COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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| AN INQUIRY INTO UNIVERSAL SERVICE AND FUNDING ISSUES | ) ) | ADMINISTRATIVE CASE NO. 360 |

O R D E R

Rehearing petitions containing significant issues have been filed by GTE South Incorporated ("GTE"), BellSouth Telecommunications, Inc. ("BellSouth"), and BellSouth Cellular Corporation ("BellSouth Cellular"). On July 2, 1998, the Commission granted rehearing on all issues, except those regarding the selection of the HAI 5.0a Model ("HAI Model").

The May 22, 1998 Order in this proceeding ("May 22 Order") indicated that the Kentucky Universal Service Fund ("USF") would begin January 1, 1999.[1] The Commission had intended that the high-cost and low-income portions of the USF commence at the same time. However, the Federal Communications Commission ("FCC") has now delayed implementation of its high-cost support until July 1, 1999.[2] Because of the use of federal support for a portion of the Kentucky USF, the Commission will adopt the FCC's implementation date for high-cost support. Low-income support will begin January 1, 1999 as originally scheduled.

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[1] May 22 Order at 38.

[2] Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Order and Order on Reconsideration, July 17, 1998 at paragraph 7.

## HAI SELECTION AND COMPANY-SPECIFIC COST MODELS

In its July 2, 1998 Order, the Commission indicated that it would provide additional clarification of its model selection. GTE's petition for rehearing infers that the Commission's model selection was capricious while BellSouth offers information not previously presented to the Commission to support its view that the BCPM 3.1 ("BCPM") Model should have been selected. As the Commission has noted, both models presented for consideration continue to evolve.[3] Utilizing the best available evidence, the Commission selected the HAI Model and has already denied rehearing. The basis for the decision has been explained in detail.[4]

Despite GTE's assertions in its petition for rehearing that costs are not covered by the HAI Model, the Commission believes they are. For example, GTE claims that the HAI Model does not account for the required cost of extended range line cards for loop lengths greater than 12,000 feet. GTE contends that extended range line cards are required for loop lengths greater than 12,000 feet to adequately transmit voice signals and support advanced services.

During the March 5, 1998 hearing, AT&T Communications of the South Central States, Inc. ("AT&T") testified that the Outside Plant Engineering Team responsible for developing the technology criteria for the HAI Model, of which the witness was a member, determined that the primary standard line card used in the HAI Model could support loop lengths up to 17,600 feet.[5] The Engineering Team's conclusion was based

[3] May 22 Order at 5.

[4] Id. at 6-14.

[5] Transcript of Evidence ("T.E."), Volume VIII at 305-306.

on its analysis of performance charts supplied by the manufacturer and conversations with the manufacturer's personnel.[6] AT&T stated that its determination was consistent with the least cost, most efficient, currently available technology.[7]

The FCC recounts that "cost models provide an efficient method of determining forward-looking economic cost, and provide other benefits, such as the ability to determine costs at smaller geographic levels than would be practical using the existing cost accounting system."[8] Because cost models are not based on any individual company's costs, they provide a competitively neutral estimate of the cost of providing the supported services. The FCC continues, "[s]electing company specific models could set up a situation where competitive local exchange carriers ("CLECs") would be faced with different cost models, operating under different sets of assumptions within the same state and between adjacent wirecenters. This would violate competitive neutrality standards of the Act."[9] The Commission agrees. There is no reason for a CLEC to necessarily encounter different cost parameters between adjacent wirecenters simply because the wirecenters are served by different incumbent local exchange carriers ("ILECs"). We adopt the FCC's reasoning regarding the selection of a single

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6 Id. at 305.

7 Id. at 305.

8 In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Report and Order (May 8, 1997) ("FCC Order") at paragraph 232.

9 Id. at 233.

cost model to estimate the costs of universal service.[10] The Commission rejects GTE's motion on this issue.

