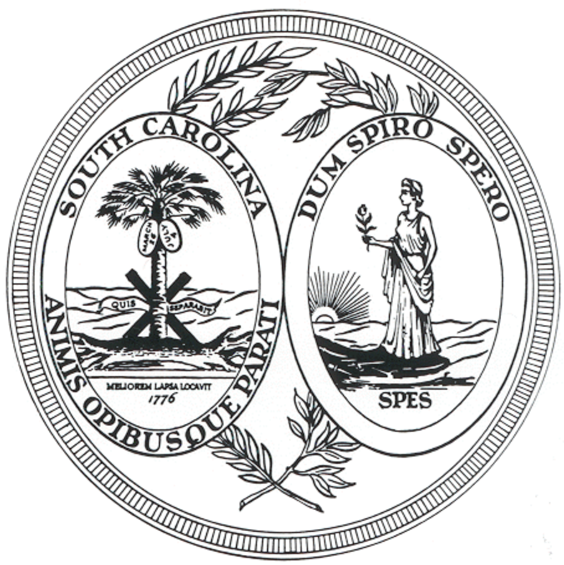
Report to the General Assembly

February 2005

A Review of the South Carolina Universal Service Fund



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A Review of the South Carolina Universal Service Fund
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South Carolina Legislative Audit Council

LAC

Report to the General Assembly

A Review of the South Carolina Universal Service Fund

Contents

Synopsis

Members of the General Assembly requested the Legislative Audit Council (LAC) to conduct an audit of the South Carolina universal service fund (USF) administered by the Public Service Commission (PSC). The requesters asked the LAC to review the need for the fund. Because the state's interim LEC fund is closely connected to the universal service fund, we also assessed the need for this fund. We also reviewed the PSC's administration of the USF.

Need for the USF

The goal of universal service is to ensure the widespread availability of affordable local exchange telephone service. The S.C. universal service fund establishes a complex system by which consumers pay a surcharge on their telephone bills to support local telephone companies. The fund amounts to $51 million for fund year 2004-2005. We concluded that the fund does not need to be continued in its present form and should be scaled down. This conclusion is based on several factors.

- ❑ Telephone companies receive support from the federal universal service fund. South Carolina companies received $126 million in 2003. Support from the federal fund would continue in the absence of the state fund.

- ❑ The goals of universal service have largely been met. Ninety-three percent of S.C. households have telephone service, which is substantially at the national average.

- ❑ None of the eight other states in BellSouth's service area has a USF comparable to South Carolina's, and their basic telephone rates are equivalent to South Carolina's rates.

- ❑ The telecommunications market is rapidly changing. The number of wireless subscribers has increased dramatically. It is not an appropriate long-term policy to strongly regulate and subsidize one part of the market ("landline" providers of basic service) when an increasing part of the market (cellular and Internet-based providers) is unregulated and unsubsidized by the state.

- ❑ The state USF focuses on replacing companies' revenue rather than providing support to areas with high costs for local phone service. The companies do not have to provide evidence of revenue losses or use the funds provided to support basic local service.

The state USF should be scaled back to continue supplements for low-income subscribers and support for those lines for which companies can provide evidence that costs are excessive.

Interim LEC Fund

The interim LEC fund was established in 1996 to replace revenues lost when participating local exchange companies (LECs) reduced the access charges paid by long distance companies. The statutory purpose of this fund has been accomplished, and it should be phased out or transitioned into the universal service fund for those companies that demonstrate a need. Other issues related to the interim LEC fund include:

- ❑ The companies receive payments based on the number of minutes that long distance companies used their networks in 1996, with increases for growth. However, when companies have fewer customers and fewer minutes of use, their payments from the fund are not decreased.

- ❑ Although the law requires the interim LEC fund to transition into the USF, further statutory change is necessary to accomplish this transition.

Administration of the Universal Service Fund

The Public Service Commission administered the state USF and interim LEC funds through 2004. Beginning in 2005, the newly-created Office of Regulatory Staff has assumed this responsibility. We found that the PSC did not implement adequate controls over the management of the state USF. Our findings about fund administration are listed below.

- ❑ The PSC has not ensured that companies receiving distributions from the USF comply with requirements for receiving the funds or have an ongoing need for them. The PSC does not review USF distributions to determine if promised rate reductions occurred or whether companies' projected revenue losses were actually realized.

- ❑ No financial audits of the universal service fund by an independent third party have been done. Both the guidelines and administrative procedures adopted by the PSC for the USF require annual financial audits of the fund, which has been operating since 2001.

- ❑ The Public Service Commission did not have adequate policies and procedures to administer the state USF. Policies are needed to ensure appropriate controls. For example, policies would help fund managers ensure that contributors are identified and contribute as required, and that standard billing and collection procedures are implemented.

- ❑ The PSC did not establish an adequate system to audit information provided by USF participants. The PSC did not conduct any audits of funds distributed to recipients and audited just 15 (8%) of the approximately 190 companies that contribute to the fund.

- ❑ The PSC used inadequate computer systems to administer the state USF and did not have appropriate data entry controls. The software program the commission used since 2003 does not calculate late payment charges, and the PSC has not charged late payment fees since October 2003.

- ❑ Until 2003 the state USF was administered by the PSC's audit department even though the audit department had responsibilities to audit as well as manage the fund. It is not appropriate for auditors to be responsible for reviewing activities they have managed.

