

THE FEDERAL UNIVERSAL SERVICE POLICY DEBATE SHOULD USE FACTS, PROFESSOR, NOT FICTION

In almost predictable fashion, the opponents of rural America have stepped up the intensity of their rhetoric, with attacks on the industry compromise proposal for intercarrier compensation reform (Missoula Plan submitted to the Federal Communications Commission on July 24, 2006) and with reaching new lows in contorting facts and misusing information with regard to the federal universal service programs. The latest volley from the opponents of universal service is found in the paper released in June, 2006, authored by Thomas Hazlett entitled: “*Universal Service Telephone Subsidies: What Does \$7 Billion Buy?*”

If the Professor were a student, he might receive an A or B for his carefully-crafted writing style. However, we mark his paper with a C for logical flow and a D for veracity of research. In this rebuttal, the authors¹ will shed some light on the erroneous conclusions and misstatement of fact that permeate his advocacy piece sponsored by the Seniors Coalition.²

We present five sections in this initial rebuttal:

Rural is Different – This section briefly details the type of empirical evidence on the record that has yet to be refuted.

USF Builds Rural Infrastructure – Even in theory, investment in plant and equipment costs money. We believe even an academician should understand capital investment concepts.

USF is NOT a Tax – USF is assessed on telecommunications carriers.

The Truth about USF Growth – The fund growth for the past five years has been fueled by competitive entrants.

Erroneous Assumptions and Other Research Errors – Simply stated, bad research leads to bad conclusions.

¹ *Jeffrey H. Smith is Chairman of the Board of Directors and Vice-President and Division Manager – Western Region for GVNW Consulting, Inc. Michael Fox is the Government Affairs Manager for RT Communications in Worland, Wyoming.*

² Based on some preliminary research, still subject to check, it strikes the authors as ironic that significant funding for the Seniors Coalition is provided by an individual that found success in the direct mail business, benefiting from the United States Postal Service’s postalized rate structure. Rural carriers simply seek comparable rates to those of their urban sister companies.

RURAL IS DIFFERENT

At certain key points in his paper, Professor Hazlett appears to view the telecommunications industry as a homogeneous group of carriers. This apparent perception is off the mark. Distance and density make rural carriers different from their urban counterparts. Since some of the best empirical data in the record is from the Rural Task Force proceeding, a brief refresher is in order.

The Commission itself has recognized that the costs of rural carriers are higher than non-rural carriers. This was demonstrated empirically in the Rural Task Force's (RTF) White Paper 2,³ and this research was corroborated in NECA's *Trends in Telecommunications Cost Recovery: The Impact on Rural America* report released in October, 2002.

In this groundbreaking White Paper *The Rural Difference*, the Rural Task Force quantitatively detailed key differences between urban and rural carriers, including but not limited to differences in costs for switching capacity and various expenses and overheads that were driven by differences in the rate calculation denominator.

In this post-RTF period, this will not be a problem so long as the Commission continues to maintain its long-standing history of differentiating between sizes of carriers in order to provide equitable solutions to regulatory challenges.

Professor Hazlett's paper exhibits the same myopia that similar advocacy pieces do, reaching erroneous conclusions by assuming that the population density of the eastern United States is the norm, when in fact it is not representative of large portions of our country's geography and concomitant population dispersion.

Professor Hazlett's misunderstanding is not hard to fathom, given the proximity of Fairfax, Virginia to the extremely high densities found in the Washington, D. C. metropolitan area. On the other end of the spectrum, what are some examples of a low density subscriber base? Three companies which illustrate this are as follows:

Range Telephone serves 2,300 customers in a 3,400 square mile area, resulting in a density of 0.68 per square mile. As a point of reference, the 300 mile distance from one end of the Range service area to the other is the same distance as from Professor Hazlett's office in Fairfax, Virginia, traveling south on Interstate 95 to the outskirts of Fayetteville, North Carolina.

RT Communications serves 16,400 customers in the state of Wyoming in a 10,000 square mile area, resulting in a density of 1.64 per square mile. Dubois Telephone Exchange serves 2,400 Wyoming customers in a 4,000 square mile area, resulting in a density of 0.60 per square mile.

³ "The Rural Difference", Rural Task Force White Paper 2, released January 2000.