## INPUTS

GTE and BellSouth requested rehearing on several inputs to the HAI Model. AT&T contends that GTE's notion that the Commission adopt company-specific inputs is misplaced.[11] We concur.

### Customer Location

The record is replete with testimony and discussion regarding how both the HAI and BCPM Models estimate customer locations.[12] It is clear that both models only estimate customer locations, albeit using different methodologies, and that both sets of model supporters claim that their methodology is superior to the others.[13] The Commission carefully considered each method in isolation and as part of each model. Despite GTE's renewed contention that the BCPM customer location methodology is clearly superior to the HAI methodology, the Commission is not persuaded by its argument. GTE presented no new evidence and its petition is denied.

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[10] It is clear from the context of the Order that the FCC intends to select only a single model. In paragraph 245, the FCC states, "[w]e will choose a specific model that we will use as the platform for developing that methodology."

[11] In its response to GTE's motion for rehearing, AT&T states at 5 that "virtually every input value GTE proposes is a default value and not company-specific. This is true despite the fact that, at the hearing, GTE witnesses admitted that they knew nothing about how these defaults were developed."

[12] In the latest round of discussions, see, for example, Formal Conference T.E. Vol. III generally, and Bowman T.E. Vol. VII at 84-114, Klick T.E. Vol. VII 277-287 and 312-357; Duffy-Deno T.E. Vol. VIII 322-330, and 345-430.

[13] Id. and AT&T's Opposition to GTE's Petition for Rehearing at 4, where it clearly indicates that it believes that the HAI Model is superior to the BCPM.

BellSouth, in its petition for rehearing, concurs with GTE's petition regarding selection of the HAI Model. Further, BellSouth has attempted to introduce new information into the record by discussing ex parte filings made at the FCC and a memorandum from the FCC Staff, dated between April 17 and May 13, 1998.[14] BellSouth argues that "[t]hese filings indicate the discovery of a significant error in the HAI Model's *preprocessing* calculations which results in a substantial understatement of the cost of the resulting distribution network modeled by the HAI Model.[15]

In its response to BellSouth's petition, MCI Telecommunications Corporation ("MCI") attached for informational purposes an additional document filed by MCI and AT&T with the FCC in the same ex parte proceeding that BellSouth had referred to in its petition. MCI claims that its document fully supports the use of the HAI Model which was dated June 10, 1998, a month after the BellSouth information. AT&T in its response states that "[a]s a procedural matter, the material BellSouth claims is new evidence was available to BellSouth at the time of the hearing, and it knew of the existence of the specific data it cites well before the Commission issued its decision."[16] Also, AT&T argues that its response to BellSouth in the ex parte proceeding "contained detailed materials demonstrating why the [filing's] analysis is deeply flawed and incorrect."[17]

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[14] BellSouth's Petition for Rehearing at 2-7.

[15] BellSouth's Petition for Rehearing at 2-3. BellSouth attached copies of these documents as Exhibits 1-10 of its petition.

[16] AT&T's Petition at 2.

[17] Id.

AT&T is correct in its assertion that the additional information was not part of the Commission record. BellSouth could have introduced this information into the record earlier and did not. In the context of this proceeding, no party has had an opportunity to evaluate, cross-examine and rebut this information. Therefore, the Commission will not consider this new information at this time. The Commission may consider this and all other pertinent information in future proceedings regarding model reviews.

Line Counts

The Commission intends to use actual updated line counts in it calculation of the high-cost fund, i.e., the $98 million in the May 22 Order is not static.[18] The Commission will set a date certain for all carriers to submit their updated line counts. This schedule will be set in the future prior to the implementation of the high-cost fund. BellSouth and GTE furnished revised USF requirements to recognize changes in line counts. Both simply used the costs per line developed by the HAI Model and multiplied it by the new line counts. Although this methodology presents a USF based on more current information, it is the Commission's understanding that the HAI modelers have provided the FCC with a template to run actual wirecenter line counts.