- ❑ It could be beneficial for the Office of Regulatory Staff to hire an independent and experienced outside administrator to manage the USF. Most other states that have universal service funds use an independent fund administrator rather than administering the fund within a state agency.

Introduction and Background

Audit Objectives

Members of the General Assembly requested the Legislative Audit Council (LAC) to conduct an audit of the South Carolina universal service fund (USF) administered by the Public Service Commission (PSC). The requesters asked the LAC to review the need for the fund. Because the state's interim LEC fund is closely connected to the universal service fund, we also assessed the need for this fund. The requesters were also interested in the operations of the USF, including fund contributions and disbursements. Our specific audit objectives are listed below.

- Determine whether there is a need for the South Carolina universal service fund.
- Review the South Carolina interim LEC fund to determine whether there is an ongoing need for the fund.
- Determine whether the Public Service Commission had adequate controls over contributions and distributions from the universal service fund.

Our findings and recommendations are discussed in the report. See Appendix A for a glossary of terms.

Scope and Methodology

We reviewed the need for the state universal service fund and interim LEC fund. We also reviewed the Public Service Commission's administration of the universal service fund. The administration of the USF and the interim LEC fund was transferred from the PSC to the newly-created Office of Regulatory Staff in January 2005, following the completion of our fieldwork. We did not review other programs administered by the PSC, including the administration of the interim LEC fund. The period of review was the period of existence of the USF and interim LEC fund, beginning in FY 96-97, when the General Assembly created these funds, through 2004.

We obtained information about fund administration from the PSC, including the following:

- Billing and accounting records.
- Commission orders.
- Reports and other evidence submitted to the commission.
- Administrative procedures and guidelines.
- Audit records.

We also obtained and reviewed information from a variety of other sources, including the following:

- Federal Communications Commission and its administrative agency, the Universal Service Administrative Company (USAC).
- National Association of Regulatory Utility Commissioners (NARUC).
- National Regulatory Research Institute (NRRI).
- Public utility commissions in other states.
- South Carolina telecommunications companies.

We examined the need for the fund by considering federal and South Carolina laws and regulations pertaining to telecommunications regulation, other states' experience, and information about telecommunications in the United States. We assessed the PSC's fund administration using principles of sound business practice and internal controls.

One of our objectives called for an assessment of internal management controls over the USF. Findings related to this objective are discussed in Chapter 3 (see p. 27). Problems with the information system used to keep records of the USF and the lack of an audit of the USF indicated that the PSC's data about the fund could be unreliable (see p. 33). This information was not central to our objectives about the need for the funds, and we have reported its relationship to controls over fund administration. This audit was conducted in accordance with generally accepted government auditing standards.

Universal Service — Background

The goal of universal service is to ensure the widespread availability of affordable local exchange telephone service (see Chart 1.1). The Communications Act of 1934 created the Federal Communications Commission (FCC) with the intent of making telecommunications service available to all U.S. citizens at a reasonable price. Advancing universal service by subsidizing the cost of basic local telephone service for some customers has been a long-standing policy of both the federal government and South Carolina state government.

Following the invention of the telephone, beginning in 1876, the Bell companies held a patent on telephone service for 17 years. After the patent expired, independent telephone companies began to be established. These companies provided local telephone service in small and rural areas that AT&T and its Bell companies did not want to serve due to the high cost of service delivery. The various companies providing service had to be connected to allow customers to make calls over a wide area. Gradually the industry established ways to compensate all companies for the portions of a call that used their networks.

Chart 1.1: Universal Service

WHAT IS UNIVERSAL SERVICE?

Providing basic local exchange telephone service, at affordable rates, upon reasonable request, to all residential and single-line business customers within a defined service area.

WHAT IS BASIC LOCAL EXCHANGE SERVICE?

For residential and single-line business customers:

- Access to basic voice grade local service with touchtone.
- Access to available emergency services and directory assistance.
- Capability to access interconnecting carriers.
- Capability to access service that allows the hearing or speech-impaired to communicate by sending messages over telephone lines.
- Access to operator services.
- One annual local directory listing.

Source: S.C. Code of Laws §58-9-10(9) and (16).

Subsidies for Costs of Basic Telephone Service

The cost of providing basic local service at affordable prices to high-cost customers has been paid by all telephone customers through a system of subsidies. The system of charging for telephone services using "implicit subsidies" (see Chart 1.2) for basic local service developed over time as a result of decisions by the FCC and state regulatory agencies.

Local exchange carriers (LECs) were granted exclusive franchises to serve particular areas. In return, these LECs (incumbent LECs or ILECs) assumed an obligation to serve all customers within that area, no matter how remote the customer was or how sparsely populated the area. Some of these areas were expensive to serve. In order to keep rates for basic local service low, long distance rates were set above costs and revenues were divided among the companies to provide support for affordable local service. Also, to keep residential rates low, businesses were charged higher rates for the same services.

In the 1980s the market for long distance telephone service became competitive; a federal court ordered the break-up of AT&T's monopoly, and other companies, such as MCI, began to offer long distance services. The FCC developed and implemented the concept of access charges (see Chart 1.2). Access charges provided a way by which all long distance carriers could pay local exchange carriers for the costs of handling long distance calls as well as to continue to provide support for universal service. The costs of providing basic local service were subsidized by access charges and also by the rates telephone companies charged for other services, such as business lines and newer services, such as caller ID and call waiting.

Chart 1.2: Telecommunications Definitions

WHAT ARE IMPLICIT SUBSIDIES?

