

Zero-based budgeting: Does it make sense for universal service reform?



Victor Glass*, Stela Stefanova, Joseph Prinziwalli

National Exchange Carrier Association, 80 South Jefferson Road, Whippany, NJ 07981, USA

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ABSTRACT

The FCC's proposal for Universal Service Fund (USF) reform proposes to replace current universal service funding programs with the Connect America Fund (CAF), a fund devoted to using government support to make broadband service available in un-served or under-served geographical locations. The goal is to maximize the bang-per-buck from available funds by looking at incremental upgrades to existing infrastructure in under-served areas and incremental infrastructure build-outs in un-served areas. The strategy is to encourage competition between broadband providers whether they are wireless providers or wireline providers.

In essence this is a zero-based budgeting strategy in which the FCC begins with a clean slate and takes no account of existing allocation of funds. This strategy, while it sounds reasonable in theory, threatens to bankrupt rural local exchange carriers (RLECs). As a result, it threatens not only universal broadband availability but also basic voice service. We show the devastating financial effects of this zero-based budgeting plan on RLECs using revenue, demand and cost data from a survey sent to RLECs, as well as data available from the FCC economic model, which projects the likely technology winner at the county level and the amount awarded.

The FCC has acknowledged that a flash cut in funding is not feasible. Instead, it has proposed freezing support per access line during a transition period. We show that this supposed glide path to the new support mechanism also produces devastating financial results for RLECs.

Tests for RLEC financial distress include comparisons of support under current programs compared to support under the new CAF, change in RLEC free cash flow and RLECs' eligibility for Rural Utility Service loans.

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1. Introduction

In its *Connecting America: The National Broadband Plan*, the FCC proposes to replace current universal service funding programs with the Connect America Fund (CAF), a fund devoted to making broadband service available in un-served or under-served geographical locations (FCC, 2010). The strategy is to maximize the bang-per-buck from available funds by looking at incremental upgrades to existing infrastructure in under-served areas and incremental infrastructure build-outs in un-served areas. The FCC believes competition for support dollars between broadband providers whether they are wireless or wireline providers, should reduce the cost of broadband deployment.

In essence the FCC adopts a zero-based budgeting approach for allocating support dollars to show the effectiveness of its plan. Using a model, the FCC identifies which technology will likely extend broadband availability in targeted areas at the lowest support funding cost. Afterwards, the FCC acknowledges that a flash cut in funding from current to new recipients is not feasible. Instead, the FCC proposes a transition period to allow current receivers of support enough time to prepare in case they lose funding.

NECA and others filed comments strongly criticizing the FCC's zero-based budgeting strategy, whether it includes a transition period or not (NECA et al., 2010). The claim is that the FCC's plan fails to recognize that existing USF recipients depend on this support for their very survival. NECA quantified potential RLEC financial distress from loss of support by projecting the size of the shift of funding away from RLECs to

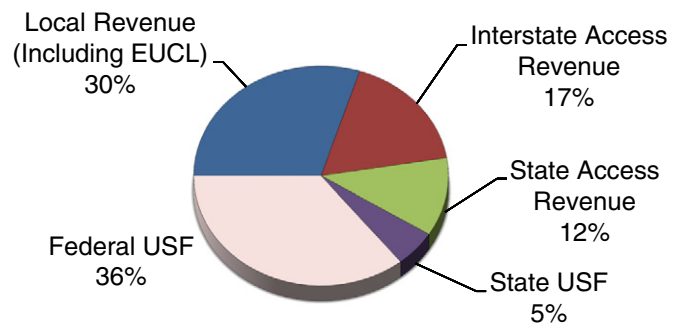


Fig. 1. Regulated revenue sources of RLECs.

* Corresponding author.

E-mail address: vglass@neca.org (V. Glass).

Table 1
Percent of current high cost support lost by state (\$ in millions).

