

USF Reform Urgently Needed

FCC Universal Service program deeply flawed and getting worse

By Pete Pattullo

For “prepaid” telecommunications service providers there is arguably no regulatory issue more important than the Universal Service Fund (USF). The USF assessment, an inconvenient regulatory burden when first implemented in 1998, is now an unmanageable and escalating surcharge that is jeopardizing the stability and efficiency of the U.S. prepaid telecommunications market. The time has come for the Federal Communications Commission (FCC) to reform the flawed USF program in a manner that reduces the contribution rate and ensures a level playing field for prepaid service providers.

How USF Works

USF is a surcharge on telecommunication services used to support programs such as the E-rate, or School and Libraries Program, which makes affordable telecommunications and broadband service available to eligible schools and libraries. USF also supports the Rural and High Cost Program (to make telecommunications services rates in rural and high cost areas reasonably comparable to rates in urban areas); the Low Income Consumers Program (which makes funds available through the Lifeline and Link Up programs to reduce the up front and monthly costs of telecommunications services for low income consumers); and the Rural Health Care Program (to make telecommunications and Internet services available to health care facilities in rural areas).

Under the current system, all telecommunications providers must pay USF each quarter based on a percentage (contribution

rate) of their gross billed end user interstate and international telecommunications revenues (contribution base). The current USF contribution rate is 10.2 percent, making it more than three times the federal excise tax rate. Based on current rules, prepaid service providers are unfairly penalized in cases where the amount of interstate traffic on their prepaid products exceeds the “12% international exemption rule”. Under this rule, prepaid providers only pay USF on their interstate revenues (exclusive of international revenue) if their interstate revenue is less than 12% of their combined interstate/international revenue. Since prepaid customers tend to make a high volume of international calls, this rule forces them to pay an additional 10.2 percent surcharge on all the international usage as well. To make matters

worse, there is no legitimate way to pass on these surcharges to consumers and still stay competitive. Even if they could, there’s no way to pass on these surcharges on a prepaid card that has already been consumed! Prepaid telecommunications providers are required to remit USF payments directly to the Universal Service Administrative Company (USAC) whether they were able to pass the cost on to the consumers or not. In contrast, postpaid service providers

can charge those payments back to their customers.

Prepaid service providers, therefore, have three choices: 1) restrict or block all interstate traffic on their international targeted products (making their products more confusing and less attractive to the consumers) or 2) pass on the

wireless provider can include only 28.5% of its revenues in its contribution base (based on the assumption that only 28.5% of wireless minutes are used for interstate calls). Due to their regulatory classification, Voice over Internet Protocol (VoIP) providers currently do not contribute to USF. This leaves the entire burden of funding USF to long distance providers, including prepaid service providers, effectively creating an unfair price advantage to wireless & VoIP service providers. This is a heavy burden to bear as the USF contribution rate has skyrocketed in recent years; the contribution rate has climbed steadily upward from 5.7% in the fourth quarter of 2000, to 7.28% in the fourth quarter of 2002, to its current level, 10.2%.

FCC USF Reform Proceeding

Recognizing the inequities in the system, in May 2001, the FCC initiated a proceeding to reform the Universal Service Fund contribution methodology. The agency recognized that reforms to USF were needed due to a declining USF revenue base and resulting increase in the contribution rate. In December 2002, the FCC sought industry comment on three specific connection-based proposals for USF reform. The first proposal would impose a minimum contribution on all interstate telecommunications providers and a flat charge per end user connection, depending on the nature of the connection. Single line businesses would pay a flat monthly fee and multi-line businesses would pay based on capacity. The second proposal would charge all USF based on capacity, with liability for each end

USF Surcharge Supports:

E-rate, or School and Libraries Program

Rural and High Cost Program

Low Income Consumers Program

Rural Health Care Program

10.2% surcharge on all international traffic to the consumers, just in case they exceed the “12% international exemption rule” (making their products uncompetitive in the current marketplace) or 3) take their chances and hope only a few consumers buy their cards to make interstate calls! (in some states this might be considered gambling.)

While USF applies to wireless services, the FCC has instituted a “safe harbor” rule by which a

user connection split between access and transport providers. The final proposal would assess USF based on the number of working telephone numbers. In the years that have since passed, the FCC has failed to take further action to reform the ailing USF program, so the inequities remain in place.

Flaws in the USF System

In addition to the inherent inequities, the existing USF system is plagued by two fundamental (structural) problems which have become self-perpetuating: 1) Public Switched Telephone Network (PSTN)-bypass which drives up the contribution rate; and 2) growing non-compliance which invites further USF payment avoidance.