Implicit subsidies occur when companies use the profits they earn from one service (such as business lines) to offset the loss they incur in providing another service (such as basic local residential service).Implicit subsidies are not shown on customers' bills.

WHAT ARE ACCESS CHARGES?

Access charges are the per-minute charges a long distance telephone company pays to both the caller's local telephone company and the local telephone company of the party being called.

Telecommunications Act of 1996

Changes in the telecommunications industry, including the beginning of competition in the local telephone service market, meant that the system of regulating telecommunications services would require change. Local exchange carriers had been regulated as to what they could charge for basic local service and the rate of return they could earn. They made up deficits from basic service revenues by offering other services at prices much higher than cost (implicit subsidies). In a competitive environment, a new carrier could enter the market by offering certain services at a price much lower than that of the existing companies without any obligation to provide service to high-cost customers. In the Telecommunications Act of 1996, Congress sought to encourage competition in the telecommunications industry while still ensuring that universal service would be preserved and advanced.

The Telecommunications Act of 1996 provided generally that implicit subsidies embedded in telephone rates would be identified and removed. Rates would be based on the cost of providing the service. A fund would be established that would replace the function of the former subsidies (making implicit subsidies explicit) to keep basic local exchange service affordable. The federal universal service fund provides support to local exchange carriers and supports other entities, such as schools and libraries, to ensure that local telecommunications service is available and affordable to all citizens. Since 1998 the federal fund has been supported by contributions from all carriers, including wireless carriers, on the basis of their interstate and international retail revenues. The telephone companies pass these charges on to consumers and they appear on telephone bills (see p. 11). As of

January 2005, customers pay a rate of 10.7% of their interstate calling charges to the federal universal service fund. Customers who make calls between states pay extra to subsidize basic local service. Customers who do not make out-of-state calls do not contribute to the federal fund.

South Carolina Background

There are 25 incumbent local exchange carriers (LECs) in South Carolina. These companies have defined service areas in which they must provide basic local exchange service (see Chart 1.3). Some of these companies have been in business for many years. Many are family companies or rural area cooperatives. BellSouth is the largest of the incumbent LECs, serving more than half of the state's customers.