USF BUILDS RURAL INFRASTRUCTURE

While Professor Hazlett's proposal to replace USF with satellite phones is engineered to grab headlines, it would not be engineered to actually work. Outside the classroom, Professor, customers expect products to work.

Current wireless, VoIP, and satellite networks require a connection to land line infrastructure to provide full functionality. This network reality is documented in the white paper *Wireless Needs Wires: The Vital Role of Rural Networks in Completing the Call*, published by the Foundation for Rural Service in March, 2006. This paper states in part:

Without thoughtful consideration by policymakers of the challenges of providing wireless services in rural America, as well as the dependence of wireless services on wireline networks, portions of the nation are likely to remain underserved . . . Most importantly, one must recognize that without the underlying wireline network, wireless networks could not exist in their current form. In spite of this obvious fact, large wireless carriers and policymakers alike continue to pursue practices and policies that will in fact undermine the critical wireline network. While discussions on how to modify reciprocal compensation, access charges, and universal service continue, attention must be placed on ensuring these mechanisms are capable of maintaining the fiscal health of that wireline network.

With the challenges of distance and density facing rural carriers described in the prior section, it is important to remember that USF is used by rural carriers to build the underlying network that enables rural customers to access quality services at affordable rates.

In addition, this rural infrastructure supports the connectivity of competing technologies. For example, the much-touted VoIP option for customers requires broadband connectivity. These new technologies require robust wireline networks in order to be functional. These rural wireline networks would not be possible in rural areas were it not for the presence of universal service funds and other support mechanisms.

Despite the protestations of some, rural wireline networks remain capital intensive, fixed cost businesses that require substantial investment to develop, operate and maintain at an acceptable level of service quality. Attempting to assume away the need for such capital reminds one of the story of the two economists who were walking through the jungle and fell into a huge hole. The first economist was concerned with the plight of the pair. The other, grinning, said: "Let's just assume we have a ladder."

Professor Hazlett's approach digs a huge hole for the future of rural infrastructure deployment and provides nothing remotely resembling a ladder.

USF IS NOT A TAX

This is one area where Professor Hazlett is particularly fast and loose with his terminology. Throughout his paper, Professor Hazlett repeatedly refers to the USF as a ‘tax’ on consumers. This is simply wrong.

Wikipedia defines a tax as follows:

In the colloquial sense, a direct tax is one paid directly to the government by the persons ([legal](#) or [natural](#)) on whom it is imposed (often accompanied by a tax return filed by the taxpayer). Examples include some [income taxes](#), some [corporate taxes](#), and [transfer taxes](#) such as estate (inheritance) tax and gift tax. In this sense, a direct tax is contrasted with an [indirect tax](#) or "collected" tax (such as [sales tax](#) or [value added tax](#) (VAT)); a "collected" tax is one which is collected by intermediaries who turn over the proceeds to the government and file the related tax return.

Obviously, the above definition does not fit an industry funded mechanism such as the USF. The closest definition that would fit the USF structure would be a Value Added Tax (VAT). However, this does not fit either. A VAT is a consumption tax which is levied at each stage of production based upon the value added to the product at that stage. Rather, the USF structure is simply a pricing strategy, employed by public policy makers over the years, to enable local exchange carriers to earn a reasonable return on their investment. Indeed, adjusting prices to meet public policy objectives is a viable and acceptable technique, and has been accepted by economists for years. As Graaff puts it, “tinkering with the price mechanism is one of the more feasible and generally satisfactory ways of securing whatever distribution of wealth is desired.”⁴

To put it simply, the USF is industry funded and a legitimate cost recovery mechanism that has grown over the years primarily due to public policy decisions to move access charges and other rates into this fund. Policy makers have decided that it is more efficient⁵ to reduce prices for interexchange carriers and other entities accessing our network and, in turn, replace these revenues (which enable RLECs to build the networks these companies use) with new USF elements (e.g., LSS and ICLS).

The support for the fund is based on an industry funded structure and is paid for by consumers of telecommunications products and services – just as consumers pay for other products and services they purchase. To expect our industry to allow the use and access of our networks by consumers or other companies without appropriate compensation is

⁴ Graaff, J. de V. *Theoretical Welfare Economics* (Cambridge: Cambridge University Press, 1957), p. 171, from Alfred E. Kahn, Cornell University, *The Economics of Regulation: Principles and Institutions* (John Wiley & Sons, Inc. 1970), p. 68.

