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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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IN THE MATTER OF REVIEW AND
POSSIBLE REVISION OF THE ARIZONA
UNIVERSAL SERVICE FUND RULES

DOCKET NO. RT 00000H-97-0137

**AT&T's COMMENTS ON ALECA's
PROPOSED REVISION**

Pursuant to Commission Order dated April 13, 2005, AT&T Communications of the Mountain States, Inc. and TCG Phoenix (collectively "AT&T") hereby submit these Comments in response to the Arizona Local Exchange Carriers Association's ("ALECA") proposed revisions to the Arizona Universal Service Fund ("AUSF").

INTRODUCTION

ALECA contends, and Staff agrees, that the Federal Universal Service Funding ("Federal USF") mechanisms, particularly those targeted to rural, insular, and high cost areas, have undergone significant changes since the establishment of the AUSF. As a consequence of these changes, both Staff and ALECA assert that the AUSF rules are ripe for re-examination. AT&T concurs.

As the Commission is aware, ALECA provided a proposal for the revision of the AUSF rules. ALECA based its proposal upon the following assertions: (a) the administration of the Federal USF "works," thus AUSF should employ similar mechanics for its administration; (b) the utilization rate of the AUSF is artificially low; (c) uncontrolled growth on the Federal USF is creating uncertainty for the continued cost

recovery for rural incumbent local exchange carriers (“ILECs”); and (d) “underserved” and un-served areas of the State are being ignored. Given this foundation, ALECA concludes that “[i]t is imperative that the AUSF Rules be revised so that AUSF is accessible to rural ILECs, and the administrative procedures controlling cost recovery through AUSF are efficient, equitable, and economically feasible.”¹ AT&T agrees that it is, indeed, imperative that the Commission revise the AUSF rules; however, AT&T disagrees with ALECA’s proposed revisions. To merely transfer the mechanics of one unwieldy social program (*i.e.*, Federal USF) to Arizona, without a comprehensive evaluation of the underlying assumptions, methods, and administration is illogical. Adopting the same obsolete and flawed funding mechanism will not address the issues that challenge AUSF; rather, a comprehensive evaluation of the underlying assumptions concerning AUSF is critical to the survival and evolution of AUSF. Moreover, such evaluation is also critical to Arizona’s ability to ensure telecommunications service in rural, high-cost areas in the future.

Consistent with its belief that the assumptions that underlie AUSF funding should be re-examined as well, AT&T will not provide specific rules comments, nor will it attempt to “revise” ALECA’s revisions that are, without the appropriate context, at a minimum premature. Instead, AT&T will discuss the “context,” informed by current research, analyses, and relevant reports, in which this rulemaking should proceed.

DISCUSSION

I. Serious AUSF Evaluation Begins with a True Picture of the Current State of the Telecommunications Marketplace in Arizona.

¹ See *e.g.*, ALECA Proposal at p. 3 bullets 1, 2 and 5 and proposed rules R14-2-1303A(1) and (2).

Despite the incremental nature of policy making in general, the intersection of multiple policy initiatives over time occasionally produces profound effects on markets and consume behavior. Indeed, time has not stood still since this docket commenced in 1997, and therefore, universal service, if viewed in a vacuum, is likely to produce wrong answers to right-minded questions.

Today, given the confluence of technology, markets, and federal regulatory policy the retail price structure of telecommunications service has been fundamentally and irreversibly altered. The price for all telecommunications services are being pushed to the cost of the underlying facilities used to provide those services. Consequently, distance has almost ceased to be a function of the cost of usage. Consistent with this reality, consumers are demanding – and carriers are responding with -- *all-distance* calling. Moreover, the all-distance phenomenon, once the purview of niche markets in the U.S., is expanding because of: (a) formidable competition from the wireless sector;² (b) Regional Bell Operating Company (“RBOC”) reentry into the in-region interLATA toll market; (c) significant interstate access reform; and (d) the emergence and growing popularity of Voice over the Internet protocol (“VoIP”).

As a result, traditional distinctions between local and toll services are swiftly being relegated to the dustbin of history. For newer generations of consumers, the local /

² When this docket opened the wireless sector had captured a mere 5% of the total industry revenue and minutes, by year end 2002, 30% of the revenue and minute and project to be at 50% in the near future. As of year-end 2004, it had risen to an astounding 35% of the revenue and minutes. See, for example, In the Matter of Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993. Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services, WT Docket No. 02-379. *Eighth Report*, rel. July 14, 2003, ¶ 102; “Consumer Wireline Erosion: The strategic response to ‘water torture’ “. Deutsche Bank 19 May 2005, p. 7.

toll distinction has *never* existed.³ That said, the purpose of universal service is to ensure access to affordable basic local exchange service at rates that are reasonably comparable between urban and rural areas. Thus, the initial question that should drive the evaluation of the current (and future) AUSF is: *Have the goals of universal service largely been met in Arizona?* The answer to this question requires the collection of relevant data for several industry sectors and reasoned analyses.⁴

To begin, in the U.S. currently, universal service, or access to basic local exchange service, is a measure of household penetration rates. Table 1 below, compares the household penetration rates for Arizona for the twenty-year period 1984-2004 with the national average household penetration rates.

