

**PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: September 23, 2003**

REGULAR X **CONSENT** _____ **EFFECTIVE DATE** January 1, 2004

DATE: September 15, 2003

TO: Lee Sparling

FROM: John Wright through Dave Booth through Phil Nyegaard

SUBJECT: OREGON UNIVERSAL SERVICE SURCHARGE: (Docket No. UM 731)
Increases the Oregon Universal Service (OUS) surcharge and contribution rates to support the expansion of the OUS program to include the service areas of rural incumbent local exchange carriers.

STAFF RECOMMENDATION:

Staff recommends that the OUS surcharge rate¹ be increased from 5.50 percent to 6.50 percent and the corresponding OUS contribution rate² be increased from 5.21 percent to 6.10 percent. The new end user surcharge rate (6.50 percent) is effective for telecommunications services billed on or after January 1, 2004. The OUS contribution rate (6.10 percent) is effective for OUS funds collected by the OUS Administrator for the period beginning January 1, 2004, due on May 28, 2004.

DISCUSSION:

A. Background:

ORS 759.425, directed the Commission to establish and implement an OUS fund. The statute provides that the Commission must establish a uniform surcharge on the sale of all³ retail telecommunications services sold in Oregon by a telecommunications provider in an amount sufficient to support the purpose of the OUS fund.

¹ The OUS surcharge rate is the rate that telecommunications providers may apply to end user telephone bills for the recovery of OUS assessments. The recovery period is the quarter beginning January 1, 2004.

² The OUS contribution rate is the assessment rate on Oregon telecommunications carriers by the OUS Administrator. The contribution rate is applied to intrastate Oregon retail telecommunications revenues, including revenues from the end user surcharge. Contributions are due by the 28th day of the second month following the recovery quarter. In this case, first quarter 2004 contributions are due on May 28, 2004.

³ In response to a federal court order the Commission changed the OUS revenue base from "all" to "intrastate" retail telecommunication services sold in the state. See Order 01-1063.

In Order No. 99-197 (PUC Docket UM 731, Phase III), the Commission adopted procedures for the collection and disbursement of OUS funds. OUS funds are collected quarterly and distributed monthly. The Commission also adopted a semiannual interval for setting the surcharge rate with an opportunity for mid-term correction, if required. Notification of the surcharge rate must be 45 days prior to its effective date. The notification must be sent to all certificated telecommunications providers offering retail telecommunications services in Oregon.

The Oregon Universal Service Fund commenced operation on September 1, 2000. Since that time, the Commission has changed the surcharge and contribution rates three times:

	<u>Surcharge Rate</u>	<u>Contribution Rate</u>	<u>Effective Date</u>
Initial Rate	2.35%	2.30%	September 1, 2000
1. Order 00-760	3.24%	3.14%	January 1, 2001
2. Order 01-752	3.00%	2.91%	October 1, 2001
3. Order 01-1063	5.50%	5.21%	February 1, 2002

In this report, staff is recommending a fourth change: to increase the surcharge rate to 6.50 percent and the contribution rate to 6.10 percent effective January 1, 2004. For comparison purposes, the federal universal service surcharge rate is currently set at 9.50 percent. For the fourth quarter 2003, the federal universal service surcharge rate will be 9.2 percent.

B. The Current OUS Fund (2001-2003 Biennium):

Currently the OUS fund supports the high cost service areas of Qwest and Verizon. Over the 2001-2003 biennium, it expended \$92.7 million: \$92.4 million in distributions and \$0.3 million in administrative costs. Income to the fund totaled \$102.0 million: \$101.1 million in contributions and \$0.9 million in interest and late fees. The higher than expected income was the result of the last surcharge rate change (Order 01-1063). In changing from the total Oregon revenue base to an intrastate revenue base, staff estimated the jurisdictional split at 55 percent intrastate. The split turned out to be about 60 percent intrastate. This created a reserve of \$9.3 million (\$102.0 million income minus \$92.7 million expense) as of June 30, 2003. The reserve will allow the fund to meet the additional distribution requirements for the rural LECs in the near term (i.e. beginning November 2003). This is because the additional income to the fund from the proposed surcharge increase (effective January 1, 2004) will not be collected until May 28, 2004.⁴