PSTN-Bypass. Currently, the contribution rate is set by the FCC based on the total funds necessary to meet the requirements of all USF programs in addition to USAC's administrative costs. The FCC first projects the amount of funds that the USF system will need to pay out in the applicable

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quarter, and then it projects the total revenue base (interstate and international telecommunications revenues) for the quarter. Using that information, the FCC determines the contribution rate that will be required to cover USF outlays for the quarter. The fundamental economic problem with this system is that if the revenue base shrinks, then the contribution rate must increase.

The current inflated contribu-

tion rate of 10.2% is the result, in part, of a rapidly shrinking USF contribution base. There are several causes of the declining revenue base, including, most importantly, a consumer shift to wireless and VoIP technologies and away from PSTN-based services. As indicated above, VoIP providers are currently exempt from the payment of USF and wireless providers, due to the "safe harbor," only pay USF on 28.5% of their revenues. As growing numbers of consumers switch to VoIP and wireless services to take advantage of the reduced rates made possible in part because of the more favorable USF treatment these technologies enjoy, the contribution base shrinks further. This, in turn, causes the contribution rate to increase and further inflates the costs of PSTN-based providers. The problem has become a vicious cycle.

Growing Noncompliance. A byproduct of the increasing contribution rate discussed above is that almost none of PSTN-based prepaid telecommunications providers are able to effectively compete in this skewed environment if they pay USF. As a result, very few of these companies pay USF. The prepaid business, in part because margins are so low, has seen a significant number of providers go to extremes to avoid paying USF. This provides non-paying competitors with a cost advantage that pressures providers otherwise inclined to pay USF to adopt the same approach. As growing numbers of PSTN-based competitors elect not to pay, a "comfort in numbers" mentality encourages yet others to join the bandwagon. This problem is very real since consumers will nearly always select the provider with the lowest rates (i.e., one that does not charge USF). Fueled by a skyrocketing contribution rate and lax FCC enforcement of USF payment, this problem, too, has become a vicious cycle.

Perhaps the best known exam-

ple of non-payment of USF to date involves AT&T, which attempted to classify its "enhanced" prepaid calling card as an "information service," thus exempt from USF obligations. In a 2005 ruling, the FCC rejected that classification, and ordered AT&T to pay \$500 million in USF. AT&T has challenged the determination in court. AT&T also filed an emergency petition with the FCC that advocated interim rules that would apply USF to all prepaid calling card services, including those currently classified as exempt "information services." The FCC has yet to act on that petition. One of AT&T's primary arguments is that many

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prepaid providers do not pay USF because of the market realities discussed above.

Prompt FCC Action is Needed

These fundamental problems in the USF system are needlessly skewing investment and business decisions, causing prepaid service providers to play games (i.e. changing company names, setting up separate companies to make sure traffic mixes don't break the "12% international exemption rule," adding non-consumer driven or utilized "information" services, etc). Action by a reluctant FCC is urgently needed.

There are three steps the FCC could take to correct the situation:

1. The FCC should act now on its pending USF reform to re-align the USF revenue base and apply USF equally to all consumers, like the proposal before the FCC based on the number of working telephone numbers.

(i.e. \$2.00 per telephone number/month to meet current USF funding requirements). Trying to apply USF to long distance providers is nothing less than a telecom lawyer's windfall and prepaid service providers nightmare, and the vicious cycles of the past will surely repeat themselves.

2. Certain technologies (i.e. wireless and VoIP) should not be favored in terms of USF treatment over others. The FCC should re-align the contribution base, reducing the escalating contribution rate and avoid allowing the unique regulatory treatment afforded a particular technology to pick winners in the marketplace for long distance services.
3. Finally, the FCC should provide amnesty to prepaid calling card providers. There is no way to go back and fairly collect these fees in the Prepaid Card Industry. This is not like DAC "Dial-Around Calls" where the service providers collected the money from the consumer for making calls from a payphone and then didn't contribute. In this case, the prepaid service providers did not charge the consumers and really had no legitimate way to do it competitively.

The current system of selective enforcement, whereby a small number of violators are selectively penalized, is both ineffective and unfair. For example, while there are hundreds (and potentially thousands) of providers not paying USF—which itself forces the contribution rate to increase—the FCC has only initiated enforcement actions against sixteen companies not paying USF in 2004 and 2005 combined.

Pete Pattullo is President and CEO of NetworkIP, a provider of stored value technologies, systems and integrated services. Visit NetworkIP online at www.networkip.net.