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Q&A on the Texas Universal Service Fund

Letting Competition Work

by Bill Peacock, director of the Center for Economic Freedom

The Texas Universal Service Fund (USF) was established in 1999 to help the state achieve its policy goal of providing universal, low-cost telephone service for citizens across the state in an increasingly competitive environment. The largest portion of the USF, which subsidizes high-cost service in suburban and rural Texas, is divided into large and small company support. The USF is also used to subsidize service to those with low-incomes and disabilities. Additionally, it is used to subsidize government agencies, schools and institutions for administrative costs and high capacity transport (such as T-1 lines).

2004 Universal Service Fund Expenses in millions (estimated)		
High Cost Support	$546.28	93.16%
Low Income/Disability Support	$ 34.34	05.85%
Government Agency/ Schools Support	$ 5.73	00.97%

Source: Public Utility Commission, "Scope of Competition in Telecommunications Markets of Texas," 2005.

The USF was revenue neutral in its implementation. In other words, it replaced implicit subsidies in toll and access rates with an explicit portable subsidy going to the provider of local service. Policymakers recognized that long distance was a competitive service and that subsidies collected through access charges had hindered the development of this market. The implementation of USF was a significant development that has done much to assist in the transition to a competitive marketplace.

The following Q&A is designed to provide a basic understanding of the USF—its purpose, strengths and weaknesses—and make recommendations as to how it can be modified to bring more competition to the Texas telecommunications marketplace. More detailed information on the USF can be found in several Foundation publications available at www.TexasPolicy.com.

1. Has the Universal Service Fund accomplished its purpose of providing reasonably priced, universal service to consumers as intended by the Texas Legislature?

The USF has been an integral part of the effort to provide the low-priced, universal service that Texans enjoy today. It has allowed competition to develop in long-distance and urban local-service markets to a degree that would have been impossible under the previous regulatory regime dominated by implicit subsidies. Despite this policy success, however, there are two major challenges with the USF that must be addressed if the goal of *reasonably* priced universal service is to be achieved.

The first is efficiency. The USF supports the existence of inefficient regulatory measures that could not survive in an unsubsidized market. One of these is the imposition of price caps on local telephone service. These price caps, which hinder the development of a true market, are dependent on USF payments—companies providing local service would not fare well in an environment where basic rates are capped and access rates are limited without USF payments. As much as the USF has been helpful in the transition to competition, true competition cannot occur in a market where subsidies exist. Another inefficient aspect of the USF is the distinction it makes between sup-

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port for large and small companies—support should be based on differences in costs, not the size of a company. Additionally, the percentage assessment may also be inefficient compared with a flat-rate charge like the federal Subscriber Line Charge.

Robert Crandall and Jerry Ellig provide some additional insight into the inefficiency of the USF in their paper for the Foundation in 2005, *Texas Telecommunications: Everything is Dynamic Except the Pricing.* They emphasize that implementing the social policy of low-cost, universal telephone service with a tax/fee on a specific industry creates economic distortions in the marketplace that decrease the efficiency of decisions made by producers and consumers. This inefficiency reduces consumer and producer welfare in Texas by about $166 to $173 million annually.

Finally, the USF may be inefficient because of the cost model used to allocate some of the high-cost support. Though the model was forward looking, it is possible that suburbanization and technological advances have lowered the costs of providing basic local service to the point that the model overstates costs in many areas of the state.

Regarding reasonably priced service, the Public Utility Regulatory Act (PURA) Sec. 56.021(1) says that one purpose of the USF is to:

> *(1) assist telecommunications providers in providing basic local telecommunications service at reasonable rates in high-cost rural areas;*

There may be several ways to determine what a reasonable rate is for service in high-cost areas. For instance, reasonableness could be based on a comparison to rates in urban areas—even though they are subject to price controls. Or to costs for a substitutable service, such as cellular. However, whatever the measure, it is clear that today's price-capped rates for basic local service in most areas are unreasonable; that is, unreasonably low.