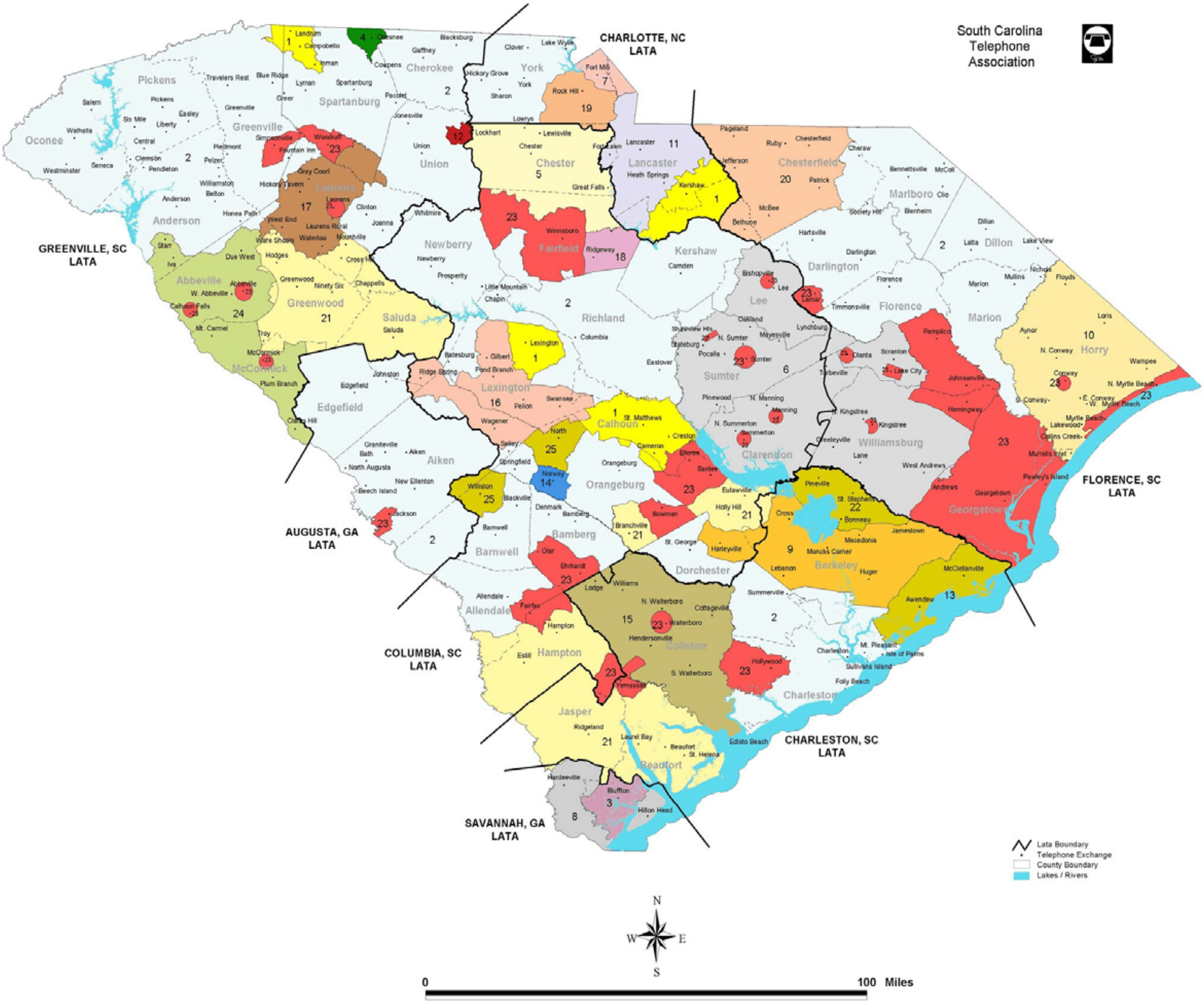
Regulation of Telephone Companies

The Public Service Commission (PSC) regulates the local exchange carriers. Traditionally they were under rate-of-return regulation, where the PSC determines the percentage of net profit that a company is allowed to earn. The approved rates of return for the S.C. incumbent LECs range from 9.4% to 13%. The rates that the companies can charge for basic local service are set by the PSC. If a company wants to increase its rates, the PSC reviews its financial records and earnings. According to PSC staff, none of the S.C. companies has requested approval for a rate change through this process since 1991.

Since 1994, some South Carolina incumbent LECs had the option to come under less stringent regulation, or alternative regulation. As of November 2004, five companies (BellSouth, Sprint, Verizon, Alltel, and Horry) have elected to use alternative regulation (S.C. Code §58-9-576) in which companies can adjust their rates within a certain range by giving notice, and the rates are valid unless challenged. The PSC does not do a comprehensive review of the company's financial position in this process.

The S.C. General Assembly passed an additional measure in 2004 which deregulates the prices that telephone companies charge for "bundled" services. Bundled services are different services, such as local telephone service, Internet access, cellular service, and satellite television services, which are offered to consumers at a single price. The trends in South Carolina's regulation of rates for basic telephone services are similar to those in other states. There is a general move from traditional rate regulation toward more flexible regulation and deregulation.

Chart 1.3: Telephone Map of South Carolina



Illustrated is a general representation of telephone company territories and LATAs in S.C.
It is not intended to define the official territorial boundaries of any of the companies listed.

Area	Company	Headquarters
1	Alltel South Carolina	Matthews, NC
2	BellSouth	Columbia
3	Bluffton Telephone Company	Bluffton
4	Chesnee Telephone Company	Chesnee
5	Chester Telephone Company	Chester
6	Farmers Telephone Co-Op	Kingstree
7	Fort Mill Telephone Company	Fort Mill
8	Hargray Telephone Company	Hilton Head Island
9	Home Telephone Company	Moncks Corner
10	Horry Telephone Cooperative	Conway
11	Lancaster Telephone Company	Lancaster
12	Lockhart Telephone Company	Lockhart
13	McClellanville Telephone Company	McClellanville
14	Norway Telephone Company	Norway
15	Palmetto Rural Telephone Cooperative	Walterboro
16	PBT Telecom, Inc.	Gilbert
17	Piedmont Rural Telephone Cooperative	Laurens
18	Ridgeway Telephone Company	Ridgeway
19	Rock Hill Telephone Company	Rock Hill
20	Sandhill Telephone Cooperative	Jefferson
21	Sprint	Columbia
22	St. Stephen Telephone Company	St. Stephen
23	Verizon	Myrtle Beach
24	West Carolina Rural Telephone Cooperative	Abbeville
25	Williston Telephone Company	Williston

Source: South Carolina Telephone Association.

South Carolina Universal Service Fund (USF)

South Carolina has established a state universal service fund by which customers pay to subsidize the cost of basic local service for all. The federal Telecommunications Act of 1996, which established the features of the federal universal service fund, also provided that states could adopt regulations to preserve and advance universal service. This could include the creation of state universal service funds, as long as the state programs were "not inconsistent" with the FCC's rules.

In 1996, the South Carolina General Assembly enacted Act 354 which required the Public Service Commission to establish a universal service fund for distribution to those local exchange carriers that have an obligation to provide service to all customers within a defined area. The PSC was to determine the size of the fund. Act 354 also established a separate fund, an interim LEC fund (see p. 9), and provided a process to allow competitive carriers to furnish local telephone service in the territory of an incumbent LEC.

Universal Service Fund Implementation

The Public Service Commission held three rounds of hearings to establish and begin implementation of the state USF. Some decisions made as a result of these proceedings, in commission orders issued from 1997 to 2001, are summarized in Chart 1.4.

After the companies submitted evidence of their costs to provide basic local service, the PSC determined that the annual amount of the fund when fully implemented would be $340 million. All telecommunications providers, with the exception of wireless providers, were required to contribute to the fund; approximately 190 companies contribute annually.

The amount collected and disbursed from the S.C. USF in the first complete year was $41 million. Each company's annual distribution remains unchanged unless the carrier requests additional support from the USF. As of November 2004, eight carriers had requested that their disbursements from the fund be increased. As of October 2004, the annual contributions and disbursements from the fund have increased to more than $51 million. Beginning in November 2004, South Carolina telephone customers pay a 2.9% monthly assessment on interstate and intrastate calls for the state USF. This is in addition to the 10.7% charge on interstate calls for the federal USF.

