facilitate competitive entry. Once support is disaggregated, it can be targeted to high-cost areas. Unless the amount of support is readily identifiable and available, it will be difficult for competitive carriers to enter markets served by Rural Carriers and compete for customers on an equal basis.

#### **C. Transparency and Portability of Support**

Prior to the 1996 Act, universal service was an obligation imposed upon incumbent local exchange carriers who received support to provide service throughout their service areas. While continuing this ILEC obligation, the 1996 Act requires affordability and removes barriers to local competition and provides for the designation of multiple ETCs in areas served by Rural Carriers for purposes of universal service support, provided that the state commission finds that having more ETCs than just the incumbent Rural Carrier as an ETC is in the public interest.<sup>25</sup> Congress did not specifically address how to implement a universal service support mechanism. In

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<sup>25</sup> See 47 U.S.C. § 214(e).

implementing regulations, however, the FCC concluded that "competitive neutrality"<sup>26</sup> requires that support equivalent to the per-line support received by an incumbent Rural Carrier be "portable" to a competitive ETC (CETC) "to the extent that it captures subscribers formerly served by carriers receiving support based on the modified existing support mechanisms or adds new customers in the ILEC's study area."<sup>27</sup>

The FCC's rules governing portability of universal service support have undergone several revisions from their initial adoption in 1997. Originally the FCC did not have a specific rule that the ILEC's support would be reduced when a CETC began providing service. In December 1997<sup>28</sup> the FCC revised Section 54.307 of the rules to state:

The amount of universal support provided to such incumbent local exchange carrier shall be reduced by an amount equal to the amount provided to such competitive eligible telecommunications carrier.

Thus, under the FCC revised rules, an ILEC's support would be reduced whenever a CETC began providing service to a customer. However, in November 1999<sup>29</sup>, the FCC deleted Section 54.307(a)(4) with the result that the ILEC's support is not directly reduced as a result of the CETC providing service to customers in a service area.<sup>30</sup> The November 1999 revision eliminated the problem that high cost support would be incorrectly taken away from an incumbent when the CETC's support was for a "new" line, and the incumbent did not lose a line.

Notwithstanding these changes to the FCC rules, some parties maintain that there are still unresolved questions about the terms "formerly served," "captured" and "new" lines as used in

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<sup>26</sup> The FCC adopted the principal of "competitive neutrality" as part of its regulations pursuant to § 254(b)(7) of the 1996 Act.

<sup>27</sup> *Report and Order* at paragraph 311.

<sup>28</sup> In re: Federal-State Joint Board on Universal Service, CC Docket No. 96-45, *Fourth Order on Reconsideration* (rel. Dec. 30, 1997), at paragraph 84.

<sup>29</sup> In re: Federal-State Joint Board on Universal Service, CC Docket No. 96-45, *Ninth Report and Order and Eighteenth Order on Reconsideration*, (rel. Nov. 1999) in Appendix C at item 7.

<sup>30</sup> The ILEC's universal service support is computed based on actual costs and working loops. Therefore, indirectly the ILEC's support could change if the CETC actually won a line previously served by the ILEC (as compared to if the CETC began providing an additional line to the customer).

the FCC rules.<sup>31</sup> For example, Section 54.307 provides that support is portable when a CETC "captures" a line from an incumbent ETC or when a CETC serves "new subscriber lines" in the incumbent ETC's service area.<sup>32</sup> Questions have been raised as to (i) how to tell if a line has been captured from the ETC, and (ii) whether "new" subscriber lines in the incumbent ETC's service area means lines that the incumbent did not serve before, lines that no carrier provided before, lines that the CETC begins to serve after its designation as an ETC, or all lines the CETC serves at any point, even those it provided at its full charges before designation. Other parties believe that no clarification to the FCC rules is necessary and that the meaning of the term "captured lines" means lines formerly served by the incumbent ETC and now served by the CETC. Furthermore, "new lines" means lines that previously did not exist as supported lines and therefore are new. Dealing with "captured" and "new" lines may create administrative problems and the need to track customers from one ETC to another. A more liberal interpretation of the term "new" lines increases the concerns of contributing carriers (and the customers who ultimately pay for a fund) about the size of the fund.