If today's rates for basic local service were being reviewed by the state's actuaries under the Insurance Code, they would no doubt be deemed "inadequate" and companies ordered to raise them. The inadequacy of the rates is supported by several observations:

- Crandall and Ellig found that "in 2002 the local rates charged by large incumbent telephone companies in Texas fell $487 million short of covering the long-run incremental cost of primary residential lines and $600 million short of covering the long-run incremental cost of all residential lines."
- Crandall and Ellig use the Federal Communication Commission's Hybrid Cost Proxy Model to estimate that only 281,000 out of 5.5 million large company residential lines examined are priced at rates that cover their long-run incremental costs.
- Basic local rates range from about $8 per month in rural areas to $11 in urban areas (or $13.82 to $16.72 including the federal subscriber line charge), whereas long-run incremental costs per line range from $11.84 to more than $1,000 per month.
- Basic local rates are generally priced below that of competitive alternatives, such as cellular service.

Of course, just because basic local rates are low does not necessarily mean that overall rates for telephone service are low. Particularly in urban markets, companies often price non-basic services at levels to help support the under-priced, regulated basic service. However, this type of pricing causes economic inefficiencies in the system because both producers and consumers make poor decisions based on misleading pricing signals.

2. Is the Universal Service Fund helping or hurting competition in the Texas telecommunications market?

When the Public Utility Commission (PUC) implemented the USF in 1999, it said that it was designed to be a "competitively neutral mechanism" to assist in "the transition to a competitive marketplace [in which] support previously embedded in various rates cannot be maintained." The USF has served this purpose well. However, today, with the transition to competition much further along, changes in the system are required to bring true competition to the marketplace.

One example of the lack of competition is that price caps on basic local service in rural Texas set prices at below long-run incremental costs. This situation creates an anti-competitive environment in many rural areas whereby potential competitors may be hesitant to enter into rural markets where the incumbent offers below-cost prices. Additionally, any government regulation of pricing creates an anti-competitive environment be-

cause prices are one of the key ways that companies compete with each other.

Another example of how the USF contributes to lessened competition is seen in the private network service mandate. Texas incumbent local exchange carriers (ILECs) are required by PURA to offer high capacity transport (such as T-1 lines), or private network service, to a variety of users at reduced rates. The entities eligible to receive this discount pricing include public schools, institutions of higher education, public libraries, non-profit hospitals, and the Texas Education Agency. Because the incumbents are required to provide this service below the market price, other telecommunications providers are generally unable to successfully offer competitive services. However, because direct USF support is paid only on discounted lines provided by small companies, subsidies for this are more indirect than direct.

Additionally, the way USF support is calculated using cost and revenue averaging, it can hinder competition. Costs averaged at wire centers create cost differentials within the centers that might be exploited by new entrants. Also, similar opportunities may exist because revenues are averaged statewide while costs are averaged locally.

3. Are the entities receiving money from the Universal Service Fund spending it as intended?

In implementing the current USF, Texas policymakers recognized that "in the transition to a competitive marketplace, [universal service] support previously embedded in various rates cannot be maintained." So a shift to explicit subsidies was made to facilitate this transition. As part of the implementation, specific requirements, e.g., reduced prices, were placed on companies and verification steps taken by the PUC to ensure that this exchange would be achieved. Companies that comply with the provisions of the law under the oversight of the PUC are spending the money as intended.

4. How should the Universal Service Fund be reformed to help increase efficiency and competitiveness in the Texas telecommunications market?

In order to take the next step towards the USF being a "competitively neutral mechanism" for "providing basic local telecommunications service at reasonable rates in high-cost rural areas," the primary focus should be on reducing its size. However, it is important to remember that this cannot be accomplished properly without a concurrent raising of price caps. Reduced subsidies and higher price caps would be completely in line with the original intent of Texas policymakers of facilitating "the transition to a competitive marketplace." The fund has facilitated the transition, but its size is now a hindrance rather than a help in fostering competition. Several steps can be taken to reform the USF and make it more compatible with today's competitive marketplace:

Make rates more reasonable by allowing the price of basic local service to rise to better reflect actual costs. This would be accomplished by providing companies increased pricing flexibility. Regulated rates for all basic residential phone service should be immediately increased to parity with the highest urban rates. This would increase phone companies' revenue by about $90 million per year and allow for a corresponding reduction in USF assessments/payments. In addition to this, a mechanism should be put in place to provide for regular increases in price caps and corresponding decreases in USF assessments.

