Despite Deregulation, Rural Phone Subsidies Are Likely to Survive
By Daniel Pearl

PARTOUP, Utah - Here in Utah's western desert, the mail comes twice a week, it's a dusty two-hour drive to the nearest store and a 100-yard stretch beside the Mormon church is the only paved road. Except on clear nights, even radio reception is scant.

But with telephones, "we've got everything they've got in town," says Duane Hicks, standing beside his Hatchet Ranch with its two phone lines.

That's because Beehive Telephone Co. serves this lightly populated area with high-capacity underground lines and modern digital switching. This enables 40-student West Desert High School to install a two-way educational-TV system. It lets accountant Dean Hayward hook up his computer to Salt Lake City. And rancher Linda Bronson pays only $15.85 a month for basic phone service that includes automatic redialing of a busy number.

Providing all that service costs five times what Beehive's customers pay. But the tiny company, based in nearby Wendover, still makes ample profits - thanks to an elaborate array of subsidies that inflate rates for long-distance and urban users.

It's a system that seems increasingly out of date as the industry pushes toward greater competition. But Congress is intent on preserving the "universal service" subsidies despite Republican pledges to cut subsidies and government regulations. As Congress completes a sweeping bill promising to open up competition in communications, it is adopting language limiting competition to protect rural service.

The current system's defenders include state legislatures worried that universal service will erode if phone companies lose revenue. So, despite talk of encouraging competition, many states make it hard to choose a different carrier for local toll calls. Texas gave rural phone companies three years of added protection against competition; Wyoming gave 10 years.

Critics say the system encourages small phone companies to spend money recklessly while discouraging more sensible wireless solutions. It spurs big carriers such as U S West Inc. to sell rural exchanges to small companies at a premium because the buyers can collect bigger subsidies. And it keeps rural rates low, however wealthy the customers may be.

Big phone companies generally balance costs internally, charging similar rates in high-cost and low-cost areas. Thus Pacific Telesis Group charges central Los Angeles users more than their true cost to avoid charging higher rates in remote areas, whether farms or ritzy beach communities. U S West charges the same in Denver as in ski resorts where wiring homes is costly. Business rates are also inflated to keep residential rates down. In all, the "hidden" subsidies run billions of dollars.
Subsidies for small phone companies such as Beehive are more explicit. They get direct payments from a $1 billion federal fund collected annually from long-distance carriers. Among other things, Beehive wants to tap this fund to bring telephones to a few dozen summer homes at a mountain-lake resort near Zion National Park. The projected cost: $430,000. Though some Utah officials doubt the part-time residents would order phones even at subsidized rates, Beehive's founder, Arthur W. Brothers, insists they would - if only for security systems to protect their expensive homes from snowmobile-riding thieves.

``This is a highly inefficient, unfair subsidy, and any serious student of the issue concluded that a long time ago,'' says Peter Pitsch, a communications lawyer affiliated with the Hudson Institute in Washington. Many policy makers privately agree. But ``it's like fighting apple pie,'' says Scott Cleland, a telecommunications analyst at the Washington Research Group unit of Lynch, Jones & Ryan, a Baltimore securities firm. ``Nobody wants to do anything that will increase rural phone rates."

When Sen. John McCain, an Arizona Republican, tried to replace subsidies with vouchers that poor people could use to get service from any carrier, he could line up only 18 votes. Instead, the Senate bill would probably spread the subsidies to new technologies such as data transmission.

Rural considerations are shaping other parts of the telecommunications bills. For example, both the House and Senate versions would increase long-distance competition by letting regional Bell companies enter the market, but both would forbid them to charge lower rates for calls to or from big cities. Universal-service concerns are also making it harder for long-distance companies to win the right to buy local phone service at low rates and resell it.

Both bills require phone companies to let new competitors, such as cable-TV operators, connect with their networks - but a House provision excludes most companies in small towns. Without such interconnections, Robert M. Rogers, chief executive of TCA Cable TV Inc., says it can't offer phone service in Texas towns such as Paris and Tyler ``unless they want to make it a long-distance call across the street to your neighbor.''

Under the Senate bill, a challenger such as Tyler-based TCA could tap rural phone subsidies - but only after proving to Texas authorities that such payments are in the public interest and would speed deployment of new technology. ``Multiple carriers unlikely in rural areas because of entry burdens,''' concluded a U.S. Telephone Association analysis of the Senate bill. Without subsidies, Rogers says, companies such as TCA could offer service only to a small town's big customers.