One key reason for the FCC's adoption of portability rules is to help enable competitive neutrality. Modifications to the support mechanisms for Rural Carrier service areas should enable competing carriers to know precisely what is required of them, what support will be available, and how support will be implemented for them if their operations differ from the incumbents whose costs and price structure are used to measure portable support.

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<sup>31</sup> 47 CFR § 54.307.

<sup>32</sup>In fact, the FCC placed the word "new" - as used in the phrase "new lines" - in quotation marks in April, 2000, when it rejected a request for loop count confidentiality. In re: Federal-State Joint Board on Universal Service, CC Docket No. 96-45, *Order*, FCC 00-125, (rel. April 7, 2000) at para. 16: "Under the Commission's high-cost universal service mechanisms, a competitive eligible telecommunications carrier will receive the same per-line, high-cost support for lines that it captures from an incumbent carrier, as well as for any 'new' lines that the competitive eligible telecommunications carrier serves in high-cost areas. Thus, a competitive eligible telecommunications carrier receives support for each line it serves based on the support the incumbent local exchange carrier would receive for serving that line."

The rules and amounts of support available to an ETC must be "transparent"; that is, the amount of support that goes toward universal service for any particular area must be explicit, readily available and easily identifiable. The transparency of support will permit competitors to make informed judgments about where to enter and provide service, and whether to seek ETC status. Today, the amount of explicit federal universal service support per line for Rural Carriers can be identified for any study area in the country via information contained on the FCC's web site, but implicit support continues to support universal service and is not easily identifiable or readily available (*see* Subsection IV. F. below).<sup>33</sup> Transparency of federal universal service support is therefore critical for the CETC's business planning. CETCs trying to determine the feasibility of market entry into a given service area need to identify how much federal universal service support per line would be available once service is provided to a customer.

Even though explicit federal universal service support available to Rural Carriers today is transparent, the support is expressed as an average amount per line for the Rural Carrier's entire study area. As discussed in Subsection IV. F., support needs to be disaggregated with payments targeted to high-cost areas. As support is disaggregated to the wire center level and below, transparency must be maintained. The amount of per line support available in any disaggregated support zone must be publicly available so that a potential competitor can obtain that information, and develop its pre-entry business plan.

A key portability concern for incumbent ETCs is the issue of stranded costs. Many ILECs argue that reduction of universal service support when a line is captured by a competitor may result in an unconstitutional confiscation or a "taking" of the incumbent's property without just compensation. Other parties argue that a change in the method of regulation for a regulated

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<sup>33</sup> For purposes of portability of federal universal service support, "transparency" means that anyone can easily determine the amount of federal universal service support per line a CETC would receive in a given study area. While study area level information is available from the FCC's web site, information for non-Rural Carriers is not available by wire center at this site.

industry – in this case the introduction of local competition in telecommunications – cannot be the basis for a “takings” claim.<sup>34</sup>

Nevertheless, incumbent Rural Carrier ETCs have a strong interest in ensuring that reforms of the universal service support mechanism for rural telephone companies provide for cost recovery consistent with their past decisions to invest in networks and incur costs under the preexisting regulatory paradigm. This system ensured that these companies were the only provider of service in their certificated service area and gave them the right to set their rates to recover their embedded costs. An industry like telecommunications is characterized by high fixed costs. When a customer switches carriers and the "portable support" associated with that customer goes to a different carrier, the costs incurred by the previous carrier are not likely to be reduced in an offsetting amount. If these costs cannot be recovered or offset by other means, then these costs are “stranded.”

The incumbent ETCs have already provided the existing investment in the rural portions of the nation based, at least in part, on a system of support and regulation that would allow full cost recovery. Policies inconsistent with this result will engender severe controversy, if not litigation.

Not all ILECs have the potential to attract alternative revenue sources derived from their underlying plant built in compliance with legal obligations imposed by state commissions, the U.S. Department of Agriculture’s office of Rural Utilities Services via Rural Electric Loan Restructuring Act (RELRA), and the FCC. The only alternative revenue source to recover lost universal service support for rate-of-return regulated carriers is to shift that revenue requirement into local service rates.