Chart 1.4: Public Service Commission Decisions to Implement the State USF

PSC DECISIONS CONCERNING THE STATE USF

- The Public Service Commission would administer the fund.
- Contributions to the fund would be based on combined intrastate and interstate revenue. (The federal USF contributions are based on interstate and international revenue.)
- Wireless carriers would not be required to contribute to the state USF.
- Companies were authorized to recover their contributions to the fund through a surcharge on consumer bills.
- The fund would be implemented in a revenue neutral manner—incumbent LECs should reduce rates that were priced above cost to offset the amount received from the fund.
- The Lifeline and Link-up programs that offer low-income subscribers reductions in their telephone rates would be funded through the USF.
- The methodologies that various telephone providers would use to determine their costs to provide basic local telephone service were specified.
- Implementation of the USF would be phased in (phases defined in Administrative Procedures).
- As a first step, incumbent LECs were to reduce their access charges by 50% and recover that amount from the USF beginning October 2001.
- Long distance carriers that benefited from the reduced access charges were to reduce rates to their customers.
- Carriers would be required to provide additional information about their costs when they exceeded 1/3 and 2/3 of the amount originally determined to be their share of the fund.

South Carolina Interim LEC Fund

Act 354 of 1996, the same Act which provided for the establishment of the state universal service fund, also established a second fund, the interim LEC fund. The purpose of this fund is to replace specific revenues for the participating telephone companies. Act 354 provided that the incumbent local exchange carriers (LECs) would immediately set their access rates for providing long distance service at the level of the access rates of the largest LEC in the state, BellSouth. This meant that they would lower their access rates to the level of BellSouth's rates. (BellSouth does not receive distributions from the interim LEC fund.) The LECs' loss of revenue resulting from this action would be made up from two sources:

- The increased revenue they would receive from raising their rates for basic local service to the state average over a period of five years.
- Payments from the newly established interim LEC fund.

The law provided that contributors to this fund would be the carriers (mostly long distance carriers) who benefited from the lower access charges. This differs from the USF contributors, which include all carriers that provide service in South Carolina. Unlike the federal and state universal service funds, contributions to the interim LEC fund are not reflected directly in consumers' telephone bills.

The interim LEC fund was implemented prior to the USF. The PSC began collections for and distributions from this fund in 1997. Each year the PSC has adjusted the fund based on increases in the number of access lines per carrier and the number of minutes used by the contributors to the fund. The five-year period established in statute for the LECs to raise their rates to the state's average has passed, but the fund is continuing. The law (S.C. Code §58-9-280(M)) requires that the obligations of the interim LEC fund will transition into the universal service fund when ". . .funding for the USF is finalized and adequate to support the obligations of the Interim LEC Fund." However, legislative action would be needed to accomplish this transition (see p. 25).

Administration of the Universal Service and Interim LEC Funds

Both the USF and the interim LEC funds are set up so that the amount collected is then disbursed monthly to the carriers who qualify for distributions. Neither fund maintains a significant balance. The administration of the state's universal service and interim LEC funds has changed. Both funds were implemented by the Public Service Commission, and were administered by the PSC through 2004. Act 175 of 2004 changed the responsibilities of the Public Service Commission and created a new agency, the Office of Regulatory Staff (ORS), which assumed some responsibilities formerly held by the PSC. The PSC continues to be responsible for setting policy and guidelines for the USF and the interim LEC fund. However, beginning in January 2005, the ORS is responsible for administering these funds.

Need for the State Universal Service Fund and Interim LEC Fund

No Long-Term Need for Current South Carolina USF

The South Carolina universal service fund (USF) establishes a complex system by which consumers pay to support local telephone companies. Consumers in South Carolina pay a surcharge to support the state USF. As of October 2004, this surcharge is 2.9% of the customer's interstate and intrastate calls. For 2004-2005, the fund amounts to more than $51 million and the USF is not yet fully implemented. Consumers will pay a projected $340 million annually when the USF is fully funded.

We found that the state USF does not need to be continued in its present form and should be scaled down. This conclusion is based on several factors.

- Telephone companies receive support from the federal universal service fund with South Carolina companies receiving $126 million in 2003.
- The goals of universal service have largely been met.
- None of the eight other states in BellSouth's service area has a USF comparable to South Carolina's, and their basic telephone rates are equivalent to South Carolina's rates.
- The telecommunications market is rapidly changing. It is not an appropriate long-term policy to intensely regulate and subsidize one segment of the market (landline providers of basic service) when an increasing part of the market (cellular and Internet-based providers) is unregulated and unsubsidized by the state.
- The state USF focuses on replacing companies' revenue rather than providing support to areas with high costs for local phone service. The companies do not have to provide evidence of revenue losses or use the funds provided to support basic local service.

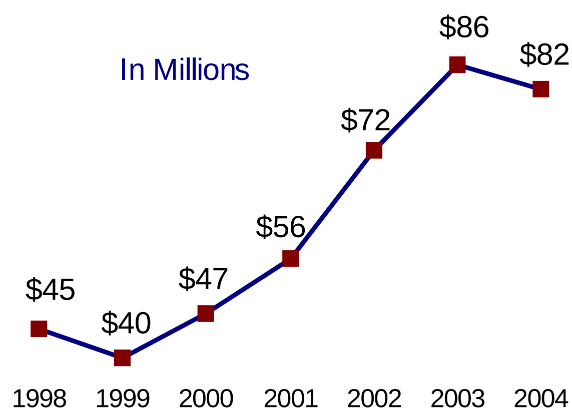
We concluded that some functions of the fund may need to continue, specifically the low-income support which contributes directly to the goals of universal service. Also, limited support for small telephone companies serving rural areas should be continued for companies that demonstrate this need.