Table 1
Comparison of Household Penetration Rates
(1984-2004)

| Date | 1984 | 2004 |
|-----------------|--------------|--------------|
| Arizona | 86.9% | 91.8% |
| National | 91.6% | 93.8% |

Source: *Telephone Subscribership in the United States* (Data through November 2004). Industry Analysis and Technology Division Wireline Competition Bureau Federal Communications Commission. *rel.* March, 2005.

³ Among others, implications for the AUSF are that the revenue funding base cannot continue to rely on the local/toll distinction (R14-2-1204) nor should so-called ‘underserved’ and / or unserved areas be presumed the sole purview of wireline communications providers (ALECA proposed rule R14-2-1202B).

⁴ A recently concluded comprehensive program evaluation entitled “A Review of the South Carolina Universal Fund” conducted by the Legislative Audit Committee is instructive for Staff and the ACC and has been provided with this filing with this document. Significantly, this Report to the General Assembly concludes that (a) the goals of universal service have been largely met; (b) the FUSF mechanisms are sufficient; (c) the fund is infirmed because it focuses on revenue replacement rather than support for basic service; and (d) it is not an appropriate long term policy to strongly regulate and subsidize one part of the market i.e. landline when an increasing part of the market is unregulated and unsubsidized by the state. “Synopsis,” p.v.

The data show that Arizona's household penetration rate lags the national average penetration rate by 2%. To conclude that this data point, alone, proves the need for a state funding mechanism, however, would be premature. Moreover, the 2003 version of this same report indicates a household penetration nationally *and* in Arizona of 95.1%. The entire variance between 2003 and 2004 is explained by a change in the study's methodology to neutralize the inadvertent inclusion of wireless.⁵ Nonetheless, a household penetration rate in excess of 90% suggests that the retail rates for basic local exchange service are generally affordable in Arizona today.

Next, and because wireless substitution is significant (*e.g.*, 35% of total industry minutes of use and revenue), wireless penetration, although not the official measure of universal service today, is clearly a force with which to be reckoned – globally, nationally, and in Arizona.⁶ That is, there are nine countries in the world today with wireless penetration rates that exceed 100% and another eight countries with penetration rates that range from 90-99%.⁷ The penetration rate in the United State is 61% and that for Arizona is 55%.⁸ Wireless penetration coupled with the hemorrhaging of wireline minutes of use, which translates to revenue loss for wireline carriers, likewise, has implications for the future design of the AUSF.

⁵ Pages 2 and 3 of the FCC's Telephone Subscriber report describe the changing nature of the survey questions and how those changes have effected the results. For the upcoming 2005 report, the survey question has been revised to ask whether the household has telephone service, *including cell phones*.

⁶ Wireless penetration is measured in "POPS" or population.

⁷ *Global Wireless Matrix 4Q04*. Global Securities Research & Economics Group, Merrill Lynch. 13 April, 2005, Chart 11. U.K, Norway, Greece, Czechoslovakia, Israel, Hong Kong, Portugal, Sweden and Italy exceed 100%. Singapore, Denmark, Finland, Taiwan, Ireland, Spain, The Netherlands, and Austria range from 90%-100%.

⁸ According to the US Census Department, the estimated 2003 population of Arizona is approximately 5.58M. The number of wireless subscribers as of June 2004 was 3.07M (up 16% from 6/03), thus the wireless penetration rate (3.07M/5.58M) is 55%. Wireless subscribership by state reported in *Local Competition: Status as of June 30, 2004*. Industry Analysis and Technology Division Wireline Competition Bureau, Federal Communications Commission. December 2004. Table 13.

Finally, the nature of the ILEC community itself has been transformed in Arizona. And, while the Commission may not regulate rates and market entry *per se* for all of the services that each carrier provides, it does have broad authority over public welfare. The public interest is not served when a dollar is taken from one Arizona customer and given to another unnecessarily. To begin to understand the breadth and depth of the financial health of all of Arizona ILECS, AT&T has constructed a matrix of service offerings and holding company relationships and it is attached to this document. In sum, Arizona's ILECs have multiple sources of revenue and are expanding in different directions simultaneously. Table 2 below, summarizes the multiplicity of revenue sources for those ILECs.

Table 2
Summary of Expanded Service Offerings of Incumbent LECS and Affiliates

| Service | % LEC Offering |
|---------------------------|----------------|
| Long Distance (Affiliate) | 73% |
| DSL/Internet | 73% |
| Cable/Satellite | 67% |
| Wireless (Affiliate) | 53% |

Source: AZ ILEC Matrix (attached)

II. Replacing One Flawed Subsidy Mechanism with Another Equally Flawed Mechanism Cannot Advance the Goals of Universal Service.