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<sup>34</sup> A constitutional challenge to the FCC's use of a TELRIC model for pricing interconnection pursuant to sections 251 and 252 of the 1996 Act was rejected by the 8<sup>th</sup> Circuit Court of Appeals as not “ripe” for consideration. Iowa Utilities Board v. FCC, 219 F 3d 744 at 754, (8<sup>th</sup> Cir. 2000).

CLECs maintain that they also have high levels of fixed costs to serve customers, without any guarantee that customers will use or remain on their networks, and that any lower support per line would discourage competitive entry in rural markets and would put CETCs that entered rural ILEC areas at an unfair competitive disadvantage. CLEC and IXC representatives question the potential for “stranded costs” resulting from competitive entry. The CLECs noted that the ILECs’ ability to attract alternative revenues that rate of return regulated carriers may pursue, would reduce the potential for financial harm that would warrant additional compensation for “stranded costs.” Indeed, the CLECs contended that to date, not one claim for such compensation has been sustained by the regulatory/judicial procedures. In addition, CLEC representatives argue that the FCC’s “competitive neutrality” principle requires that support for CETCs be fully equivalent to the support for ILEC ETCs. Thus the CLECs believe that any “additional” support to the ILEC, which is not portable to the CETC, to compensate for “stranded costs” would violate that principle.

#### **D. Other Portability issues**

##### **1. Basis of Portable Support**

Currently, federal universal support for areas served by Rural Carriers is based on the embedded costs of the ILEC. Should the CETC’s support be based on their own costs rather than the ILEC’s costs? Since the regulatory reporting requirements vary significantly between ILECs and CETCs, it may be difficult for CETC’s to report their own cost data, and it may not be practical to base the level of universal service support on each carrier’s individual costs.

##### **2. The Effect of Competitive Losses on Per Line Support**

Under current rules the CETC receives per line support based on the ILEC’s total support divided by the number of lines served. The ILEC’s support is based, in large part, on embedded

investment and expense which may not change, regardless of competitive losses. As a result, as the ILEC loses lines, the amount of per line support available to the CETC, on a per line basis, increases.<sup>35</sup> A primary consideration is whether the CETC's support would continue to be revised based on the amount of support available to the ILEC. Should the support be a fixed amount, based on the point in time when service was initiated by the CETC, or when the CETC added a line?<sup>36</sup> (*Footnote appears on next page*)

### **3. Location of and Support for Mobile Customers**

Universal service support is supposed to be competitively and technologically neutral. However, since the local service areas and network configurations for CETCs may be significantly different than for incumbents, and support needs to be disaggregated below the service area, how should a mobile (i.e., non-fixed location) customer be identified for purposes of administering distribution of support? Should these customers be assigned to the proper incumbent wire center and to the appropriate sub-zone in the wire center?

### **4. Frequency of Reporting and Lag in Support**

How frequently should line count data be reported by incumbent and competitive ETCs (e.g., daily, monthly, quarterly or annually)? In addition, what methodology should be used for the line count data to compute the carrier's USF support (e.g., average line count data for the period, end-of-period data, or an average-of-period averages)? Since the competitive inroad of the CETC usually begins with a slow ramp-up as customers are signed on for service, customer additions are likely to occur at any time. The interval between the provision of service and

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<sup>35</sup> For example, under existing rules, if an ILEC served 1,000 lines and received \$1,000 in monthly universal service support, this would equate to \$1 of support per line. This amount would be available to any CETC which captured a line from the ILEC. If the ILEC lost 500 lines to competitors, but the ILEC's support based on embedded cost still amounted to \$1,000 per month, the per line support available to the ILEC and CETC would double to \$2 per line to the ILEC and CETC. Since the support level is not based upon the CETC's costs, the amount of support available to a CETC on a per line basis may still not be equal to the CETC's costs.

