

# **Performance Audit No. 15-01**

## **A Limited Review of the Utah Universal Service Fund**



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March 23, 2015

Ron Allen, Chairman  
Public Service Commission  
Heber M. Wells Building  
160 East 300 South  
Salt Lake City, Utah 84114

Dear Commissioner Allen:

The Office of the Utah State Auditor conducted *A Limited Review of the Utah Universal Service Fund* (UUSF) and presents its recommendations to the Utah Public Service Commission herewith. As part of this review, we examined reports from the state's Division of Public Utilities, federal reports on changes in the telecommunications landscape, statute and administrative rules, and historic financial data provided to the Division of Public Utilities by Utah's Rural Local Exchange Carriers (RLEC).

The information provided in this report will bring increased awareness to potential funding concerns regarding revenue sources for the UUSF. Implementation of the audit recommendations will help to ensure transparency of UUSF revenues and accountability for the use of the funds.

We appreciate your assistance during the course of this review.

Sincerely,

David S. Pulsipher, CIA, CFE  
Performance Audit Director

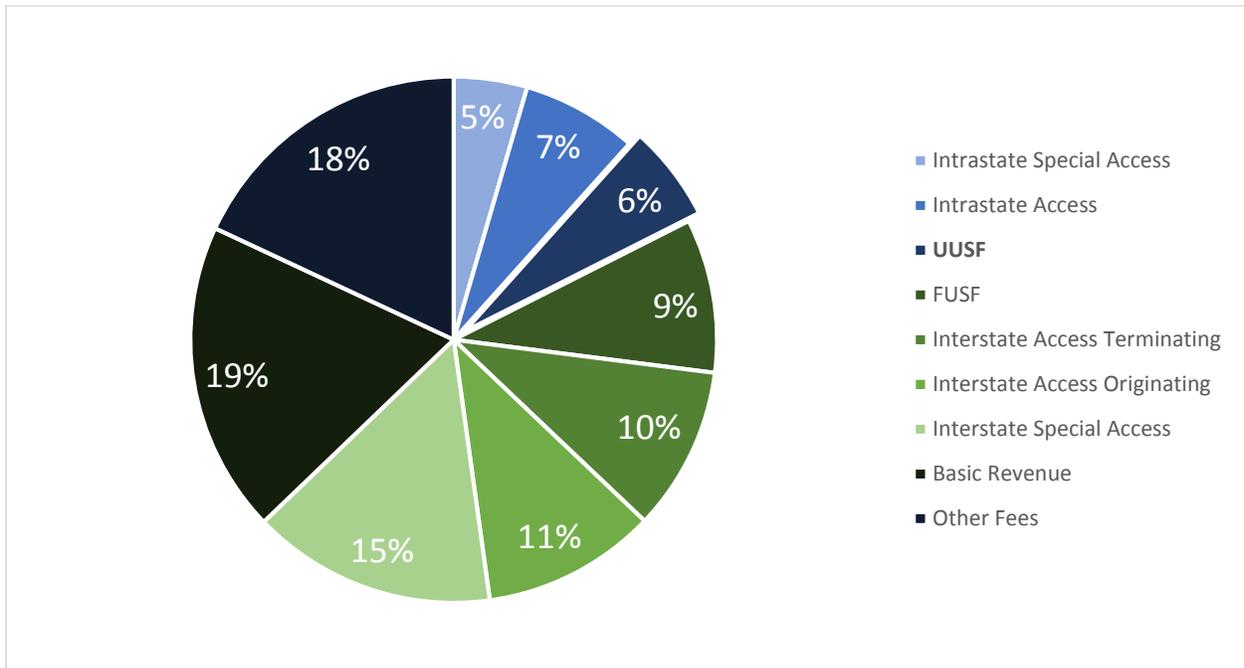
**Supervisor:** Chris Otto, MPA  
**Audit Staff:** Charlie Fuller, MPA

## Background

The 1996 federal *Telecommunications Act* created the Federal Universal Service Fund (FUSF) to help establish telecommunications service in all regions of the country, including rural, high-cost, and low-income areas of the nation.<sup>1</sup> The UUSF was created in 1997 to subsidize ratepayers in rural areas of Utah for the cost of providing telephone service to those areas. The UUSF was structured to “promote equitable cost recovery of basic telephone service through the imposition of just and reasonable rates for telecommunications access and usage” and “preserve and promote universal service within the state by ensuring that customers have access to affordable basic telephone service.”<sup>2</sup>

Utah’s RLECs collect revenue from a variety of sources. Figure 1 shows the percent of revenue sources for the 16 RLECs operating in Utah from 2005-2013.