⁴ From the time that the Commission approves a new OUS surcharge, there is a lag of about seven months before moneys are remitted to the fund. Notices of the increase must be mailed to all carriers a month and a half ahead of the effective date of the surcharge so that carriers can modify their billing

A second important factor in the current OUS fund performance is that, while there is a reserve to meet the expanded distribution requirements for rural LECs, the contributions to the fund are declining significantly. In the last four quarters, the average annualized income to the fund has dropped by 10.8 percent. The good news is that the loss in the most recent quarter for which information is available (2nd quarter 2003) was slightly lower at 8.7 percent. The decline in income is a significant factor in developing the 2003-2005 biennium budget.

C. Expenditure Requirements for the OUS Fund (2003-2005 Biennium):

Rural LECs: In Order 03-085 in UM 1017, the Commission ordered that the OUS fund expand to include the service areas of the rural LECs. The Commission noted that the OUS fund was currently distributing about \$47.0 million annually. Staff at that time estimated that the expansion would cost the fund an additional \$11.3 million annually based on cost data for the year 2000. This estimate would have increased the OUS surcharge by about 1.2 percentage points. The parties to the proceeding, however, agreed to update the costs and OUS distribution amounts to a new test year before expanding the fund.

In staff's companion report, OREGON UNIVERSAL SERVICE EXPANSION (UM 1017), staff completed new cost studies for the rural LECs based on 2001 cost information and updated the federal loop compensation and federal universal service support to reflect current 2003 information. Based on this updated analysis, staff computed per line support amounts as shown in Exhibit A to that report, and estimated the additional cost to the OUS fund at **\$9.38 million** annually. Because the rural LECs have an opportunity to update cost studies next July, staff included a 10 percent increase for rural LECs in the second year. The total biennium amount budgeted for the rural LEC expansion is \$16.6 million.

Non-rural LECs: For non-rural LEC distributions, staff included \$90.5 million for the biennium. This is down slightly from \$92.4 million distributed in the last biennium. The reduction is due to line losses in some of Qwest's and Verizon's rural exchanges. The annual growth rate is a negative 0.5 percent.

Eligible Competitive LECs: Anticipating that some competitive LECs will petition for and become eligible over the next biennium, staff budgeted \$967,000. The growth rate is a positive 10 percent.

Payphone provider Refunds: In Order 03-221 (Docket AR 454), the Commission established a rule for payphone provider refunds of OUS surcharges. Staff included an estimated \$370,000 for the biennium for refunds and associated expenses. The refund to the payphone providers was mandated by the 2001 legislature.

OUS Administration, Audit, and Banking Expenses: Staff included \$216,000 for fund administration, audit and banking costs.

OUS Fund Total Expenditure Budget: Including each of the elements above, the OUS funding requirement for the 2003-2005 biennium is \$108.7 million

D. Income Forecast and Surcharge (2003-2005 Biennium):

As noted in the 2001-2003 biennium discussion above, the intrastate revenue base is declining. The last four quarters saw an average 10.8 percent decline, with the last quarter showing an 8.7 percent annualized decline. The OUS Advisory Board met on June 25, 2003, to discuss various budget scenarios. The Board considered revenue decline options ranging from minus 10.8 percent to minus 2.5 percent. The minus 2.5 percent alternative was judged too optimistic. The minus 10.8 percent appeared overly pessimistic because the decline appeared to be tapering off.

After considering a number of options, the Board recommended increasing the OUS surcharge by one percentage point to 6.5 percent. This rate would provide flexibility and greater stability for the OUS fund through the biennium. If the fund continues its decline in the range of 8.7 to 10.8 percent through the remainder of this year, there would still be an opportunity to adjust the surcharge effective in July or October of next year. If the revenue decline levels off to a range of minus 5.0 to 6.0 percent, the 6.5 percent surcharge will carry the fund through the 2003-2005 biennium.

PROPOSED COMMISSION MOTION:

An order be prepared in Docket UM 731, authorizing the surcharge increase from 5.50 percent to 6.50 percent for intrastate retail telecommunications services billed on or after January 1, 2004; and authorizing the associated contribution rate increase from 5.21 percent to 6.10 percent for moneys remitted to the OUS Fund (as billed in the first quarter 2004) due on May 28, 2004.