⁵ We will reserve the argument as to whether or not these changes have indeed resulting in a more efficient pricing structure, or not, to another place and time. For this article, it is sufficient to note that these changes have been made over time and have been the primary cause of the growth of the fund in recent years.

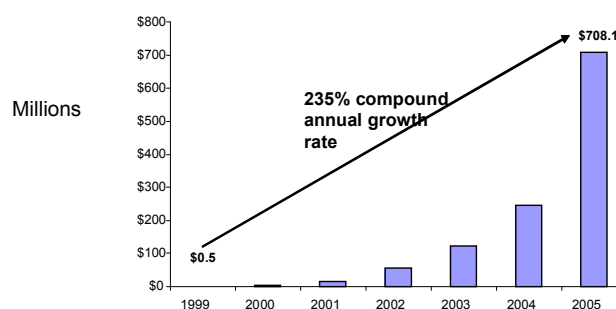
both ludicrous and potentially anti-constitutional.⁶ However, this fact has not stopped some individuals from arguing that incumbent telephone companies should indeed be required to provide access to our networks at zero cost – effectively giving it away. This is the only industry that the authors are aware of that would be required to build networks and not receive an adequate return for them, if the policy recommendations of people like Professor Hazlett are adopted.

THE TRUTH ABOUT USF GROWTH

The concept of Universal Service is not new. Indeed, it goes back at least to the passage of the Communications Act of 1934. The idea is that all Americans should have the right and means to affordable telecommunications service. The existence of programs like the RUS lending program and both state and federal universal service funds has enabled our country to enjoy remarkable success in this area. Today, over 94% of all Americans have basic telephone service – definitely a testament to the success of universal service goals and programs.

Universal Service funding is designed to support the networks that are built by companies providing service to rural and remote areas of our country. Professor Hazlett would lead his readers to believe that the growth in this fund is primarily caused by the rural telephone carriers. Again, this is not true. Indeed, the High Cost Loop Fund, which is the USF element that primarily supports the RLECs efforts, is already capped (subject to an annual index⁷).

What Professor Hazlett fails to make clear is that other elements of the USF are not capped and have resulted in dramatic increases in the fund in recent years. Furthermore, none of the funding received by Competitive Eligible Telecommunications Carriers is subject to a cap. For example, as the following graph illustrates, from 1999 through 2005, CETCs enjoyed a growth rate of 235% in high cost funding. This compares to a very flat growth rate for RLEC funding – the annual growth rate for RLEC high cost funding was only 0.6% in 2005.



⁶ While the authors do not purport to be attorneys, we are aware that some parties have argued that such a policy would be contrary to the 5th Amendment as an anti-constitutional ‘taking’ of property.

⁷ The indexed cap is based on the prior year’s rural high cost loop support grown by the rural growth factor, which is the loop change times inflation. Because of competition and substitution, rural carriers are actually losing support.

It is also important to note that much of the growth in the USF, particularly the funding now received by CETCs, is due to wireless CETCs offering the wireless services that Professor Hazlett claims would be more efficient than rural landline service. Indeed, in 2005, wireless CETCs represented approximately 97% of all CETCs. These companies also receive their funding based upon the RLECs' cost, not upon their own costs of providing service. Furthermore, they have essentially no requirements or obligation to enhance or improve their networks to better serve rural consumers. Indeed, for CETCs, the opportunity to receive high cost funding has proven to be 'found money'. In 2006, it is an estimated \$1 billion in USF funding – continuing the staggering growth rate seen in the above graph.

The other critical fact about fund growth that Professor Hazlett fails to make clear is that billions of dollars in HCF growth has resulted from FCC orders and other public policy decisions. Roughly \$1.9 billion of the current USF is the result of access replacement – shifts from implicit to explicit access support. This is not new money for rural wireline carriers. On the other hand, due to the identical support rule, CETCs do receive 'new money' from their receipt of high cost funding, plus they have benefited from reduced access levels.