**Figure 1 RLEC Revenues Come From Multiple Federal and State Sources**



Source: OSA Analysis of RLEC Annual Reports

This distribution represents the percent of aggregate revenues distributed from 2005 to 2013 to RLECs as reported to the Division of Public Utilities. As demonstrated in the figure, Utah’s RLECs receive revenues from a variety of access fees, service charges to customers, and a mix of

<sup>1</sup> 47 U.S.C § 254(b)(2)-(3).

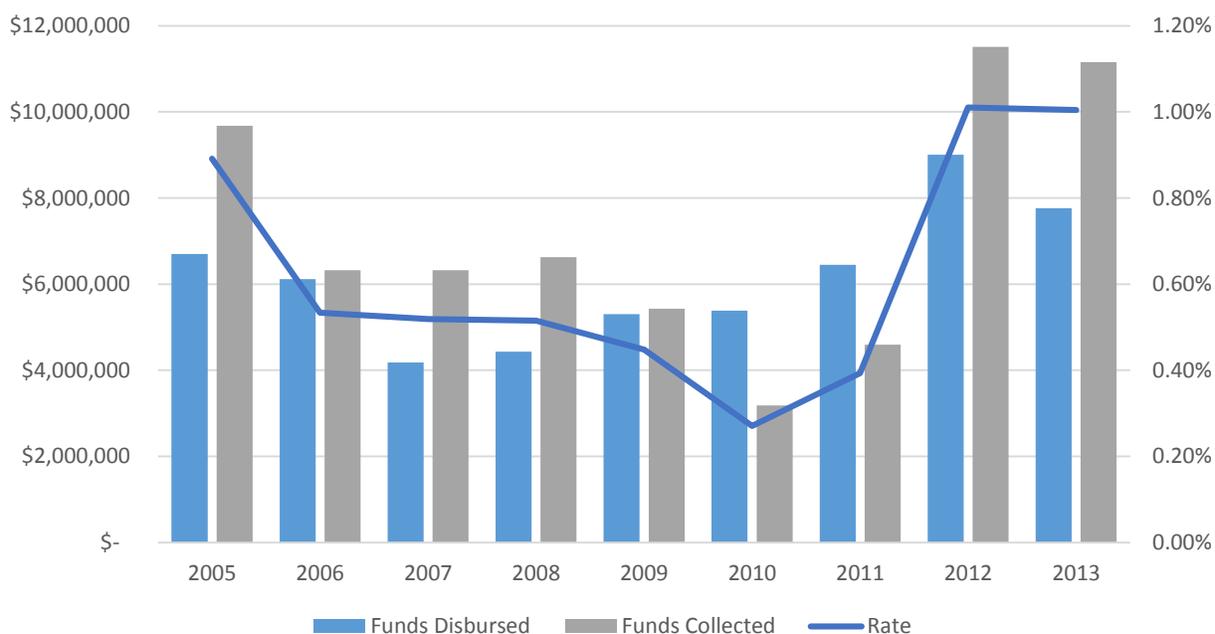
<sup>2</sup> Utah Code § 54-8b-15(6)(a)-(b).

state and federal subsidies. Approximately six percent of revenue historically received by Utah’s RLECs has come from the UUSF.<sup>3</sup>

## Utah Ratepayer’s Contributions to the UUSF Increased 81 Percent since 2007

The UUSF was statutorily designed to defray the portion of costs to provide basic telephone service that was not funded by other revenues or the FUSF.<sup>4</sup> All state telephone customers—including cell phone customers—are charged a fee, as a percentage of their monthly phone bill, to support the UUSF. UUSF disbursements to RLECs have increased almost every year since 2008. Currently, Utah telephone customers are charged a one percent fee, set by the Public Service Commission. Revenues collected as a result of this one percent fee were more than \$11 million in 2013. The Public Service Commission determines RLEC disbursements in rate cases presented by an RLEC with audit support from the Division of Public Utilities. Figure 2 shows the amount of funds collected by UUSF and the disbursements made to RLECs from 2005 to 2013.

**Figure 2 RLEC Demand on UUSF Peaked at \$9 million in 2012**



Source: OSA Analysis of RLEC Annual Reports

Figure 2 shows some variability in the support RLECs have received and the amount the UUSF has collected. The rate has been adjusted by the Public Service Commission to meet demand

<sup>3</sup> UUSF support for individual RLECs varies depending on the year and RLEC need. Three RLECs did not receive any UUSF support for the years reviewed in the analysis while one RLEC had 18% of its total revenue come from UUSF.

<sup>4</sup> Utah Code § 54-8b-15(7).

and has fluctuated from a high of one percent to a low of one-quarter of one percent. The UUSF has historically maintained an operational reserve of approximately \$5 million over that time period. The reduction in disbursement amounts from 2005-2007 was partially due to three companies having their UUSF disbursements stopped as a result of Division of Public Utilities audits. The subsequent increase in disbursements in 2010 appears to have been caused by “increased competition from wireless providers, upgrades to more advanced technologies, and a variety of other factors.”<sup>5</sup> As some RLEC customers have transitioned from land lines to cell phones or Voice Over Internet Protocol (VoIP) devices, RLEC revenues decreased and additional demands were made on the UUSF.

