

Report from Center for the New West Conference on Universal Service Phil Weiser*

On Friday, April 22, 2005, the Center for the New West held a conference in Washington, D.C. to bring together leading policymakers, academics, and industry participants for a day-long discussion of universal service policy. In particular, the conference focused on the challenges of implementing the Telecommunications Act of 1996's universal service provision (i.e., Section 254) and considered what mid-course corrections are necessary. Overall, there was an important consensus that the system—which currently relies on interstate long distance revenues to support both existing providers and new entrants—is flawed and in need of significant reform. As to what reforms are necessary, however, the participants emphasized different solutions and, in general, raised more questions than offered convincing answers.

First Principles

The concept of “universal service” dates back to Theodore Vail’s vision of the Bell System as providing “one system, one policy, universal service.” What Vail meant by this motto remains a matter of interpretation, with some claiming that it called for *universal access* and others arguing that it envisioned *affordable (i.e., subsidized) access*.¹ As an “academic” matter, Commerce Committee Chairman Joe Barton opened up the conference by suggesting that it is “debatable” whether the government should subsidize telephone

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¹ *Compare* MILTON L. MUELLER, JR., *UNIVERSAL SERVICE: MONOPOLY IN THE MAKING OF AMERICAN TELEPHONE SYSTEM 92* (1996) (arguing that when Theodore Vail championed “universal service,” he did not mean “rate subsidies to make telephone service more affordable”; rather, he meant “the unification of telephone service under regulated monopolies”) *with* PAUL STARR, *THE CREATION OF THE MEDIA 446* (2004) (arguing that Vail envisioned a system of cross-subsidies based on standard rates, such as those used by the post office).

service for those living in remote areas; after all, he noted, housing prices in rural areas are far cheaper than urban areas, so paying more for telephone service in rural areas might be reasonable. He conceded, however, that no such debate would take place in the legislative arena because “political realities” demand that universal service subsidies continue for the foreseeable future.

The political support for universal service subsidies dovetails with a powerful economic rationale. As Federal Communications Commissioner Adelstein explained, rural America needs to remain connected to a modern communications network to take part in today’s economic, social, and political opportunities. This policy recognizes that individual decisions not to adopt critical communications technologies hurt the entire society by limiting the “network externality” of that technology. Stated simply, this network externality means that the more who are connected to a communications platform, the more valuable the platform.

The political realities of universal service also explain an economically questionable regulatory strategy: the use of an obscured and opaque system to raise the necessary money to support universal service programs. Unlike farm subsidies, for example, which are paid for by general revenues and not by taxing food, the universal service fund is levied through a series of charges imposed on telecommunications services. From an economic standpoint, this policy is difficult to defend because broader-based taxation schemes are almost always preferable to targeted ones on the ground that they do not discourage using the taxed service. The notable exception to the principle against imposing industry-specific taxes is for “social bads,” such as alcohol, cigarettes, and gasoline—all of which impose costs on society if used in great amounts. Nonetheless, the current system’s use of a distortionary and disguised tax to support universal service is said to be politically

untouchable. As Chairman Barton put it in dismissing the argument for using general revenue to support universal service: “try telling that to a President who ran on a platform of no new taxes.”

The commitment to some form of subsidized telephone service for those living in remote areas begs the question of exactly what type of program to use? Notably, the current system relies—to a substantial degree—upon subsidies *implicit* in the rate structure. To use a very rough rule-of-thumb, many rural companies receive one-third of their revenue from *explicit* subsidies (either from the federal high cost fund or a state counterpart); another third from *implicit* subsidies, such as the “access charges” received when they terminate long distance telephone calls placed to their customers; and the final third comes from *direct subscription fees* paid by their customers.

Looking forward, policymakers should consider a series of issues in examining the different possible avenues for reform. First, the delivery of communications services depends on the presence of communications *networks*, which often require massive upfront investments. Second, states face an incentive to certify “eligible telecommunications carriers,” or ETCs, to compete with incumbent providers and receive funds for each customer served. This incentive results from the fact that states receive more total money once the ETC begins receiving subsidies and the incumbent provider is supported at the same level. Finally, the nature of communications usage is changing, making technology-specific assessments—like those on particular industry segments—problematic and subject to “arbitrage,” as consumers change their behavior to save money and avoid purchasing services that pay into the universal service fund.

Who Pays and Who Receives?

The current system imposes charges on those using interstate long distance services. This system emerged from the Telecommunications Act of 1996’s unclear direction about how to develop a universal service fund. Like other aspects of the Act, about which Justice Scalia wryly noted, “[i]t would be a gross understatement” to describe as “a model of clarity,”² the Act’s universal service provision (i.e., Section 254) did not outline a clearly defined strategy. Consequently, the debate over the scope of the FCC’s authority to impose obligations on carriers to contribute to universal service—like many of the Act’s provisions—ended up in court. After the Fifth Circuit Court of Appeals ruled that the FCC’s authority only extended to “interstate” (i.e., long distance) rates,³ the FCC found itself in an untenable position because of the increasing shift to bundled offerings and the decline of the long distance sector altogether.