Federal Universal Service Support

South Carolina local telephone companies receive universal service support from the federal government which will continue without state support. The Federal Communications Commission (FCC) created a federal universal service fund (USF) to fulfill the policy of universal service established by the federal government (see p. 2). This fund has four main programs — high cost, low income, schools and libraries, and rural health care. South Carolina has received more than it contributes to this fund. South Carolina telephone companies, schools, libraries, and hospitals received almost $126 million from the federal fund in 2003. S.C. companies paid approximately $76 million, funded through a surcharge on consumers' bills.

The high-cost program of the federal USF allows telephone providers in areas where it costs more to provide phone service to recover some costs from the federal USF. The amount paid is calculated on interstate and international revenues using a contribution factor determined by the FCC each quarter. The contribution factor has increased from 5.877% in 2000 to 10.7% in 2005. South Carolina telephone companies received approximately $82 million from the high-cost portion of the federal fund in 2004. Graph 2.1 shows how S.C. distributions from the fund have increased from 1998 to 2004.

Graph 2.1: S.C. Federal High-Cost USF Support



Source: Federal Communications Commission.

Progress Toward Universal Service Goals

Although we could not identify a specific benchmark that would indicate that universal service has been achieved, it is clear that substantial progress has been made toward telephone service being readily available at a reasonable price. A 2002 survey by the National Regulatory Research Institute (NRRI) found that most states with state universal service funds did not have a specific standard to determine when universal service goals had been met. However, two states did have a specific penetration goal, such as 95%, and other states used the national average as a goal for universal service success. The percentage of households with telephone service has increased over the past 20 years (see Table 2.2), and South Carolina's rate (93.3%) is substantially at the national average.

Based on the current market (see p. 16), it is clear that some customers do not have basic telephone service because they prefer to use a wireless carrier. Also, evidence indicates that telephone service is affordable. According to data compiled by the Bureau of Labor Statistics, about 2% of all consumer expenditures are devoted to telephone service. This percentage has remained virtually unchanged over the past 15 years.

If the goals of universal service have been attained, it is a questionable priority for the state to allocate increasing resources to advance these goals.

Table 2.2: Percentage of Households With Telephone Service, November 1983 and July 2004

Jurisdiction	November 1983	July 2004	Increase
South Carolina	81.8%	93.3%	11.5%
United States TOTAL	91.4%	93.8%	2.4%

Source: Federal Communications Commission.

Other States' USF Funds

None of the other states in the nine-state BellSouth service area has a state universal service fund that is comparable to South Carolina's. We could not determine any conditions that make South Carolina uniquely in need of this fund. The federal Telecommunications Act of 1996 allows for states to establish funds in addition to the federal universal service fund. While approximately half of the states have established some sort of universal service fund, many of these funds are more limited than South Carolina's and different in scope and operations.

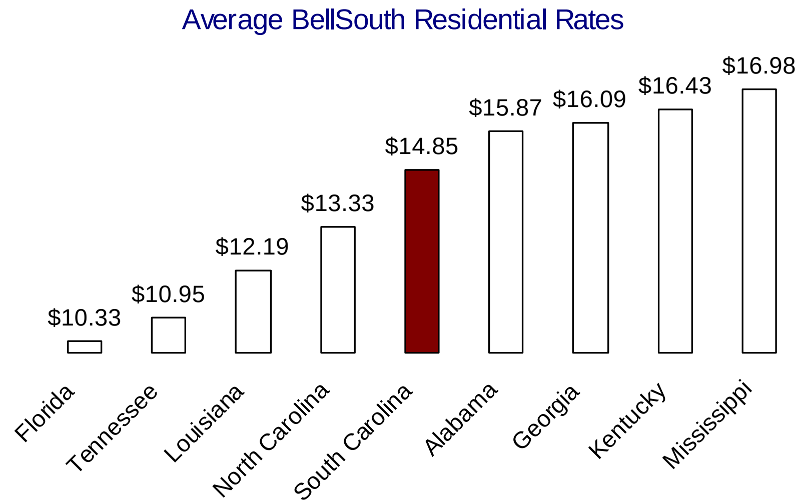
Map 2.3: BellSouth's Primary Service Area

There are nine states in BellSouth's primary service area (see Map 2.3). In addition to South Carolina, two of these states have some type of universal service fund. Neither of these funds is comparable to South Carolina's USF.

- Kentucky has a universal service fund that supports only the Lifeline program, the program in which low-income citizens are given a reduced rate for telephone service (see p. 20). According to officials in Kentucky, the fund currently pays out about $2.8 million annually.
- Georgia has a Universal Access Fund, which, when originally established, was similar to South Carolina's interim LEC fund (see p. 9). According to Georgia officials, the fund has been phased down. While originally 26 companies received funds, now just 5 small companies receive support totaling $2.9 million annually.

We could not determine a reason that South Carolina's environment for telecommunications would differ significantly from that in the other BellSouth states. For example, we noted that the average BellSouth residential rates in the other states are comparable to the rates in South Carolina (see Graph 2.4). However, the other states have not needed to implement a state USF to maintain these rates.

Graph 2.4: Statewide Average BellSouth Residential Rates in BellSouth Region, September 2004



Source: BellSouth.

We also reviewed features of state universal service funds in other states not in BellSouth's service area. In 2002, the National Regulatory Research Institute (NRRI) completed a survey of all states regarding their universal service fund programs. The survey found that about half (24) of the 51 jurisdictions reporting had a fund. We obtained information to update this survey and contacted NRRI officials and an official with the National Association of Regulatory Utility Commissioners (NARUC). We identified some states with funds that are relatively similar to South Carolina's, such as Kansas, Maine, Nebraska, Pennsylvania, and Texas. However, we noted that each fund has different features.