State	PV of investment gap in RLEC areas awarded to wireline	PV of investment gap in RLEC areas awarded to wireline and wireless	Annual gap payments in RLEC areas awarded to wireline	Annual gap payments in RLEC areas awarded to wireline and wireless	Current high cost support	% Current support lost
AK	\$1043	\$1043	\$133	\$133	\$71	87%
AL	\$0	\$44	\$0	\$6	\$32	–100%
AR	\$0	\$113	\$0	\$14	\$37	–100%
AZ	\$131	\$138	\$17	\$18	\$40	–58%
CA	\$117	\$129	\$15	\$17	\$56	–73%
CO	\$105	\$146	\$13	\$19	\$24	–43%
FL	\$0	\$36	\$0	\$5	\$15	–100%
GA	\$0	\$96	\$0	\$12	\$66	–100%
HI	\$0	\$0	\$0	\$0	\$24	–100%
IA	\$0	\$171	\$0	\$22	\$70	–100%
ID	\$284	\$314	\$36	\$40	\$27	34%
IL	\$0	\$91	\$0	\$12	\$37	–100%
IN	\$0	\$58	\$0	\$7	\$63	–100%
KS	\$6	\$234	\$1	\$30	\$131	–99%
KY	\$0	\$59	\$0	\$8	\$47	–100%
LA	\$0	\$25	\$0	\$3	\$49	–100%
MA	\$0	\$0	\$0	\$0	\$1	–100%
MD	\$0	\$0	\$0	\$0	\$1	–100%
ME	\$1	\$30	\$0	\$4	\$12	–99%
MI	\$0	\$58	\$0	\$7	\$21	–100%
MN	\$3	\$400	\$0	\$51	\$72	–100%
MO	\$0	\$194	\$0	\$25	\$63	–100%
MS	\$0	\$88	\$0	\$11	\$22	–100%
MT	\$787	\$958	\$101	\$122	\$62	63%
NC	\$0	\$28	\$0	\$4	\$32	–100%
ND	\$1	\$502	\$0	\$64	\$59	–100%
NE	\$23	\$203	\$3	\$26	\$43	–93%
NH	\$1	\$1	\$0	\$0	\$8	–99%
NJ	\$0	\$0	\$0	\$0	\$1	–99%
NM	\$706	\$748	\$90	\$95	\$44	103%
NV	\$169	\$169	\$22	\$22	\$11	88%
NY	\$2	\$21	\$0	\$3	\$24	–99%
OH	\$0	\$14	\$0	\$2	\$23	–100%
OK	\$16	\$216	\$2	\$28	\$96	–98%
OR	\$136	\$141	\$17	\$18	\$38	–54%
PA	\$1	\$54	\$0	\$7	\$44	–100%
SC	\$0	\$75	\$0	\$10	\$97	–100%
SD	\$29	\$451	\$4	\$58	\$64	–94%
TN	\$0	\$123	\$0	\$16	\$47	–100%
TX	\$120	\$504	\$15	\$64	\$162	–91%
UT	\$280	\$284	\$36	\$36	\$17	106%
VA	\$1	\$52	\$0	\$7	\$15	–100%
VT	\$6	\$6	\$1	\$1	\$11	–93%
WA	\$32	\$38	\$4	\$5	\$23	–82%
WI	\$1	\$107	\$0	\$14	\$72	–100%
WV	\$0	\$15	\$0	\$2	\$6	–100%
WY	\$205	\$227	\$26	\$29	\$25	6%
Total	\$4206	\$8406	\$537	\$1073	\$2008	–73%

other entities, especially wireless carriers. NECA also showed the resulting shift from positive to negative free cash flow¹ for many RLECs and their loss in ability to borrow funds from Rural Utilities Service (RUS) loans, a prime source of RLEC funding, because of a sharp drop in their Times Interest Earned Ratio (TIER).²

Using revenue, demand and cost data from a new survey sent to RLECs in April 2011, we confirm NECA's original dire projections. We go on to suggest that any reform plan for universal service should treat as a priority preserving the financial viability of carriers of last resort because the outside plant used for telephone service also provides digital subscriber line (DSL) service.³ Many RLECs fall into this category.

¹ Free cash flow = earnings before interest, taxes, depreciation, and amortization (EBITDA) less change in telephone plant in service, less expense on long term interest, less income tax.

² TIER equals earnings before interest, taxes, depreciation and amortization (EBITDA) divided by interest expense on long term debt. RUS requires a TIER of at least 1 by the end of the fifth year of a loan feasibility study.

³ A carrier of last resort is a local exchange company that accepts a set of obligations in return for economic benefits. Among the obligations are duties to extend retail service to any retail customer within its franchise area and provide interconnection and wholesale services to other carriers (NRR, 2009).

Without them, rural customers now well-served won't be served broadband at all. Controls and incentives for broadband deployment make sense that financial viability is reasonably assured.

The RLECs and larger carriers produced their own plans for universal service reform. We recommend that each plan should be evaluated based on the likelihood that it will not cause financial distress to carriers of last resort, and on its ability to fund broadband more efficiently. The FCC has made it clear that it believes companies facing no limits on support have the incentive to increase costs without regard to efficiency (FCC, 2012). This belief has support from the academic community. Recent academic studies suggest that current support programs may incent companies to maximize payouts from support funds instead of maximizing operational efficiencies (see Berg, Jiang, & Lin, 2010, 2011; Zolnierok, 2008). The FCC's OPEX/CAPEX model is one of several new approaches for allocating support more efficiently.⁴ Although funding

⁴ The FCC set limits on overall capital and operating expenditures, but declined to set limits on eleven separate cost categories (USF Benchmarking Order, FCC, 2012) as originally proposed in the USF/ICC Transformation Order and FNPRM (FCC, 2011b). The FCC recognized that a larger number of caps could limit carriers' ability to optimize spending through tradeoffs among different categories.

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