In order to ascertain the feasibility of this template, BellSouth, GTE, and Cincinnati Bell Telephone Company ("CBT") should obtain the template and furnish the Commission with trial runs using December 31, 1997 actual wirecenter counts by September 30, 1998.

[18] See Criterion 1 of the May 22 Order at 10.

Network Operations Factor

GTE's petition requests that the Commission reconsider its selection of 70 percent as the Network Operations Factor and adopt a 100 percent factor as proposed by GTE. As stated in the May 22 Order, it is expected that ILECs will find it necessary to better control expenses in a competitive market. It is unreasonable for GTE to seek to maintain 100 percent of its current costs incurred in a monopoly environment once that environment becomes competitive. GTE has not offered any additional evidence and thus rehearing is denied.

Poles, Anchors, Guys, and Manholes

GTE requests that the Commission use the cost of poles, anchors, guys, and manholes as paid by GTE. The May 22 Order states, "[t]he Commission has selected inputs for the HAI Model based on the criterion that the model should estimate the costs of a forward-looking, least-cost network. The costs should not duplicate the existing network costs of the existing providers."[19] The existing costs that GTE pays do not meet this criterion and therefore can not be used.

Cost of Capital and Depreciation Rates

The Commission's selection of cost of debt of 7 percent and cost of equity of 12.5 percent with a 40 percent and 60 percent ratio respectively is based on the Commission's analysis of the current markets and the expected conditions to exist in the future. This is consistent with the Commission's review of debt rates in recent years. The 30-year Treasury bond rates have fallen from 9.03 percent as of September 1990 to 6.61 percent as of August 1997. The Commission notes that on July 22, 1998,

[19] May 22 Order at 19.

pursuant to the Orders of the Commission, GTE filed its report to the Commission on its recent debt issuance that reported that the coupon rate on its nine-year issue was 6.125 percent.[20] Therefore, the Commission's estimate of 7 percent is conservative.

The cost of equity selected by the Commission, 12.5 percent, is also conservative in relation to recent decisions across the country. In 1988, the average equity return awarded by state commissions for telephone utilities was 13.13 percent.[21] In 1997, the average equity return awarded was 11.56.[22] These results appear to be consistent with electric and gas utility decisions over the same time period.

GTE's petition requests that the Commission reconsider its decision with respect to depreciation rates and allow the use of economic lives that currently reflects the financial results presented to investors and others. The Commission reasserts that it selected depreciation rates within the FCC ranges to comply with the FCC Order. Until such time that the FCC reconsiders its decision, the Commission will not review this issue.

Underground and Buried Excavation

BellSouth has requested that the Commission reconsider its decision on the inputs for underground and buried excavation. The Commission accepted the Georgetown Consulting Group's composite recommendations for excavation but modified the composite values by weighting them on the ratio of access lines by density

[20] GTE letter filed July 22, 1998 in the matter of the Application of GTE South Incorporated for Authority to Issue Debt Securities, Case Nos. 95-352 and 98-122.

[21] Regulatory Research Associates Inc., Regulatory Focus: January 21, 1998.

[22] Id.

zones to be more consistent with the required inputs of the model. BellSouth contends that this weighting by density zones is improper and even results in a smaller fund than that which was proposed by either party.

In its motion for reconsideration, BellSouth proposes to weight excavation inputs on the cable footage by density zone. This proposal increases BellSouth's portion of fund size from $55 million to $80 million and the entire fund from $98 million to $142 million. AT&T and MCI argue that the Commission's decision should stand. MCI states that some of the inputs proposed by BellSouth in its rehearing exceed similar inputs in the BCPM Model.

Changing this series of excavation inputs is critical to the sizing of the fund. The Commission and BellSouth have proposed to change the inputs as suggested by the Georgetown Consulting Group because as submitted these inputs did not appear to "fit" the model format. However, as BellSouth pointed out, the use of density zones as a distribution of costs may cause errors. Ironically, BellSouth also used density zones to distribute costs. After much analyses and consideration of its significant impact, the Commission finds that reconsideration of this issue is warranted.

