

WRITTEN STATEMENT

of

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on

***The Future of Rural Telecommunications:
Is the Universal Service Fund Sustainable?***

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Subcommittee on Rural Enterprise, Agriculture and Technology**

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STATEMENT OF COMMISSIONER KATHLEEN Q. ABERNATHY

Good afternoon, Chairman Graves and distinguished members of the Subcommittee. I appreciate the opportunity to appear before you to discuss the challenges confronting universal service and the FCC's efforts to preserve and advance this critical policy objective.

The goal of providing high-quality telecommunications services to all Americans at affordable rates is a cherished principle in U.S. telecommunications policy and one of the cornerstones of the Telecommunications Act of 1996. As Chair of the Federal-State Board on Universal Service, I make it a top priority to ensure that the federal support mechanisms fulfill their objectives.

The 1996 Act directed the FCC to promote two key goals that at times appear to be in tension with one another: opening local markets to competition and preserving universal service. The prior monopoly environment enabled regulators to promote universal service by building implicit subsidies into local and long distance rate structures. In a competitive environment, however, these implicit subsidies cannot be sustained, since the rates that provided surplus funds — such as business rates in urban areas — are undercut by new entrants and eventually driven down to a cost-based level. Congress accordingly directed the FCC to adopt explicit support mechanisms that would be sufficient to ensure that rates remain affordable and reasonably comparable throughout the nation. In response, the FCC developed several explicit support mechanisms for carriers that provide service in high-cost areas. High-cost support will total approximately \$3.3 billion in 2003.

The 1996 Act also expanded the scope of universal service by directing the Commission to establish support mechanisms for schools and libraries and for rural health care facilities. The schools and libraries program (often called the E-Rate program) provides up to \$2.25 billion in annual support and has enabled millions of school children and library patrons to gain access to advanced telecommunications and Internet services. While the rural health program generally has been underutilized, the FCC is considering a variety of measures to strengthen it, as discussed below.

In addition to the high-cost support mechanisms and the programs supporting schools, libraries, and rural health clinics, the FCC's Lifeline and LinkUp programs provide discounts off monthly service charges and connection fees to ensure that low-income consumers have access to basic telephone service. This year, these programs will provide approximately \$691 million in support.

All of these programs promote the universal service goals set forth in section 254(b) of the Act, including the availability of quality services at affordable rates; access to advanced services in all regions of the Nation; comparable access to telecommunications services for all consumers, including low-income consumers and those living in rural, insular, and other high-cost areas; and access to advanced services for schools, libraries, and rural health care facilities. Shortly after Congress's enactment of the 1996 Act, the FCC adopted rules regarding the collection and distribution of universal service support. Now, with several years of experience under our belts, we are engaged in a reexamination of many aspects of the program to ensure that each component is administered as efficiently and effectively as possible and that the overall program remains sustainable. A host of marketplace and technological developments

have already prompted some course corrections, and may ultimately cause us to reassess certain fundamental policy choices made in the initial implementation period. As we engage in this review, our commitment to preserving and advancing universal service remains unwavering.

I describe below the key challenges confronting universal service and the efforts the FCC has underway to ensure that the universal service program remains faithful to the principles set forth in section 254 of the Act. In my opinion, the FCC will soon need to revise its rules regarding the collection of funds and their distribution through the various support mechanisms. I will begin with the contribution methodology and then discuss issues pertaining to the distribution of support.

Contribution Methodology

The Commission collects funds for the various universal service support programs pursuant to section 254(d) of the Communications Act. Service providers must pay a percentage of their revenues from interstate end-user telecommunications services to the Universal Service Fund. This percentage fee, called the contribution factor, changes on a quarterly basis depending on the demand for funding and the base of reported revenues. The current contribution factor is 9.5 percent.