The panelists, with the notable exception of Tom Sugrue from T-Mobile, agreed that the current system’s contribution methodology—which now imposes an almost 11% assessment on interstate services—is unsustainable. The panelists discussed three possible alternatives: (1) an assessment on all revenues; (2) an assessment on all “connections”; or (3) an assessment on telephone numbers. All agreed that each model had its weaknesses; the revenue approach, for example, requires the FCC to repeatedly redefine what services are subject to the assessment. More fundamentally, some services (such as peer-to-peer voice over Internet services provided by companies like Skype) will be difficult to assess even if they fall within the FCC’s definition. Similarly, deciding what connections should be assessed and at what rate raises a significant challenge. Even the “numbers tax,” which appears simple and appealing, invites powerful criticisms, such as whether businesses will

² AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366, 397 (1999). He went on to add that the Act “is in many important respects a model of ambiguity or indeed even self-contradiction. That is most unfortunate for a piece of legislation that profoundly affects a crucial segment of the economy worth tens of billions of dollars.” *Id.*

³ Texas Office of Pub. Util. Counsel v. FCC, 183 F.3d 393, 424 (5th Cir. 1999).

be able to avoid it by relying on extensions. In any event, any of the above approaches would improve upon the current system's focus on a declining pool of interstate revenues.

The second point of (at least rough) agreement between the panelists is that the concurrent reform of intercarrier compensation and universal service can provide important benefits. First, some version of intercarrier compensation reform is inevitable as implicit subsidies cannot continue to exist in an open system. Thus, for example, if providers of Voice over Internet services are not subject to long distance access charges, the access charge system (including those imposed by the FCC and state agencies) will collapse as consumers avoid the implicit charges. Regulators can attempt to continue to bring new services into the regulated framework and force them to pay access charges, but that strategy is ultimately doomed as Voice over Internet services like Skype—and even mobile telephones—will increasingly provide a viable option to avoid the current system. Consequently, if regulators seek to phase out implicit subsidies, doing so will almost certainly require additional universal service support to substitute for the old implicit charges. Second, if regulators address both universal service reform and intercarrier compensation reform together, they may be able to ensure that the end result is more palatable to individual stakeholders who may suffer on one front (say, wireless carriers contributing more to universal service) and benefit on the other (say, wireless carriers avoiding high terminating access fees).

The third point of agreement was that there is a very strong argument for supporting broadband from general tax revenues in the event that Congress decides that it is important to subsidize broadband for those living in remote areas. (The current regime calls for support for an “evolving level of service,” which presumably would ultimately require the existing fund to support broadband deployment and service delivery.) Such subsidies could

be provided through a program like that managed by the Rural Utilities Service, although some panelists noted that its restrictions on eligibility for grants and loans limit the usefulness of that program. Additionally, it is important to realize that other policy strategies—such as freeing up spectrum in rural areas and supporting the development of Wireless Internet Service Providers (WISPs)—are important means of supporting broadband deployment in rural areas.

On the question of who should receive universal service funds, the degree of consensus about directions for reform largely evaporated. One exception was the observation that the current formulas for large incumbent providers tend to direct almost the entire available subsidy to Southern states, thereby depriving large Western states of support. Another exception was that all agreed on the unsustainability of the current policy, which provides that rural wireline providers will continue to receive support at the same level even when customers gravitate to ETCs (often wireless providers) that receive support for providing service to such customers. Participants differed on the implications of this fact, however, with some emphasizing the folly of allowing ETCs to enter easily and others suggesting that the incumbents are often not the lowest cost provider and should be allowed to fail.

In terms of reforming the support side, Professor (and former FCC Chief Economist) Mike Riordan offered a novel solution focused on empowering state agencies to experiment with alternative approaches. Riordan explained that a system premised on something like a block grant (calculated based on the needs of a particular state) could provide both the incentive to ensure more efficient use of the subsidies and the obligation not to promote ever-accelerating spending (at least from the federal fund). The rationale for experimentation in this area is that there is considerable dispute and uncertainty about,

for example, the efficiency of rural providers; the wisdom of encouraging ETCs; and whether to peg support to customer choice (via something like vouchers) or network efficiency (as determined, say, by an auction model). In the face of such uncertainty, a greater reliance on state administration is an appealing option because it encourages local innovation. To be sure, such a system, as Ray Gifford (the President of the Progress and Freedom Foundation) noted, could lead to a “patchwork of approaches,” but businesses manage to follow different state laws in scores of regulatory domains (and already do in a number of cases in the telecommunications industry).

Final Thoughts On Congressional Reform

The difficult dilemmas raised by universal service reform will almost certainly receive congressional attention in the years ahead. As Senator Craig and Congressman Cannon emphasized, that process will take time and involve a significant amount of education about the relevant issues. Unlike the 1996 Act, there are no longer two warring sides that can make peace and present Congress with a “consensus bill”—albeit one rife with ambiguity. Thus, members of Congress will have to take on the difficult project of making sense of a complex area. As both Senator Craig and Congressman Cannon agreed, that process almost certainly will not happen this year and it is likely, because of the election next year, to be a project for the next Congress. But to prepare for a potential future revision of the Telecommunications Act of 1996, it is important that conferences like this one engage members of Congress and leaders in the industry so as to narrow and frame the difficult issues involved in universal service reform.