The excavation inputs along with inputs for pole investment, underground and buried cable placement, drop investment, terminal investment and sharing are used in calculations of loop costs. It is evident from this list that any weighting needs to fully recognize the internal allocation and distribution processes of the model. Now that a model has been chosen, focus can be placed on these internal calculations. The Commission requests that parties provide analyses detailing the impact of the various means of entering excavation inputs. The Georgetown Consulting Group has recommended composite costs and has applied them to all density zones. The accuracy of the Georgetown Consulting Group's method should be discussed in comments. The Commission and BellSouth have offered two weighted methodologies. Comments should also focus on these two options as well as any other appropriate methodology. In addition, comments are requested on the advent of these variable inputs subsequent to Hatfield Model Version 4.0.[23]

## REVENUE BENCHMARKS

GTE argues that the Commission should reconsider its decision to calculate the revenue benchmark based upon the revenues from supported services, as well as other services. It argues that the costs of supported services should only be compared to the revenues generated by supported services. The Commission's decision to include revenues in addition to those generated by supported services will fail to identify all implicit subsidies, according to GTE, and will cause a mismatch between revenues and costs and uneconomic incentives to serve high-cost customers. Finally, GTE asserts, leaving any implicit subsidy in rates will prevent all carriers from contributing toward universal service on an equitable and nondiscriminatory basis.

The FCC will "adopt a benchmark based on nationwide average revenue per line to calculate the support eligible telecommunications carriers [will] receive."[24] The FCC will be "setting the benchmark at the nationwide average revenue per line because that average reflects a reasonable expectation of the revenues that a telecommunications

[23] Prior to Hatfield Model Version 4.0, excavation inputs were within the preprocessing functions of the Hatfield Model.

[24] FCC Order at paragraph 257.

carrier would be reasonably expected to use to offset its costs."[25] The FCC also states that the revenue benchmark will be periodically reviewed at the same time as the means for calculating forward economic costs so [the FCC] can adjust both the forward-looking cost methodology and the benchmark to reflect the positive effects of competition. The FCC declines to adopt a benchmark based upon cost or upon household income or upon local service rates.[26] In declining to use only local service rates, the FCC states, "such a benchmark would ignore the revenues that carriers receive from other services that contribute to the joint and common costs of providing those and the supported services."[27]

This Commission has stated that it agrees in principle with the FCC's discussion regarding revenue benchmarks.[28] As a point of clarification, the Commission concurs with the FCC's discussion regarding revenue benchmarks, except where specific deviations are discussed, and adopts it herein.[29] The FCC specifically rejected the argument that the revenue benchmark be based solely on revenues generated from supported services.[30] The Commission concurs and accepts the FCC's arguments for including additional service revenues in the revenue benchmark calculation.

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[25] Id. at 258. See also Id. at 259 and 263 and Id. at 260-262 where the FCC discusses reasons for including revenues from discretionary services and interstate and intrastate access as the average revenue calculation.

[26] Id. at paragraphs 265 and 266.

[27] Id. at paragraph 265.

[28] May 22 Order at 25.

[29] FCC Order at paragraphs 257-267.

[30] Id. at paragraph 265.

As GTE is well aware, the process to identify implicit subsidies and establish a USF has been a time consuming process and will not occur overnight. By its May 22 Order, the Commission has taken another step in that process. As a point of clarification, the state-specific benchmark mentioned in the May 22 Order was intended to be company specific. GTE, BellSouth, and CBT have filed revenue information which should enable the Commission to establish the company-specific benchmarks. This information submitted in response to the May 22 Order and the June 30, 1998 informal conference is pending review.

