



USF and Inter-Carrier Compensation Reforms Would Benefit Consumers and Create 90,000 New Jobs

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Summary

On July 29, 2011, six major telecommunications and broadband providers filed the American's Broadband Connectivity Plan (ABC Plan) with the Federal Communications Commission (FCC). The ABC Plan proposes to fix an out-dated Universal Service Fund (USF) and reform the current inter-carrier compensation mechanisms. The plan proposes modernizing the USF program by ending the current support paid to telecommunications providers for deploying traditional telephony services in high-cost (generally rural) areas and redirecting these dollars to broadband services.

Along with reforming the USF mechanism, the plan recommends dramatically reducing hidden telephone company subsidies, called *switched access charges*. By virtually eliminating these subsidies, consumers benefit by seeing significantly lower long distance and toll rates, as well as lower wireless telephone rates – yielding billions in economic benefits. Moreover, as this ConsumerGram shows, the plan will create over 90,000 new jobs, bringing some relief to the struggling economy.

Background: Universal Service and Switch Access Rates

As a means to promote affordable telephone services to all consumers, universal service was the historical justification of regulatory pricing policies that set residential and rural rates for telephone services below costs, and offset these lower rates through increased long distance and business service rates. Prior to the Telecommunications Act of 1996 (the Act), universal service was predominantly funded by implicit support mechanisms. One source of implicit funding was the use of interstate and intrastate switch access charges, a mechanism that still operates today.

Switched access charges are fees paid by long distance companies to local telephone companies for the regulatory purpose of redistributing revenues between their respective services. Essentially, when a telephone customer makes a long distance or toll call, depending on where the call originates and where it terminates, that

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customer's long distance telephone companies needs to pay the local telephone companies access charges as a cost recovery and redistribution mechanism. While the customer never sees these access charges, long distance carriers simply bury these intercompany payments into the rates paid by customers. In effect, access charges represent a hidden fee that keeps toll and long distance rates artificially high in order to subsidize local telephone companies.

After the passage of the Act, explicit universal service funds were created to support the affordability of telephone services in rural areas and for low-income consumers, but access charges have remained an implicit (hidden) subsidy collected through higher long distance and toll prices. In many cases, access charges have little bearing on direct service costs, as demonstrated by the fact that the magnitude of these charges vary by telephone company size, type of technology, geographic calling area, and population density. For instance, access charges can be five times higher for a 35-mile toll call than a 2,500-mile long distance call. A long distance call can generate more access charges in one direction than in the other direction – even if they use the identical network facilities in both directions. Technologies, like wireless services and Voice-over-Internet-Protocol (VoIP) telephony, often pay higher access charges than they receive – effectively taxing these newer networks to subsidize traditional voice technologies. Such subsidies serve to produce more problems than they solve – they affect market prices and costs; they deter market entry, competition and investment; they impede operational efficiency; and they encourage corporate welfare, arbitrage, gaming and fraud. For instance, the opportunity for arbitrage of rates has resulted in unscrupulous schemes to collect more terminating access charges through traffic pumping, phantom traffic and sex chat lines.

Reform Means Billions in Consumer Benefits

The ABC plan calls for the virtual elimination of terminating switch access charges, reducing terminating inter-carrier compensation to a uniform rate of \$0.0007. In analyzing the plan, noted economist Professor Jerry Hausman of MIT used a widely accepted economic approach to measuring consumer benefits, called *consumer welfare*, and estimated that lower access prices would yield \$9 billion of benefits per year.¹ Hausman estimated that the reductions would yield significant benefits for wireless, long distance, VoIP and broadband customers, as well as promote efficiency gains and promote investment and innovation in broadband infrastructure.

Because switched access services are relatively more price elastic (price sensitive) than local services, the stimulation in demand from reducing access fees more than offsets any demand repression elsewhere.² In effect, the net result of the ABC Plan

¹ See Professor Jerry Hausman, "Consumer Benefits of Low Inter-carrier Compensation Rates," Attachment 4, ABC filing, available for download at <http://americasbroadbandconnectivity.org/wp-content/uploads/2011/07/Attachment4-Professor-Hausman-Consumer-Benefits-Paper.pdf>.

² The ABC Plan allows an increase in line charges as high as \$3.75 per month, though it is highly unlikely that competitive market conditions will make it possible for carriers to flow through the full amount of

will benefit consumers primarily from lower wireless, toll and long distance prices. In addition to these direct savings, consumers will benefit by stimulated usage at lower prices. This point is supported by Professor Hausman's results, but it is also consistent with earlier analyses. For example, 10 years ago, the FCC's adopted a plan to dramatically lower switched access rates, resulting in \$7.4 billion in annual benefits for consumers, net of line charge increases.³

