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Ignore Regulatory Costs At Your Peril: The Strange (And Evolving) Case Of The Federal Universal Service Fund

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Part of a corporate counsel's job description is to monitor changes in the law. Every day your company is relying upon you to evaluate changes in the legal landscape and translate how those changes affect your company's financial health. But, to what degree is your company – and more specifically, are you – taking time to track changes in the more volatile and less predictable worlds of regulation and legislative policy? Changes in the regulatory landscape – the decision of an agency, the release of a particular study, the opinion of a five person commission – can have a greater immediate effect on your company's financial future than any jury or judge. To understand the effect a seemingly obscure regulation may have on your business, consider the issue of the Federal Universal Service Fund.

Background On The Universal Service Fund

The Universal Service Fund ("USF" or "the Fund") was formally established by Congress in the Telecommunications Act of 1996 (the "Act"). Congress sought to turn what were once implicit subsidies into a visible program. The concept of "universal service" was invented in the early 20th century when the "old" AT&T, also known as "Ma Bell" held a recognized monopoly over telephone service in America. The idea that every American should have access to telephone service at an affordable price was used to justify a complex combination of demand and supply side subsidies. Pre-divesture AT&T used revenues from long distance services, business customers, and consumers in urban areas to subsidize the availability of telephone service in rural areas. As a then-Chairman of AT&T explained in 1973, AT&T distorted the price of telecommunications services to subsidize residential and rural customers in an effort to "bring service to within economic reach of as many people as possible, thereby enhancing the usefulness of service for everybody." For decades, AT&T practiced different forms of the same process that kept long distance rates high and residential rates low, although the network economics were the opposite.

Congress charged the Federal Communications Commission ("FCC") with the task of establishing programs that ensure that "quality services" are available at "just, reasonable, and affordable rates," and that "consumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas, should have access to telecommunications and information systems…that are reasonably comparable" to those in urban areas at "rates that are reasonably comparable" to those in urban areas. The Act mandated that all telecommunications carriers must contribute a percentage of their interstate telecommunications revenues into the USF.

The High Cost Of The Fund

Since the establishment of the USF in 1996, the FCC has continually struggled with how to best accomplish the mission and administer the USF. The FCC has issued over 23 regulatory orders regarding the Fund, which comprise over 1,900 pages. These orders have not targeted or stabilized the fund; quite the opposite. The FCC's Chairman and most classes of telecommunications companies that contribute to the Fund are calling for a serious evaluation of the sustainability of the current fund. USF has grown tenfold since 1996 and is currently a $7 billion program.

Telecommunications providers are allowed to pass their USF payment obligations onto their customers, and primarily all of them do just that – the surcharge appears on almost every telephone bill, including most of the *Fortune* 500 companies. This results in all American telecommunications customers that use interstate service, including wireless customers, Voice Over Internet Protocol customers, and prepaid calling card customers, to continue to experience a significant increase in their monthly phone bill. Considering the high volume of long distance service used by businesses, this *de facto* tax most certainly takes a consequential amount out of any bottom line.

Do the benefits of the USF program justify its immense cost? The FCC still states the goal of USF is to provide basic telephone service at reasonable rates for all Americans. At the end of 1996, 93.9% of American households had telephone service. That rate has remained relatively steady through the decade. It has, in fact, experienced a slight decline in the last few years primarily due to the trend of telephone users substituting wireless services for traditional landlines. By most accounts, where the FCC has failed is through its failure to effectively establish programs that promote

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the deployment of advanced broadband services nationwide. In the Act, Congress stated the Fund should be used to ensure that all Americans have access to "an evolving level of telecommunications services…taking into account advances in telecommunications and information technologies." The United States, however, ranks 15th in the world in broadband penetration, and the cost to American business is felt not only in increased expenses on reliable broadband access, but also in decreased competitiveness with other multinational firms.

USF Reform – The FCC And Congress

The Chairman of the FCC and many members of Congress have stated that reform of the USF is a top priority. Since the fall of 2005, several USF-related bills have been introduced in the House and Senate. Further, the FCC has held an almost on-going rulemaking proceeding open on USF reform. It was widely believed that significant reform would happen this year. It now appears that it will not occur until 2007.

The Chairman of the U.S. Senate Committee on Commerce, Science and Transportation, Senator Stevens (AK), has always been a staunch supporter of USF. He has also been very vocal and active in supporting USF reform. In anticipation of legislation, in February and March of 2006 Chairman Stevens held hearings on USF Reform. The hearings demonstrated that very few lawmakers were content with letting the fund exist in its current state. Most Committee members expressed frustration with witnesses who supported the status quo due to their vested interests in the current system. Senator Sununu (NH), for example, warned the witnesses that it does not benefit the Committee to talk to people who currently benefit from the fund's status quo. Similarly, Senator DeMint (SC) said the Committee is going to have to make some "hard decisions" regarding USF, and told the witnesses that "if your purpose for being here today is to defend the status quo, frankly, it will not do the Committee a lot of good."