FUND ASSESSMENT MECHANISM

The Commission has received petitions for rehearing as well as many comments from the June 30, 1998 informal conference concerning the method of fund assessment. It appears that the methods adopted by the Commission may cause undue hardship, confusion, and inequities. In order to address assessment issues, the Commission will reconsider its decision. Within 30 days of the date of this Order, parties may file any additional comments regarding recommendations for assessment mechanisms. Many filings have already been submitted. The Commission will decide these issues in the near future without further hearings.

GTE argues that the Commission's decision to fund the USF in part through usage sensitive network access rate elements is flawed because it is not equitable. As a matter of clarification, the Commission never intended to charge carriers for this part of the fund, per se. The Commission fully anticipates that any usage sensitive network rate element would be explicit and paid for by end-users.

BellSouth asserts that the assessment based on the percentage of services billed "will be determined by dividing the retail portion of the fund requirement by the total regulated local retail revenues generated in the state (post reduction). Local exchange carrier ("LEC") payments for the retail component of the fund will be collected via a percentage end-user subscriber-line charge. However, a LEC may choose to forego the surcharge on business customers and pay into the fund through existing business retail revenues when the surcharge would be offset by required reductions."[31]

BellSouth has also proposed, at the ILEC's discretion, to pay the USF assessment out of current rate revenues. This proposal could have several consequences. BellSouth has claimed that its business customer revenues are at most risk due to competitive pressures. BellSouth also has signed resale agreements with many CLECs. By taking the USF assessment out of current business revenues, rather than actually levying the assessment on business customers, BellSouth will have given its business customers an implicit and untariffed rate reduction. CLECs purchasing business service from BellSouth on a wholesale basis will still be required to pay the tariffed rate minus the wholesale discount and will not receive the benefits of the implicit rate reduction. This in turn could squeeze CLEC profit margins. Such actions could be anti-competitive. Also, as competitive pressures continue to build, ILECs may be inclined to continue to lower business rates. In parts of the state, some business customers may already be paying rates that are below cost. Paying the USF assessment out of business revenues may either introduce another implicit subsidy into an ILEC's rate structure or may effectuate a rate reduction for customers whose rates

[31] BellSouth's Petition for Rehearing at 13.

are already below cost. For all of the reasons discussed above, BellSouth's proposal to pay the USF assessment out of business revenues should be rejected.

GTE'S INTERIM SURCHARGE

GTE argues an interim surcharge is appropriate. It states that "[it] is facing competition now, and [its] competitors will be able to siphon off the implicit subsidies."[32] GTE maintains that the surcharge should apply to any CLEC purchasing an unbundled loop or an unbundled port. Further, GTE maintains that the surcharge must also be applied to facilities-based CLECs, because The Telecommunications Act of 1996 ("the Act") requires all telecommunications providers to contribute to universal service.[33]

The implementation of an interim surcharge is not necessary at this time. There is neither sufficient evidence in the record to support GTE's contention that it is facing significant facilities-based competition nor that its revenues are at significant risk from facilities-based competition. Further, the Commission is not obligated to adopt and implement GTE's proposed surcharge "to serve as a mechanism to support universal service until permanent state and federal support systems are in place."[34] The current universal service mechanisms under which GTE is operating are continuing to function. The Act states that "[a] state may adopt regulations not inconsistent with the Commission's rules to preserve and advance universal service."[35] Also, the Act states, in part, "[a] proceeding shall include a definition of the services that are supported by

[32] GTE's Brief at 18.

[33] GTE's Brief at 19.

[34] GTE's Petition For Rehearing at 13.

[35] Section 254(e).

federal universal service support mechanisms and a specific timetable for implementation."[36] The FCC determined that it was operating within its legal guidelines in its quest to make universal service funding "explicit."[37] This Commission is likewise operating within these guidelines. The Commission rejects GTE's petition for rehearing on this issue.

GTE is a rate-of-return utility and, as such, GTE has certain pathways open to it to seek relief for pricing problems. If GTE feels that its service prices need adjusting, it should file for rate relief.

