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THE UNIVERSAL SERVICE PROGRAM: A REGULATORY SUBSIDY CASE STUDY

Executive Summary

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The Universal Service Fund (USF) currently distributes more than \$7 billion per year among participants in the telecommunications industry. It is a regulatory cross-subsidy system--broadly defined as an industry-specific subsidy system that charges higher prices to one group of consumers as a means of subsidizing lower prices for another--administered by the rules of the Federal Communications Commission (FCC). The USF affects consumers through higher prices for subscribers to services that pay into the fund and lower prices for subscribers to services subsidized by the fund. Companies currently pay into the fund 14 percent of revenue derived from interstate long-distance calls and 5.2 percent of their revenue derived from cellular service. The companies charge customers for the fees they are required to contribute to the USF; consequently, it increases consumer prices by about 14 percent for interstate long-distance calls and by about 5 percent for cellular service.

The USF subsidizes four categories of service. The largest portion (62 percent of the total fund) subsidizes companies that serve rural areas where the cost of telephone service is high (high-cost subsidy). The companies with the highest cost per telephone line receive most of this subsidy money. About half of the high-cost subsidy goes to companies providing the 1 percent of all telephone lines that have the highest cost. The money goes to the companies, but they are expected to reduce their rates to customers because of the subsidy. The second-largest category of payments (25 percent of the fund) is used to subsidize communication and Internet services for schools and libraries. The third category (12 percent of total payments) subsidizes basic telephone service for low-income individuals. The final category (1 percent of the fund) subsidizes communication for rural health-care providers.

The universal service program provides a good example of how regulation can create subsidies because it has taken three forms over the past half century. At first, the program created the subsidies by regulatory control of the relative prices of local telephone service and long-distance service when the industry was monopolized. As competition emerged, the mechanism to create the subsidies shifted to regulatory control over the terms and conditions by which companies interconnected their lines and transferred calls among companies. Finally, the FCC changed the program to the current approach of explicit charges to specified service providers and payments to others. Each of the three forms illustrates a way in which regulation can create subsidies. The persistence of the program even when threatened by changing technology and industry structure also is observed in other industries: Once subsidies are granted to specific beneficiaries, they generate political pressure to continue receiving them.

The evolution in the methods by which the subsidies were managed was accompanied by an evolution in their substantive nature. The early phase of the program

(pre-1984) provided a flow of subsidy funds from the users of interstate long-distance service to the providers of local telephone service. During the second phase (1984-1996), the source of subsidy funds continued to be users of interstate long-distance service, but the funds were targeted to the providers of local telephone service in rural areas, with particularly generous provisions for smallest companies. The long-distance-to-local-service subsidy for large companies in urban areas was phased out and replaced by a subsidy for low-income subscribers designed to prevent them from dropping service as local telephone rates rose. During the third phase (1997-present), the funding source shifted toward users of cellular telephones, in addition to earlier sources of subsidy funds, in order to continue generating revenue to support the growing program. Subsidy payments for high-cost telephone companies and low-income persons were increased over the earlier program, and new subsidies for Internet service to schools and libraries were added.

The program creates a flow of funds from urban to rural areas. The largest source of funds is generated by raising the price of cellular telephone service by approximately 5 percent (the percentage of cellular telephone revenue paid into the fund) and cellular users are concentrated in urban areas. Most of the funds go to small rural telephone companies. On a statewide basis, Delaware residents are the largest contributors to the fund and Alaska residents are the leading recipients. The urban-to-rural flow of funds also occurs within individual states.

This historical case study of the Universal Service Program illustrates one way subsidies can be delivered through regulation. By describing both the subsidies within the program, as well as the structural arrangements creating them, this case study provides an overview of a regulatory policy over time that can serve as a reference for those analyzing other regulations or creating new regulatory policy. The Pew Charitable Trusts has no position on the issue.