Rural operators say that's exactly why they need protection. David Kneece, whose family runs Pond Branch Telephone Co. in Gilbert, S.C., says competitors would ignore his elderly customers, who typically have poor credit and are scattered across 600 square miles of farmland. ``They'd come in and cream-skim,'' picking off lucrative customers such as a truck
stop and a factory and thus making it hard for Pond Branch to keep basic rates down to the current $12 a month.

The Organization for the Protection and Advancement of Small Telephone Companies, one of several groups that lobby in Washington for such companies, contends that, without the "support mechanisms," the average rural phone bill would increase by $31.27 a month, or 72 percent. Rural areas consider good, affordable phone service essential to economic development. The companies say deregulation has made rural bus and plane travel difficult, and a loss of subsidies would inflate phone bills that are already high because many rural calls are toll calls.

The companies resist the notion of limiting subsidies to poor people, who already can get other aid. They tried in vain to quash a Federal Communications Commission request for zip-code data to show who benefits from the subsidies. What if wealthy ranchers or movie stars get help? "That's not the point. The point is, it's a high-cost area," says Lisa Zaina, Opastco's general counsel.

Rural companies seem about to get their favorite terms in both bills. The powerful regional Bells back the rural companies, and long-distance carriers have kept quiet on the issue—partly because their two main Senate allies, Democrat Daniel Inouye of Hawaii and Republican Ted Stevens of Alaska, also strongly support rural subsidies. Indeed, most lawmakers now writing a compromise bill are from largely rural areas, and Senate Majority Leader Bob Dole of Kansas backs the rural companies.

Even skeptics seem resigned. "Universal service is a political necessity, and we're going to have to work around it," says Rep. Michael Oxley, an Ohio Republican.

Rutgers University Professor Milton Mueller says the subsidies emerged in the 1960s for political reasons, after competition and rural-electrification loans had already brought phone service to most Americans. Using complex formulas, regulators shifted more and more of the cost of local phone service to long-distance customers. They assumed that customers cared most about basic local rates and that the poor didn't make many toll calls.

However, studies now show people often lose phone service because they can't pay long-distance bills. Meanwhile, affluent people are moving into rural areas; Pond Branch's customers include professionals with lake-side homes who commute 25 miles to Columbia, S.C.

The funding system has grown more complex. Following the 1984 breakup of AT&T, the industry and the FCC set up the National Exchange Carriers Association. NECA collects fees from long-distance carriers and sends monthly checks to local ones. To get payments, a local company usually files studies showing that its spending per line runs at least 15 percent above the national average. Moreover, those with fewer than 50,000 customers get extra money, regardless of operating costs. And some states have their own funds.
Not surprisingly, small operators spend aggressively. They have installed digital switches and fiber-optic lines faster than the Bell companies have. With extra cash, some rural companies have become wireless pioneers or bought cable-TV systems. And with extra capacity, some offer commercial services. Beehive Telephone uses its computerized switching center to run chat-line services connecting groups of eight people who want to talk dirty.

NECA, the industry group, says it reviews small telephone companies to make sure they follow FCC rules. But the FCC was sufficiently concerned recently about allegedly lax supervision to demand that NECA put more outsiders on its board.

A few big companies with rural customers also pocket subsidies. GTE Corp. says it got $191 million last year. But lately GTE and U S West have found it more profitable to sell rural exchanges to operators that can draw full subsidies. U S West has sold or plans to sell $1.1 billion of such exchanges. Both companies say the subsidies are just one factor behind the sales. Yet Idaho's regulators blocked 10 U S West transactions in October, calling the prices "excessive and unreasonable" and too reliant on federal subsidies.

Such sales also concern the FCC. In 1993, it capped the rapidly growing subsidy fund, and now it seeks to reform the system. One solution would make payouts depend on fixed formulas rather than a carrier's size or cost estimates. Some phone companies have proposed a complicated formula that computes the probable costs of serving an area, by considering such factors as the terrain and rainfall.

In Utah, Brothers of Beehive Telephone would like to bill the long-distance companies directly. Last year, he quit some subsidy programs and instead charged long-distance carriers 47 cents a minute for each of their calls his system completed. That was 10 times more than normal, but he says his high costs justified it, and the FCC let the rates stand. Thanks to Beehive's chat lines, traffic into its system rose 25-fold, and the company billed AT&T and MCI Communications Corp. over $1 million apiece.

They refuse to pay, and AT&T challenged his rates even though he recently reduced them to a still-high 14 cents a minute. AT&T officials say Brothers is exploiting the system. He says he is just doing what the universal system intended: bringing quality service to places that otherwise wouldn't have it. "I didn't write the rules," he says with a grin, "but I read the book."

AP-DATAPORT-NY-11-30-95 1102EST