Reform Could Also Create 90,000 New Jobs in the Economy

There are two ways in which the ABC plan would produce positive effects on the economy, including increases in economic output, employment earnings and jobs. The first effect, USF reform, diverts the USF High-Cost support from traditional voice services to broadband services.⁴ On the positive side, USF reform will increase deployment and demand for broadband services. The increase in demand will require direct hiring workers or contractors, as well as purchasing of equipment and services. These direct activities spur indirect effects by suppliers and equipment manufacturers. In addition to the direct and indirect benefits, workers will use the additional earnings to make various household purchases, which will create additional economic benefits called *induced effects*. The combination of direct, indirect and induced effects will represent the total value of these economic benefits. Essentially, as a dollar of investment (or spending) is made, increased economic output cascades along various stages of production, employees spend their additional earnings, and the economy ends up with more than one dollar of final product. This phenomenon is referred to as the *multiplier effect*. These direct, indirect and induced benefits can be measured in terms of their effect on U.S. Gross Domestic Product (GDP) – the most comprehensive measure of final demand – and they can be reflected in terms of their effects on jobs and employment earnings. However, by diverting USF support away from telecommunications, there will be offsetting negative effects, which will moderate the positive benefits of USF reforms. However, since the multiplier effects for Internet services exceed the multiplier effects for telecommunications services, the effect of diverting support from traditional voice services to broadband services will produce “net” benefits to the economy, in terms of additional GDP, employment earnings and jobs.⁵

permissible price increases. However, any line charge increase will lead to some demand repression, which we estimate to be approximately a \$1 billion welfare loss, with \$2 billion being a worse case, varying based on assumptions of competition and price elasticity. In this ConsumerGram, we lower Hausman's consumer welfare estimates to reflect this demand repression.

³ The CALLS Plan demonstrated that rebalancing interstate rates toward more rational market prices produce net welfare benefits. See Steve Pociask, “An Assessment of Consumer Welfare Effects of the CALLS Plan,” Joel Popkin and Company, October 25, 1999; and Steve Pociask, “The CALLS Plan Revisited: A Quantification of Consumer Benefits,” March 31, 2000 (filed with the FCC by the Alliance for Public Technologies).

⁴ For the purpose of these calculations, high-cost support was \$4.3 billion in 2010. See USAC 2010 Annual Report <http://www.universalservice.org/about/governance/annual-reports/2010.html>.

⁵ All industry multipliers are from the latest BEA's RIMS Model (Type II).

The second positive effect, access reform, is the consumer benefit as described by Hausman. Similar to USF reform, the benefits from access reform produces sizable multiplier effects. However, this analysis assumes that these benefits are partially offset by negative effects from increasing line charges.⁶ **Table 1** (below) shows a summary of the multiplier effects from USF and access reform – both positive and negative effects – and the resulting “net” increase in GDP (labeled *Output*), employment earnings (labeled *Earnings*) and full-time jobs (labeled *Employment*).

<u>Negative Effects</u>	<u>Output (\$B)</u>	<u>Earnings (\$B)</u>	<u>Employment</u>
Due to USF Reform	\$7.45	\$1.53	36,401
Due to Access Reform	\$0.91	\$0.19	4,470
Total Effect	\$8.36	\$1.72	40,871
<u>Positive Effects</u>	<u>Output</u>	<u>Earnings</u>	<u>Employment</u>
Due to USF Reform	\$7.79	\$2.21	56,944
Due to Access Reform	\$15.59	\$3.20	76,187
Total Effect	\$23.38	\$5.42	133,132
<u>NET GAINS</u>	<u>Output</u>	<u>Earnings</u>	<u>Employment</u>
Due to USF Reform	\$0.34	\$0.68	20,544
Due to Access Reform	\$14.67	\$3.02	71,717
Total Effect	\$15.02	\$3.70	92,261

Sources: ACI calculations and BEA RIMS Multipliers (Type II)

As **Table 1** shows, the multiplier effects are sizable and they demonstrate that the ABC plan will result in “net” benefits for the economy. In terms of losses, the reduction in the USF high-cost fund for traditional voice services is more than offset by benefits in support for broadband services. The combination of reforming USF and switched access rate mechanisms would produce an increase in economic output, including increases of nearly 90,000 new jobs.⁷

Summary

The ABC plan would produce lower long distance and wireless telephone rates, and it would divert USF support from traditional voice networks to broadband networks.

⁶ For the base case scenario, it is assumed that line charges will increase by \$3.75 for 10% of customers, \$1.88 for another 10% of customers, and \$0.75 for yet another 10% of customers.

⁷ For a sensitivity analysis, if the increase in subscriber line charges produces welfare losses that are four times higher than the base case scenario, the resulting net employment gains will be 15% lower than shown in the table.

Even when including the negative impacts from the plan, the net result is a sizable increase in consumer welfare benefits, as well as 90,000 new jobs.

This *ConsumerGram* provides empirical support for dramatically reducing access charges and reforming the current USF support mechanism. Reducing these subsidies would provide the correct market signals, which would encourage competition, innovation and investment in broadband technologies. Most importantly, consumers and workers would benefit.