Several trends have combined to put upward pressure on the contribution factor, which in turn has increased the funding burden on consumers. While long distance revenues grew between 1984 and 1997, they have since been flat or in decline as a result of price competition and substitution of wireless services, e-mail, and, more recently, Voice Over Internet Protocol (VOIP) services. Because federal universal service contributions under existing rules are assessed only on *interstate* revenues from end-user

telecommunications services, this shrinking of the applicable revenue base has contributed to a steady rise in the contribution factor over time — it has increased by more than six percentage points over the last six years. While the contribution factor for the fourth quarter of this year will be 9.2 percent, the slight reduction from the current factor likely represents a one-time reprieve resulting from an earlier over-collection, considering that the reported revenue base remains in decline.

Another important trend has been the increasing prevalence of bundled service plans. For years, wireless carriers have offered buckets of any-distance minutes at flat rates, and now wireline carriers are offering packages including local and long distance for a single price. In addition, many carriers offer business customers bundles that include local and long distance voice services, Internet access, and customer premises equipment. Such bundling has been a boon for consumers but has made it difficult to isolate revenues from interstate telecommunications services. And the problem is likely to get worse as bundling becomes more and more popular.

In December 2002, the Commission adopted a number of measures to stabilize the universal service contribution factor in an effort to mitigate the growing funding burden on consumers. For example, the Commission increased from 15% to 28.5% the safe harbor that wireless carriers may use to determine the interstate percentage of their revenues. The Commission also eliminated the lag between the reporting of revenues and the recovery of contribution costs, which lessened the competitive disadvantages facing long distance carriers with sharply declining revenues. And the Commission prohibited mark-ups of contribution costs on customers' bills to ensure that carriers cannot profit from inflated line charges.

While these were important steps, I believe that more fundamental reform will be necessary to ensure the sustainability of universal service funding in the long term. Bundling together interstate and intrastate services — and telecommunications and information services — gives carriers the opportunity and incentive to understate the portion of their revenues that are subject to assessment and increases the difficulty of identifying interstate revenues. Contribution factors therefore are likely to continue their ascent under a contribution methodology based on interstate telecommunications service revenues.

For this reason, the Federal-State Joint Board has recommended that Congress amend section 254 to provide the FCC with authority to assess intrastate revenues, in addition to interstate revenues. A total revenue assessment would be far lower and more stable than one based solely on interstate revenues, and, just as importantly, it would prevent carriers from avoiding their contribution obligations by allocating revenues to the intrastate jurisdiction.

In addition, the Commission has been considering whether to make substantial changes under its existing statutory authority. The Commission has sought comment on alternative methodologies based (in whole or in part) on end-user connections or assigned telephone numbers, because such approaches arguably would create a more sustainable model for funding universal service in the future. The number of end-user connections has been more stable than the pool of interstate revenues, and connection-based charges can be adjusted based on the capacity of each connection to ensure an equitable distribution of the funding burden among business and residential customers. Moreover, proponents of a contribution methodology based on telephone numbers (with connection-

based charges for high-capacity business lines) argue that it would not only be more stable but also promote number conservation. Critics of these proposals — including carriers that would face increased assessments based on connections or telephone numbers — argue that reducing the contributions of long-distance carriers (which have very few assigned telephone numbers or end-user connections) would violate the statutory requirement that all carriers contribute on an equitable and nondiscriminatory basis.

Finally, the Commission also has sought comment, in the Wireline Broadband NPRM, on whether all facilities-based providers of broadband services should be subject to the same contribution obligations. While a total-revenue methodology or one based on end-user connections or telephone numbers would address problems arising from the blurring of the line between interstate and intrastate telecommunications services, such changes would *not* necessarily broaden the contribution base to include all broadband transmission services and new services such as VOIP. The Commission accordingly sought comment on whether or not to change the contribution pool to include new services that currently are not assessed. Regardless of whether such services are classified as telecommunications services or information services, section 254 gives the FCC permissive authority to assess contributions on “telecommunications,” which underlies both types of services.

Distribution of Support to Carriers Serving High-Cost Areas

The steady increases in the contribution factor have resulted not only from the shrinking of the interstate revenue base, but also from the significant increases in the demand for funding. Much of the increased demand has resulted from the FCC’s reform

of interstate access charges: Many incumbent LECs now recover from the Universal Service Fund costs that previously were recovered from long distance carriers. In addition, the increasing entry of wireless carriers and other competitors as eligible telecommunications carriers (ETCs) has raised questions about the long-term sustainability of the high-cost support mechanisms.