South Carolina's fund is not like the majority of existing state funds in some significant features, discussed below. The way South Carolina funds its USF results in some customers paying a greater share toward funding the state USF than others. It also results in the same revenues being taxed for both the state and federal universal service funds.

Contributions by Wireless Carriers

Wireless carriers do not contribute to South Carolina's USF. The federal USF requires contributions from wireless carriers. Also, 15 of 23 state universal service funds reporting in the NRRI 2002 survey stated that wireless carriers were required to contribute to the state USF. South Carolina law requires all telecommunications providers (including wireless) to contribute to the USF *if* the PSC determines that the company is providing services that compete with a local telecommunication provider. The PSC determined in 2001 that there was not enough evidence presented in its proceeding that any wireless provider competes with any local exchange carrier in South Carolina, and it reserved the right to revisit this issue. The PSC could reconsider, on its own initiative, contributions by wireless providers, or the Office of Regulatory Staff (see p. 10) or a carrier could petition the PSC to require wireless carriers to contribute. Competition from wireless providers is increasing and, as of December 2003, South Carolina had over 2 million wireless subscribers. The result of not requiring wireless providers to contribute is that customers of "landline" providers pay more than their share to support universal service in the state.

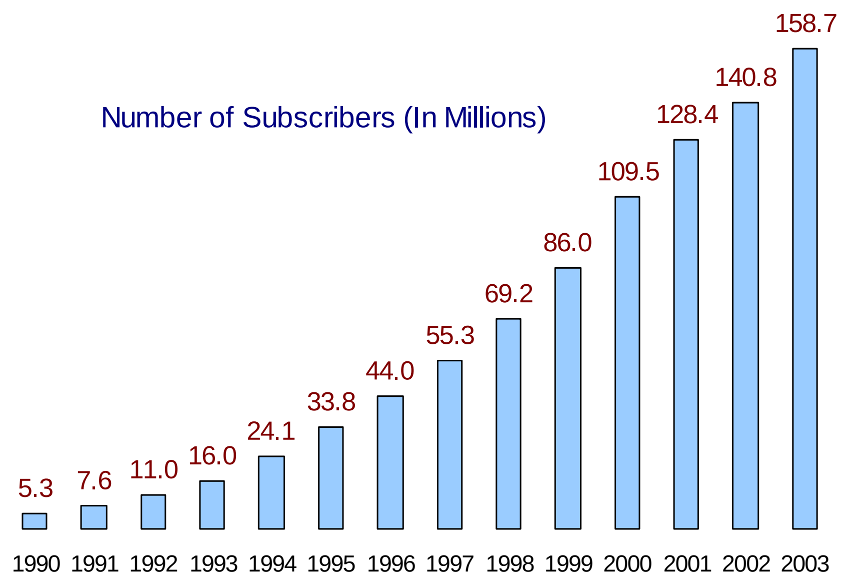
Contributions on Interstate and Intrastate Revenues

Contributions to the South Carolina USF are based on companies' interstate (for calls between states) and intrastate (for calls within S.C.) revenues. Contributions to the federal USF fund are based on companies' interstate and international revenues. Most other state universal service funds base their contributions on intrastate revenues only. According to the NRRI 2002 survey, the most common way that states collect universal service funds is a percent surcharge on revenues. Of the 22 states that used this method, 17 (77%) funded the USF by a percent surcharge on intrastate revenues only. A federal court has ruled that Texas could not fund its USF with a mix of interstate and intrastate revenues because it burdened interstate carriers more severely than intrastate carriers in violation of federal law. While South Carolina's funding mechanism has been found legal by a state court, it results in the same revenues (interstate) being taxed for both the state and federal universal service funds.

Telecommunications Market is Changing

The options that consumers have available for telecommunications are changing and decrease the need for universal service support. When telephone service began, the carriers had a monopoly and were subject to regulation by the states. When a court ordered the break-up of AT&T's monopoly in 1984, local (AT&T and Bell) phone companies became subject to competition. Telephone companies have competition not only from traditional wireline phones but also wireless and voice over Internet Protocol (VoIP). According to the Cellular Telecommunications & Internet Association, as shown in Graph 2.5, the number of wireless subscribers nationally has increased from about 5 million in 1990 to about 150 million in 2003. As shown in Graph 2.6, telephone revenues are also shifting from long distance to wireless service.

Graph 2.5: National Mobile Wireless Telephone Subscribers



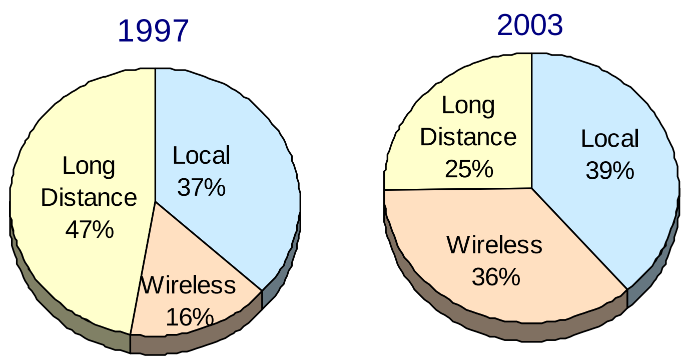
Source: Cellular Telecommunications & Internet Association.

