The 1996 Telecommunications Act and Universal Service

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The 1996 Telecommunications Act took significant steps toward opening telecommunications markets to competitive forces. But, Congress was ambivalent about the universal service commitments of the old system. On the one hand, they recognized that competition would require reform of universal service; on the other, they expanded the overall commitment. As a result, there has been an inherent tension between a competitive marketplace and a system of cross subsidies to support universal service. Last year, the Federal Communications Commission (FCC) took action to reduce these tensions by reforming universal service, but more needs to be done, particularly at the state level.

Universal Service Subsidies

A major goal of U.S. telecommunications policy has been to provide telephone service to as many Americans as possible at a reasonable price. To do this, state and federal regulators have employed a tangle of implicit and explicit subsidies to keep rural and residential rates affordable. The central mechanism is the subsidization of local residential phone rates by long distance, and in some cases, business rates.

The Changing Environment for Universal Service

In the regulated, technologically stable telephone environment that existed when the universal service system was developed, the distortions to the telecommunications market were manageable because the regulation of monopoly prices was an easy way to transfer wealth between consumer segments. Prior to the 1996 Act, subsidies could occur with little competitive affect since local competition was nascent. Moreover, the technology was relatively stable, essentially consisting of the circuit switched phone network over wires.

In the 1990s, this began to change. The Internet and the development of packet-switched and broadband networks make the shift to a fixed-price system more likely.

Most significantly, the 1996 Act opened up the local market to competitive forces. But, one of the keys to making competition work is aligning prices with costs. If prices are above costs for some items and below for others, competitors will focus on the former rather than the latter. If prices are aligned with costs, however, the market disciplines itself, rather than relying on regulatory intervention with respect to prices.

Getting prices right in a competitive environment is critical if the market is to send the right signals to stimulate investment. Because the cross-subsidy rate structure distorts investment decisions for both telecommunications companies and consumers, the universal service system threatened to slow investment in technological advances, especially packet-switched and broadband networks. In addition, by pricing some services and areas below cost without any explicit universal support for actually serving the area, incentives to build out or upgrade the network are reduced.

And this is exactly what has happened. The most robust competition in local phone service has emerged in business markets in metropolitan areas where prices historically – and as a result of government regulatory prescriptions – often exceeded costs. Competition has been slower to develop in the subsidized side of the marketplace – residential and rural – where current revenues do not always justify investments.

The 96 Act and Universal Service Reform

The 96 Act did two things with regard to universal service. First, it provided that a new set of institutional users – schools, libraries, and rural health centers – would be eligible to receive universal service funds to subsidize not only phone usage, but also the costs related to hooking up to and using the Internet. Funds for those recipients are provided through an explicit universal service fee paid by all telecommunications carriers. Those funds, however, go not only to the institutional users listed above, but also to the Lifeline/Linkup programs[1] and to support service in high-cost areas (primarily to small phone companies in rural areas). A fee on interstate long distance and wireless calls and charges paid by long distance companies to local telephone companies finances the overall universal service fund. Second, the Act charged the FCC with extending universal service support to advanced services (e.g., residential broadband) if those services became widely used over time, although defining this was up to the FCC and the Joint Universal Services Board.

But while increasing cross subsidies, the Act also directed the FCC to make all subsidies explicit (based on universal service charges appearing on phone bills, not on hidden cross subsidies created by charging more for some services than for others). Congress at least partially recognized the inherent conflict between price subsidies and a competitive telecom marketplace. Consistent with this, the FCC has recognized that "implicit [universal service] support can also delay or deny the benefits of competition to residential or high-cost customers if a competitor finds that it is unable to compete against the incumbent's artificially low rates."

Progress Since the Act

The FCC has made substantial progress in implementing the market-opening provisions of the law, but until recently, the implementation of the universal service provisions has lagged and the traditional system of cross subsidies has remained the backbone of the nation's commitment to universal service.

In 2000, the FCC took major steps to reform the universal service system, principally by implementing a version of a proposal by the Coalition for Affordable Local and Long Distance Services (CALLS). The FCC:

- Reduced implicit cross subsidies by reducing time-sensitive long distance access fees while raising fixed-rate monthly subscriber line charge (SLC)
- Enacted some geographic rate rebalancing so that rural high-cost users now pay a slightly higher SLC than urban lower cost users
- Increased support targeted to low income users (e.g., Lifeline).

In spite of the fears of some opponents of these changes, consumers took almost no notice of them (in large part, because the changes were revenue neutral and not overly large).

But more needs to be done.

To bring competitive markets in line with universal service commitments, states should also take steps to reform universal service and rebalance local retail rates. Some states, such as Maine and Illinois, and countries such as Canada have engaged in significant rate rebalancing to bring costs closer to prices, including reducing the costs of interstate long distance service while raising some local service rates, and they have done so without experiencing significant decreases in subscribership.

The FCC and states should also resist pressures to extend the definition of universal service to include the Internet or broadband communications. Universal service subsidies for the Internet beyond schools, libraries, and rural healthcare centers make no sense in an environment where so many people who could afford Internet access are still choosing not to acquire it. Similarly, with less than 5 percent of American households subscribing to broadband, we are a long way off from mandating subsidies to support broadband subscription.

Conclusion

Policy makers have taken steps in the right direction to bring the universal system in sync with the new competitive marketplace. However, not only should more be done at the state level, but policy makers should avoid expanding the old system in ways that are inconsistent with the new telecommunications environment.

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This article is based on a PPI policy brief, "Social Policy in a Competitive Marketplace."

Endnotes

[1] A federal program that subsidizes the initial telephone connection charges and monthly service costs for targeted lower income consumers.