Senator Steven's bill, the "Consumer's Choice and Broadband Deployment Act of 2006," was released in June 2006 and has become the main bill for reform in the Senate. The bill, however, does not include new structures that would cap or reduce USF levels; in fact, it adds new programs that would appear to increase the costs of the program. Further, the bill as introduced prohibits the reduction of most USF accounts. The bill states that "[N]othing in this Act…shall be construed as limiting…the amount of support or means of distribution for the schools, libraries, rural health care, life-life, link-up, and toll limitation program." It further states that "The [FCC] shall ensure that such amendments do not result in a decrease of such support to a level below the level for the fiscal year preceding the fiscal year in which this Act is enacted." The bill addresses the broadband deployment challenge by creating a "Broadband for Unserved Areas Account." This is a new, separate, $5 billion account within the fund that provides broadband deployment assistance in underserved areas.

The bill adds new revenue sources to fund USF by expanding the services upon which USF can be assessed. First, it expands the USF assessment base from "telecommunications services" to "communications services." The definition of "communications services" includes telecommunications service, broadband service, or IP-enabled service. Further, the bill would allow the FCC to impose USF contributions on intrastate services, and allows states to impose USF obligations on interstate services. Carriers, therefore, could be subject to both state and federal USF obligations on the same service.

The leading House legislation to revamp the USF is called the "Universal Service Reform Act" and is led by Representatives Terry (NE) and Boucher (VA). The bill would implement a stronger spending cap on the fund by extending the current cap on the portion of the high cost loop support mechanism that is distributed to rural incumbent local exchange carrier study areas to all eligible telecommunications carriers receiving support from the high cost support mechanism. The bill would also expand the USF contribution base to include every carrier that uses phone numbers or IP addresses and that provides "connections" to the public. It also addresses the broadband challenge by requiring that all service providers that receive USF funds meet the basic requirements for the deployment and provision of high-speed service.

It does not appear that a USF reform bill will pass Congress this year. The USF provisions of the Senate bill have been overshadowed by different, more controversial telecommunications issues, and debate over these issues has halted the movement of the bill. The House bill is not expected to pass the House this year. It is reported, however, that Congress is preparing to pass a universal service fund bill next year, whether it be as a stand-alone USF reform bill, or as part of a larger telecommunications reform bill.

What This Means To Your Business

Notwithstanding the current environment of a deregulatory policymaking, the nature of regulatory activity by the government will continue to affect businesses and very likely will increase their costs. Today, the Universal Service Fund fee has, for all practical purposes, morphed into a vehicle for the federal government to obtain funding to support its operations and perform certain socially desirable functions. For example, the Schools and Libraries Fund, commonly referred to as the "E-Rate Program" has become a mechanism to allow the private sector to upgrade embedded technologies and communications infrastructure in educational institutions. Without imposing value judgments on the wisdom of these actions by the government, the bottom line financial effect for your business is real.

With the reduction of multiple long distance telephone providers, which at one time served as a major source of USF revenues, the government cannot rely on consistent funding for the USF program. The financial consequence is that the percentage of revenues contributed by telecommunications service providers has risen steadily from 3% of every dollar of revenue in 1996 to 11.8% in 2005, to 10.5% today, and is projected by the Congressional Budget Office to reach 17% by the end of 2007.

So, why is this important to you? These charges – and the accompanying increases – are almost surely to be passed through to your company's telecommunications bill. As a member of your company's general counsel's office, your job is to advise your operations and finance departments that, due to legal and policy changes, the company's communications costs are subject to quarterly fluctuations.

What can you do to reduce costs? The most immediate solution is to consider your vendor/supplier relationship contracts. If your company is providing a product to a customer that requires the use of telecommunications services (such as just-in-time delivery or RFID-inventory tracking), it is important to consider supplier price fluctuations as part of any telecommunications service level agreement ("SLA"). During initial negotiations regarding long-term purchase of telecommunications services, it is important to include ceilings or firm fixed prices in your contract with the service provider. Your company's responsibility to cover certain regulatory fees and charges will be governed by the terms of the SLA.

You must consider certain scenarios: does the SLA provide the company with protection for increases in USF surcharges over a semi-annual or annual period? Is your company prepared to pass through these regulatory costs to its customers? Does a decision to pass through charges from your telecommunications supplier to your company's customer violate the down-line customer contract? If the SLA does not include a regulatory charge ceiling, can your company stand to endure a spike in regulatory fees, and an equivalent decline in the margins on certain products?

At bottom, monitoring, tracking, and where appropriate – influencing – regulatory trends affecting your company's operational inputs, such as communications and energy, are vital aspects of serving your company's needs. As the foregoing illustrates, establishing an appropriate relationship with regulatory and government affairs counsel to understand these issues is critical for reducing your company's costs and increasing margins.