The USF should not be expanded to cover new services or technologies. The fund has supported the provision of low-cost phone service in most areas of the state. Some advocate the expansion of USF support to new technologies like broadband. However, the rapid adoption of new technologies makes USF support for them unnecessary. The adoption rate of broadband, for example, is running on par or ahead of the rate of most older technologies. USF assessments should not be placed on any new services; any savings realized from increased price caps or reduced costs should be returned to consumers, not used expand the services subsidized by the USF. The fact that this might place an increasing share of USF assessments on traditional telephone service highlights the importance of reducing the size of the USF.

Eliminate the distinction between large and small company USF support. Telephone service for customers in rural Texas is subsidized by urban/suburban consumers well beyond what is necessary to maintain reasonable rates. In many cases, this subsidy flows from low-income to high-income customers. Nationally, only 27 percent of rural telephone company revenues come directly from customers paying for basic local service. Subsidies that

support this system encourage small companies to remain inefficiently small, as may the current distinction between large and small company support. USF support should be based on the legitimate costs a company occurs, not the size of the company. The PUC should examine how a cost-based approach can be applied to all Texas markets.

Eliminate mandated provision of Private Network Service. By eliminating this and its associated subsidies, USF assessments/payments could be reduced by $2 million per year.

In the short-term, it is impossible to imagine local phone service in at least some parts of Texas without USF support. Yet 15 years ago it would have been impossible to imagine the vast array of largely deregulated telecommunications services we receive today. While it is not possible at this time to address the universal, reasonable-cost policy of the state solely through the market process, the task at hand is to prepare the market for the day when it will be the primary means of meeting this goal.

5. What relationship should exist between the Provider of Last Resort obligation and the Universal Service Fund?

As long as the state requires companies to serve as the provider of last resort (POLR) in high-cost areas, the state should assist the companies in meeting this obligation. The state should not expect companies to bear the POLR obligation on their own. Policymakers should examine what the POLR obligation should look like in the future.

6. Should the definition of basic local telecommunications service be expanded or otherwise changed?

The definition of basic local service should not be expanded. The rapid adoption of new technologies makes increased universal service support unnecessary. The adoption rate of broadband, for example, is running on par or ahead of the rate of most older technologies like color TVs, VCRs, and computers, which spread quite rapidly themselves without any universal service support.

7. How should "reasonable rates" be defined or determined?

There are a variety of mechanisms by which the reasonableness of rates can be determined. As already mentioned, reasonableness could be based on a comparison to rates in urban areas. Or to costs for a substitutable service, such as cellular. Or to the cost of providing the service. What is clear is that the current rates—based on the old value of service pricing—are clearly unreasonable. That is, unreasonably low. Of course, another way that reasonable rates could be determined is through voluntary transactions in the marketplace. For the time being, as long as price caps continue, they should be increased over time along with relaxations of other pricing restrictions in order to allow rates to more accurately reflect the costs of providing service.

8. How should money for the Universal Service Fund be collected?

The ideal way for universal service funds to be collected is through general taxation. This creates fewer economic distortions than an assessment on a specific industry. To the extent that the funds are collected through a telecom specific tax/fee, a flat rate charge similar to the federal Subscriber Line Charge should be considered.

9. Will the current funding mechanism for the Universal Service Fund be adequate to sustain the purposes for which it was created?

The need for the USF is decreasing, not increasing. And the rapid adoption rate of new technologies, like broadband, shows that there is no need to expand the fund into new areas. No new services should be subjected to fund assessments, and no new technologies should be covered by fund payments. Therefore, the current funding mechanism will provide more than adequate funding for the purpose for which it was created. However, it will continue to be inefficient.

Bill Peacock is the director of the Center for Economic Freedom at the Texas Public Policy Foundation. Contact Bill Peacock at: bpeacock@texaspolicy.com.