LIFELINE SUPPORT

The Commission will, as planned, implement the Lifeline fund on January 1, 1999. The Commission will require all telecommunications carriers to place a charge on all customers' bills as a percentage of total billed intrastate regulated revenues. To determine the percentage, all carriers will be required to submit by October 15, 1998 their estimated annual revenues and projected annual revenue requirement for the Lifeline program for 1999. The Commission will then calculate the rate at which carriers will collect funds from their subscribers.

Collection will begin on any service rendered on or after January 1, 1999. Also, after this date carriers will begin offering Lifeline to qualified customers. Customers currently enrolled in the Lifeline program at this time will automatically begin receiving the new rate. Any other eligible customer must sign up for the program through a LEC. Automatic enrollment and self-certification will not be permitted. These qualifying

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[36] Section 254 (a)(2).

[37] FCC Order at paragraph 246. See also Id. at paragraph 13.

customers can receive a discount of up to $10.50 for their basic local service and federal subscriber line charge. In addition, all LECs must update their tariffs to reflect these changes no later that December 1, 1998 to be effective January 1, 1999.

On a monthly basis beginning February 15, 1999 all carriers shall submit to the fund administrator and the Commission a report stating the amount of billed revenues, the amount collected, the number of customers with Lifeline service, and the amount of credit given each month to be collected from the state fund. The amount of credit funded by the state fund is $3.50, with the remaining $7.00 to be collected from the federal fund. These amounts shall be netted and remitted to the fund administrator for payment to the fund or for the amount to be collected from the fund. Payments from the fund will be made by the last day of the month with one month lag in payments to assure that there are funds available for payment.

The Commission, having considered the petitions and having been otherwise sufficiently advised, HEREBY ORDERS that:

1. Issues related to the selection of the HAI Model shall be affirmed.

2. The high-cost portion of USF shall be implemented July 1, 1999.

3. The low-income portion of the USF shall be implemented January 1, 1999.

4. Petitions for rehearing related to customer location, Network Operations Factor, poles, anchors, guys and manholes and cost of capital and depreciation rates shall be denied.

5. The Commission shall set a date certain for all carriers to submit actual line counts.

6. By September 30, 1998, BellSouth, GTE, and CBT shall submit trial runs of line count data using actual wirecenter counts as of December 31, 1997.

7. Rehearing shall be granted for the underground and buried excavation inputs. Within 30 days of the date of this Order, parties shall file comments as described herein. Thereafter, this matter shall be submitted to the Commission for its decision.

8. The May 22 Order is clarified to require the use of company-specific benchmarks to initiate the USF. An Order establishing these benchmarks shall be forthcoming.

9. Within 30 day of the date of this Order, parties may file any additional comments regarding recommendations for assessment mechanisms. Thereafter, this matter shall be submitted to the Commission for its decision.

10. BellSouth's proposal to pay the USF assessment out of business revenues shall be denied.

11. GTE's request for an interim surcharge is denied.

12. By October 15, 1998, all carriers providing local service shall submit their estimated annual revenues and projected annual revenue requirement for the Lifeline program for 1999.

13. For service rendered on and after January 1, 1999, all carriers shall place a charge on all customers' bills as a percentage of total billed intrastate regulated revenues. The percentage will be determined as stated herein.

14. Lifeline service shall be available for qualified customers up to $10.50 per month.

15. Neither automatic enrollment nor self-certification for the Lifeline program shall be permitted.

16. By December 1, 1998, all carriers shall revise their tariffs to be effective January 1, 1999, to reflect the new Lifeline rate.

17. Beginning February 15, 1999, and monthly thereafter, all carriers shall submit to the Commission and the fund administrator a report and shall make payments as described herein.

18. Any request for rehearing not specifically granted herein shall be denied.

Done at Frankfort, Kentucky, this 7th day of August, 1998.

PUBLIC SERVICE COMMISSION

B. J. Helton

Chairman

Vice Chairman

Gary W. Gillis

Commissioner

ATTEST:

Helen C. Helton

Executive Director