receipt of universal service funding (known as the "lag") should be as short as technically and administratively feasible to ensure provision of universal service. Similarly, to the extent customers are replacing an ILEC service with a CETC service, the ILEC's line count can decline precipitously throughout the same period. The line count submissions to the USF administrator (currently the Universal Service Administrative Company, or "USAC") must be sufficiently sensitive to this mid-period activity. Thus, continuing support for the ILEC for a whole period when it is not serving the customer for the whole period, coupled with the failure to compensate the CETC for the portion of the period that it is providing service may constitute a barrier to entry for the CETC. Several alternatives are available to minimize this concern:

One alternative would be to require daily line counts to be reported to the federal universal service fund administrator. While this solution would provide the most accurate solution, many believe this option would be administratively burdensome. A second alternative might be to use the average of the period (i.e., averaging beginning with end of period data). A third alternative would be some form of "true up" mechanism to estimate mid-period activity.

#### **E. Disaggregation of the Service Area for ETC Purposes**

This paper has previously discussed the need to disaggregate support so that it can be appropriately targeted to high-cost areas. Should the level of disaggregation of the service area for ETC purposes match the level of disaggregation of federal universal service support? A CETC will not be allowed to receive support unless it serves the entire Rural Carrier study area. However, if the serving area required for ETC designation is larger than the area targeted for high-cost support, then the CETC may be competitively disadvantaged. State commissions have the authority to certify ETCs. States and the FCC, taking into account recommendations of the

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<sup>36</sup> Establishing fixed per line support levels creates new issues. If the CETC were to receive a fixed amount per line based on the point in time when the line was captured, there could be a significant administrative burden to keep customer records based on which quarter of which year a customer began service. Problems could also occur related

Joint Board, are jointly responsible for determining the size of the serving area for ETC designation. Disaggregation of support is discussed further in White Paper 6.

#### **F. Elimination of Implicit Universal Service Support**

Implicit interstate universal service support should be identified and replaced to the extent such support is necessary to support universal service. If a competitive carrier does not have access to the same implicit support available to ILECs, this may create an uneven playing field with the ILEC having access to "X" amount of universal service support and the competitive carrier has access to less than "X" amount of universal service support. Conversely, an ILEC may be subject to pervasive regulation, which may create an uneven playing field when compared with a virtually unregulated competitive carrier.

A competitive market may be more efficient if the rates for local telephone service are based upon the cost of providing service, or if an explicit universal service support mechanism based upon the cost of providing service provides the same amount of support to both the ILEC and the competitive carrier. To eliminate, to the extent possible, implicit universal service support that may exist in interstate rates, it is likely that access charge reform for rural carriers will be needed. This implies that an additional high-cost fund (e.g., High-Cost Fund III)<sup>37</sup> (*Footnote appears on following page*) should be created as an explicit replacement for the implicit support formerly embedded in access rates.

#### **G. Availability of Universal Service Support For All Lines In Rural, High-Cost Areas.**

Current FCC rules provide support for all lines in high-cost areas served by Rural Carriers. However, some parties have argued that support should be limited to primary lines

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to new lines and customers that switch back and forth or customers who take a line from both an ILEC and a CETC.

only. Other parties argue that providing universal service support for only primary lines could create a market abnormality in that urban consumers would have access to as many affordable lines as needed, but rural consumers would have access to only one affordable line. In that case, the price for the non-primary line would not be eligible for support, and would presumably rise to cover the full cost of providing the service.

## V. CONCLUSION

The essential mandates of the 1996 Act are to foster competition while preserving and advancing a specific, predictable and sufficient universal service mechanism. Of equal importance, the universal service mechanism ultimately adopted must simultaneously produce incentives for investment and market entry into high-cost service areas served by Rural Carriers, while maintaining a competitively neutral playing field that will ensure consumers in high-cost areas served by Rural Carriers, have access to telecommunications choices reasonably comparable to those provided in urban areas, at rates reasonably comparable to rates charged for similar services in urban areas. This paper identifies the competitive issues and concerns in reforming federal universal service for Rural Carriers. The FCC will need to find a workable balance in replacing implicit support with explicit support to ensure that smaller Rural Carriers are able to remain economically viable in an openly competitive market.

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<sup>37</sup> See the Rural Task Force Recommendation for a discussion of High-Cost Fund III issues, the Recommendation is available at [www.wutc.wa.gov/rtf](http://www.wutc.wa.gov/rtf).