In addition to growth in state support for RLECs, the federal subsidy has also seen increased demand across the nation. According to a recently released report from the federal Government Accountability Office (GAO), FUSF disbursements have grown considerably since the program’s creation. The report states that the FUSF “has increased by approximately 73 percent, from \$2.6 billion in 2001 to \$4.5 billion in 2013.”<sup>6</sup> As the cost of the program has increased, additional attention has been given to the impact of charging fees to all consumers to subsidize rural telephone service.

## **UUSF Disbursements Could Quadruple by 2020**

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In November 2011 the Federal Communications Commission (FCC) issued the Universal Service Fund Transformation Order. This order called for transitioning FUSF support from basic telephone service to broadband service, and capped the program at \$4.5 billion. The FCC noted, “the reforms for rate-of-return carriers are meant to increase incentives for these carriers to be efficient in their use of public resources.”<sup>7</sup> In addition, the Public Service Commission stated in its 2013 annual report that, “This order, if implemented as written, will significantly alter the federal programs relating to the [FUSF]. . . As a result the Commission anticipates that over the next five to ten years, the state’s telephone carriers will lose a significant amount of FUSF subsidies.”<sup>8</sup>

Although neither the transition to broadband nor the program cap has yet to be implemented, the FCC has set a schedule, which began in 2013, that phases out terminating long-distance access fees.<sup>9</sup> Historically, terminating long-distance access fees have represented an estimated 10 percent of the total RLEC revenue. The impact of substantially reducing this revenue source and FUSF support over the next five years could have a significant impact on Utah’s RLECs and the need for additional UUSF support. Figure 3 below highlights the potential percent of RLEC

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<sup>5</sup> 2013 Division of Public Utilities Report to the Public Service Commission.

<sup>6</sup> U.S. Gov’t Accountability Office, GAO-14-587, FCC Should Improve the Accountability and Transparency of High Cost Program Funding (2014).

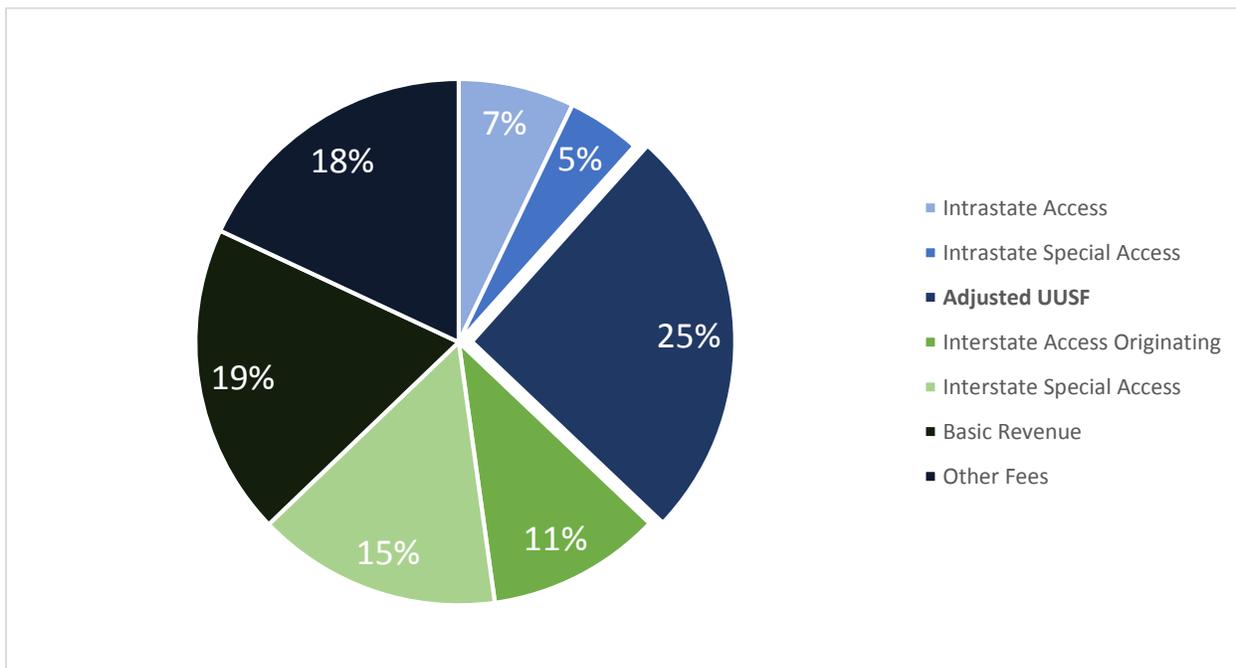
<sup>7</sup> Ibid., 18.