ALECA correctly observes that the Federal USF experienced growth that may effect its sustainability.⁹ But, "sustainability" at the current level of federal subsidy for the rural carriers should not be confused with no (*i.e.*, \$0.00) subsidy nor does ALEC's inference reveal anything about the appropriateness of the current levels of subsidy.

⁹ ALECA Proposal, p. 4.

Arguably, the current level of funding is excessive. Furthermore, ALECA did not provide the Commission with the three most important variables that are contributing to the growth of the federal high cost mechanisms. Simply stated they are:

1. A declining revenue funding base;
2. Growth in number of supported wireless lines; and last but not least,
3. ILEC support mechanisms based on the institutionalization of inefficiencies inherent in ROR and hold harmless provisions.

All three require attention by the Federal Communications Commission ("FCC"), but the third, institutionalization of ILEC inefficiencies is particularly relevant here because ALECA's proposal potentially transfers these inefficiencies into a revised AUSF.¹⁰

Since its inception, the high cost support mechanism, unlike to the low-income assistance programs, remains largely unfocused and ill-targeted.¹¹ That is, the Life Line and Link-UP programs are targeted to specific households at risk of dropping off the network and thus exhibit a demonstrable need for support. The high cost mechanisms, on the other hand, have been used to reimburse carriers for costs higher than national cost averages. As a result, the growth in the untargeted carrier-centric subsidy has been and continues to be exponentially higher than that for the targeted customer or household-centric subsidy mechanism.¹²

¹⁰ A particularly insightful research study about this issue is attached to these comments. See, *Lost In Translation: How Rate of Return Regulation Transformed the Universal Service Fund for Consumers into Corporate Welfare for the RLECs*. Economics and Technology Inc., February 2004.

¹¹ See, for example, Eriksson, Ross C., David L. Kasserman, and John W. Mayo. "Targeted and Untargeted Subsidy Schemes: Evidence from Post-Divestiture Efforts to Promote Universal Telephone Service." *Journal of Law and Economics*. V 41 n 2, October 1, 1998.

¹² *Ibid*, p. 8.

And, in Arizona specifically, before the implementation of rural carrier "reform," Arizona rural LECs received \$ 22 million in Federal high cost support.¹³ Post-reform in 2005, these same carriers are projected to receive approximately \$ 65.8 million in high cost support. Adding in the non-rural carriers the State will receive approximately \$ 81 million in Federal high cost support.¹⁴ This represents an enormous amount of unfocused, ill-targeted government subsidy that, as noted above, essentially takes away from one Arizona consumer and gives to another.

III. The Commission Should Revise its Rules to Ensure that the Subsidy is "Sufficient" without Undue Growth That Ultimately Harms Arizona Consumers and Carriers Alike.

Going forward, the Commission should contemplate devising rules designed to avoid the pitfalls that have bedeviled Federal high cost support mechanisms and will ultimately lead to their demise. In particular, the Commission should focus its rules such that they are more targeted to rural, insular, and high cost areas. Toward that end, the Commission should consider the following actions: (a) limiting universal service support to a single connection to a household or a business, (b) capping per line support upon competitive entry, and (c) carefully scrutinizing whether additional ETC designations in ICO study areas are indeed in the public interest. At a minimum, AT&T believes re-evaluating the AUSF rules, with these proposals in mind will lead to an efficient, sustainable AUSF that treats all customers in Arizona fairly.

¹³ "Study Area Detail For All Exchange Carriers." National Exchange Carrier Association, Inc. 9/21/2000 for year end 1999. p. 2 & 3. Note: for 1999 neither then US WEST nor then Contel California received any federal high cost support because under the prevailing rules they were not high cost carriers.

¹⁴ "High Cost Support Projected by State First Quarter 2005." Universal Service Administrative Company. Appendix HC02, p 1 of 1.

CONCLUSION

To conclude that it is imperative that the AUSF be revised to mirror the Federal USF is to inject into the AUSF all the flaws that will ultimately collapse leaving some rural Arizonans without access to affordable telecommunications services. In short, ALECA asks the Commission to place the cart before horse, results before data, emotion before experience. The challenge for the Commission is to move Arizona in a new direction. That is, this inquiry—as described in AT&T's Comments—should precede and inform the development or alteration of rules.

Respectfully submitted this 30th day of June, 2005.

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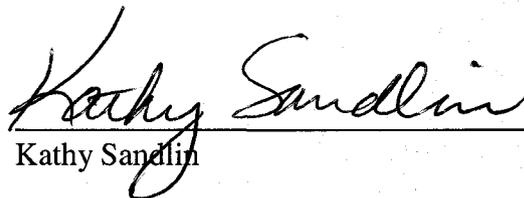
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