Clearly, the growth of the USF is not due to 'inefficient' RLECs or abuses on the part of rural carriers. Rather, we need to discipline the CETC process. If the FCC and other policy makers would require CETCs to be compensated based upon their own costs, and demonstrate that they are using this funding for improved service in rural areas, rural consumers would benefit greatly, and the fund would not be experiencing the growth pressures it is today.

ERRONEOUS ASSUMPTIONS AND OTHER RESEARCH ERRORS

For us to point out all of Professor Hazlett's errors, wrong assumptions or misleading conclusions would require a paper longer than that of the original study by our esteemed professor. Rather, in the interest of brevity, we have elected to identify and discuss some of the professor's more egregious mistakes.

This study is seriously flawed and its overall conclusion that rural LECs are enriching themselves at the expense of customers is simply wrong. The existence of universal service funding has enabled rural telephone companies to continue to invest in state-of-the-art infrastructure to the benefit of their customers. This infrastructure supports rural wireline, wireless and broadband networks and services – some of the very services that Professor Hazlett claims would be more efficient for rural consumers. Indeed, without the infrastructure that rural carriers have deployed over the years, rural wireless and broadband services simply would not be possible. VoIP services, which both Professor Hazlett and prior FCC administrations have claimed would eliminate the need for the USF, require a robust broadband infrastructure.

Closely related research and assumption errors lead to Professor Hazlett's conclusion that the USF encourages RLECs to be 'inefficiently small'. Professor Hazlett forgets that the very reason small rural LECs exist is because years ago the 'big' telephone companies (most notably, Ma Bell) refused to provide ANY SERVICE in many rural and remote areas of America. So, these companies were formed because there was no other way for these rural Americans to get telephone service. The creation of the Universal Service Fund and other rural support mechanisms (e.g., the RUS program) were created to enable these rural companies to continue to provide the quality of service to their customers. If the Professor thinks 'bigger is better', let him compare the quality of telecommunications service in the *rural* areas served by BIG telephone companies (e.g., Verizon, Qwest or AT&T) with the quality of service in *rural* areas served by RLECs. Better yet, talk to customers in rural areas served by both RLECs and RBOCs! Obviously, the good Professor did not do his homework in this area.

Perhaps the most egregious assumption error and misleading statement that Professor Hazlett makes is his conclusion that even if the high cost fund results in lower telephone costs, consumers don't benefit because other prices are increased in an offsetting amount.⁸ Economists like to make assumptions – indeed, the joke is often made that if an economist doesn't like the results of his study, he simply needs to change his assumptions. This appears to be what Professor Hazlett has done here. The professor provides no proof for this assumption nor does he back up his conclusion. Does the professor truly believe that homeowners and landlords really base the price of real estate or rents on how high (or low) telephone service is? Or, taken to the extreme, would the price of pizza delivery also increase in areas where consumers have had their telecommunications bills reduced by universal service payments? To make blanket statements, assumptions and conclusions like these, without any backup or documentation to support such claims, seriously weakens the entire study. Again, Professor Hazlett, you failed to do your homework and, thus, we have to give you a D for the veracity of your research.

⁸ "To the extent that landline telephone rates are reduced below other alternatives, the price of land (as reflected in home prices and apartment rents) will rise by an offsetting amount, eliminating the gain to consumers." Page 3 of Dr. Hazlett's study.

CONCLUSION

Rural advocates have been working overtime in 2006, dealing with proposed changes to both federal universal service policy and intercarrier compensation rules. It seems sometimes that there are not enough hours during the day job to meet all the challenges. Professor Hazlett's erroneous conclusions should focus rural advocates to sharpen their universal service message. It is time to step up and refute such specious claims with facts, similar to the excellent advocacy advanced earlier in the 2003 OPASTCO study.⁹ Otherwise, we will watch a decade of careful development of an empirical record regarding the different circumstances facing rural carriers become lost in an avalanche of unsupported allegation and incorrect conclusions.

⁹ See, for example, OPASTCO's *Universal Service in Rural America: A Congressional Mandate at Risk*, January 2003, page viii: "High-cost universal service support is not a subsidy program for end-user customers. It is a cost recovery program designed to promote infrastructure investment in areas where it would not otherwise be feasible for carriers to provide quality services at rates that are affordable and reasonably comparable to urban areas."