1. ETC/Portability Issues

Before enactment of the 1996 Act, only incumbent LECs received universal service support. In recent years, however, wireless carriers and competitive LECs have been designated as ETCs. While competitive ETCs receive a very small percentage of high-cost funds overall, their share has been increasing dramatically in recent months along with a surge in the number of ETC applications. Competitive ETCs receive support under the “identical support” rule (also called “portable support”), which provides per-line support based on the incumbent ETC’s costs. Incumbents do not lose support when a competitive ETC captures lines; rather, both carriers receive universal service funding. Rural LECs have argued that this regime creates uneconomic arbitrage opportunities and threatens the viability of universal service, while competitive ETCs generally contend that providing identical support — whether based on the incumbent LEC’s embedded costs or based on forward-looking economic costs — is essential to competitive neutrality.

In November 2002, the Commission asked the Federal-State Joint Board to consider the intersection of competition and universal service in rural areas. The Joint Board subsequently sought comment on several key issues, including the manner in which competitive ETCs receive support and the impact of providing support to

competitive ETCs on the growth of the universal service fund. The Joint Board also sought comment on the process for designating ETCs and whether the FCC should establish guidelines for consideration by the state commissions that make these determinations under section 214(e)(2). In July, the Joint Board held a public forum on these issues, and a wide range of industry representatives, consumer advocates, and state commissioners provided valuable insights.

Parties advanced a variety of proposals in their comments and at the public forum. Several groups of incumbent LECs argue that competitive ETCs should receive support based on their own embedded costs. Some competitive ETCs argue that incumbents and competitors should receive support based on forward-looking economic costs. To control growth, some parties advocate capping support upon entry of a competitor and dividing the funds pro-rata based on the percentage of lines each carrier serves; other parties advocate supporting only a single connection per household (current rules do not limit the number of wireline or wireless connections that are funded). Incumbent LECs generally oppose these proposals, arguing that reforming the ETC-designation process — in particular, making the public interest analysis more exacting — would suffice to keep the Universal Service Fund from growing too large.

The Joint Board is now considering the record and plans to provide a recommended decision to the FCC as expeditiously as possible.

2. Support for Non-Rural Carriers

While the rural high-cost support mechanism provides the lion's share of the funding — and correspondingly has received most of the attention — “non-rural” carriers (the Bell operating companies and other relatively large LECs) also receive high-cost

support. Whereas rural carriers receive support based on their embedded costs, non-rural funding is determined based on forward-looking economic costs. Non-rural carriers receive support in a particular state if the statewide average cost per line, as determined by a computer cost model, exceeds the national average cost by a certain margin. Currently, non-rural carriers receive support in eight states (Alabama, Kentucky, Maine, Mississippi, Montana, Vermont, West Virginia, and Wyoming). While non-rural carriers in other states serve many high-cost wire centers, their *statewide average* costs are not sufficiently high to receive support. Moreover, rural carriers receive substantial support in each of the states for which non-rural support is unavailable.

The Commission is nearing completion of a review of this support mechanism in response to a remand by the Tenth Circuit Court of Appeals. The court ruled that the Commission did not adequately explain how the non-rural support mechanism is sufficient to enable states to set affordable rates that are reasonably comparable in both rural and urban areas. In addition, the court directed the Commission to consider how to induce states to develop their own support mechanisms to fund high-cost areas within their borders, since the federal mechanism aims primarily to mitigate cost differentials *among* the states. The Joint Board issued its recommendations last October, and the Commission will complete its consideration of these issues next month.

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Taken together, the reforms being considered by the Commission should ensure the continued vitality of the federal universal service support mechanisms. The Commission has no higher priority than delivering on the promise of ubiquitous, high-quality, and affordable services. I would like to thank you, Mr. Chairman, for calling this

hearing, and I look forward to working with you and other members of the Subcommittee on these challenging and critical issues.