<sup>8</sup> Public Service Commission 2013 Annual Report.

<sup>9</sup> “Terminating” refers to the location where a call ends. In the scenario where a call is placed from Denver, CO to a home or business in Hanksville, UT the Hanksville line would be the terminating end of the call. A long distance carrier would bill the call then reimburse the rural carrier for terminating the call on the rural carrier network.

revenue that the UUSF could be obligated to cover if existing administrative rules remain unchanged and if the Public Service Commission continues the practice of complete cost defrayal.

**Figure 3**      **The UUSF Could Significantly Increase if FUSF Support And Interstate Terminating Access Fees Decline**



Source: OSA Analysis of RLEC Annual Reports

Assuming the relative stability of other revenue streams, the UUSF could increase from covering six percent of RLEC operational revenues, shown in Figure 1, to contributing up to 25 percent, shown in Figure 3, if FUSF support is reduced and when terminating interstate access fees complete their scheduled decline in 2020.<sup>10</sup> In this scenario, the impact on the UUSF could be an increase from an average annual disbursement of \$6 million to up to \$26 million. Should the FCC implement additional planned reforms, as expected, the impact on the UUSF could be even greater.

The FCC transformation order will likely result in a reduction of federal revenues for Utah’s RLECs in a variety of ways. To date, the Public Service Commission has taken a “make whole” approach for allocating UUSF monies. Therefore, as the federal revenues decrease, there will be a corresponding increased demand for UUSF to cover the funding gap if the current defrayal practice continues. Although the FCC appears to be taking policy positions that encourage

<sup>10</sup> This analysis assumes that the average FUSF support, which has historically represented 10 percent of RLEC revenue, and the terminating interstate access fees, which represented approximately nine percent of RLEC revenue, would be eliminated. Legal challenges to this transformation order, as well as subsequent FCC orders on the future of analog phone service, prevent a precise calculation on the impact those changes will have on Utah’s RLECs.

efficiency, the administrative rules for use of the UUSF have not expressly been written to encourage the efficient use of the funds.

## **Focusing on Efficient Use of UUSF Could Increase Accountability and Deter Unnecessary Costs**

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Statute requires the Public Service Commission to determine the eligible costs that can be defrayed by the UUSF.<sup>11</sup> Current administrative rules that outline costs and determine the amount of state support that will be provided to a Utah RLEC state, “Monies from the fund will equal the numerical difference between the Incumbent telephone corporation’s total embedded costs of providing public telecommunications services . . . less the product of the Incumbent telephone corporation’s Average Revenue Per Line . . . times the Incumbent telephone corporations active access lines.”<sup>12</sup>

In light of the anticipated increased demand on the UUSF, we recommend that the Public Service Commission adopt additional rules, or strengthen existing rules, to encourage efficient use of the UUSF, as the FCC has already begun to implement with the federal subsidy. In addition, as the FCC continues to implement changes to its funding support for basic telephone service, we encourage the Public Service Commission to provide more frequent updates to its legislative oversight committee regarding the financial impacts that these changes will have on Utah’s RLECs so the committee can determine if the practice of defraying all RLEC costs is in the best interest of ratepayers.

## **Recommendations**

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1. We recommend that the Public Service Commission adopt rules that encourage efficient use of the Utah Universal Service Fund.
2. We recommend that the Public Service Commission continue to track the changes in federal support of Utah’s Rural Local Exchange Carriers and report the impacts of those changes to the Legislature’s Public Utilities and Technology Committee.

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<sup>11</sup> Utah Code § 54-8b-15(7).

<sup>12</sup> Utah Administrative Code R746-360-7.



## State of Utah

GARY R. HERBERT  
*Governor*

SPENCER J. COX  
*Lieutenant Governor*

## Public Service Commission

RON ALLEN  
*Chairman*

DAVID R. CLARK  
*Commissioner*

THAD LeVAR  
*Commissioner*

March 17, 2015

David S. Pulsipher, CIA, CFE  
Performance Audit Director  
Office of the Utah State Auditor  
Utah State Capitol Complex  
East Office Building, Suite E310  
Salt Lake City, UT 84114-2310

Dear Mr. Pulsipher,

The Public Service Commission (Commission) has reviewed the audit report and appreciates the effort and work contained in the report. The Commission agrees with the findings of the audit and will implement the following recommendations: (1) The Commission will review and adopt rules that encourage efficient use of the Utah Universal Service Fund (UUSF); (2) The Commission will continue to monitor and track changes in federal support of Utah's RLECs (Rural Local Exchange Carriers) and report such changes to the Legislative Public Utilities and Technology Committee.

Thank you for the report and please contact me if you have any questions or concerns.

Sincerely,

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Ron Allen  
Chairman  
Public Service Commission