Voice over Internet Protocol (VoIP) allows customers to make telephone calls using their Internet connection. This service is currently offered in S.C. Wireless and VoIP competitors are not subject to the same regulation as traditional telephone companies.

In a competitive market, rate regulation is not needed for consumers to have affordable choices. In a February 2002 order, the PSC noted that "competition in the local services market is strong in South Carolina." The Federal Communications Commission (FCC) monitors local telephone competition. In its latest report in June 2004, the FCC found that new entrants (competitive carriers) in South Carolina had 8% of the access lines and, from 2002 to 2003, wireless subscribers had increased 13%.

BellSouth officials stated that the FCC reports on competition understate the level of competition because the FCC only includes carriers with 10,000 or more access lines in its report. Only 14 competitive carriers in South Carolina were included in the report. However, BellSouth estimated that more than 55 competitive local carriers serve approximately 18% of the business market and 4% of the residential market in its S.C. territory. Competition has only increased in the almost three years since the PSC's 2002 order. In April 2004, there were 82 competitive carriers registered in BellSouth's territory.

Graph 2.6: Changes in Telecommunications Revenues



Source: Federal Communications Commission.

The universal service fund acts as a subsidy to allow incumbent local telephone carriers to reduce their rates to be competitive. The companies argue that the funds from the USF are used to subsidize the cost of basic service. However, the PSC does not verify that these funds are used for basic service or that the company has lost the amount of revenue they predicted when they reduced the rate (see p. 27). The carrier could be using these funds to unfairly compete and keep new entrants out of the market.

State USF Not in Line With Concept of Universal Service

While universal service funds are commonly thought to assist companies in connecting customers who are costly to serve, in South Carolina all companies receive this support for most of their customers. The state USF is focused on revenue replacement rather than providing support to areas with high costs for local phone service. The philosophy of universal service is to keep local phone rates affordable for everyone. Support is targeted to those areas where it is costly to serve individual customers, such as in rural areas where a customer could live several miles from the telephone network. To determine the cost to provide basic service, phone companies use models specified by the federal and state government that allocate expenses to the service those expenditures support. These models assign all the costs of the local loop (the circuit from a customer’s location to the telephone network) to basic service even though that loop carries all the services. As a result, the cost of basic service is increased when compared to the revenues received for the service.

Some areas qualify for USF assistance even though they may not be difficult or expensive to serve, such as within the city of Columbia.

Due in part to this cost allocation, for USF purposes, almost all of South Carolina is considered a high-cost area because the cost to the phone company to provide basic service is determined to be much greater than the rate received for the service. In reality, companies receive revenues from other services, such as Internet services, that use the lines whose cost is allocated to basic local service. From 1992 to 2002, the revenues that telephone companies received nationally from nontelecommunications sources increased from $7 million to $60 million. Because areas are considered high cost, they qualify for universal service assistance even though they may not be difficult or expensive to serve, such as within the city of Columbia. The federal USF provides additional high-cost support for those states where the costs for basic local service are 135% above the national average. South Carolina is not one of the eight states that receive funding from this source. Therefore, even using this cost allocation, S.C. costs are not extremely high and may not require additional USF support.

The operations of the state USF do not directly advance universal service but instead replace revenues. Phone companies receive support from the state USF by reducing rates that include implicit subsidies for basic service. The PSC does not verify that the USF support is still needed and that the funds are used to supplement basic service (see p. 27). By providing revenue replacement rather than a supplement for basic service rates, it is not clear that the support is for universal service.

The state consumer advocate, the S.C. Cable TV Association and the Southeastern Competitive Carriers Association have argued that the state USF operates in violation of state and federal law and that the telephone companies’ costs are not allocated as required by law. The state circuit court ruled that the fund was established and operates as required by statute and that it advances the concept of universal service. The case has been appealed to the S.C. Supreme Court, which had not issued a decision as of December 2004.

Options for State USF

The state USF could be eliminated or changed to provide support for those companies that can demonstrate a need for funding. The state has options to ensure that the fund is used to support universal service or can use alternate means to support universal service.

Demonstrated Need for Funding

The state USF could be phased down to provide support for those companies that demonstrate a need for funding. The Georgia Universal Access Fund was created to ensure reasonably priced access to basic local telephone service. According to a Georgia PSC official, originally 26 companies received disbursements from the fund. Currently only 5 small rural companies are receiving funds, and they must file cost studies to justify the need for the funds. The Maine Public Utilities Commission requires telephone companies to have a hearing to establish an allowed rate of return that the company can earn. Before a company can receive distributions from the state USF, the commission must find that its revenues will not be adequate. The South Carolina PSC could reduce the size of the USF in a similar manner. Companies requesting USF funding could be required to file detailed cost studies and be subject to reviews of their revenues.

Rate Regulation

Current options for rate regulation could help to compensate for the loss of universal service funding. In South Carolina, five larger companies have chosen to have their rates regulated by alternative regulation (see p. 5). Additional flexibility for pricing came with the deregulation of pricing for bundled services which was enacted in 2004 (see p. 5). Without legislative change, the Public Service Commission could also raise the amount below which telephone companies could raise rates without participating in a rate hearing. In order to provide universal service at affordable rates, however, telephone companies may need more flexibility in rate setting. Under current statutory provisions, companies can only adjust prices for certain basic services pursuant to an inflation-based index. By giving telephone companies more flexibility in setting prices, rates could be closer to actual costs and decrease the need for universal service funding.

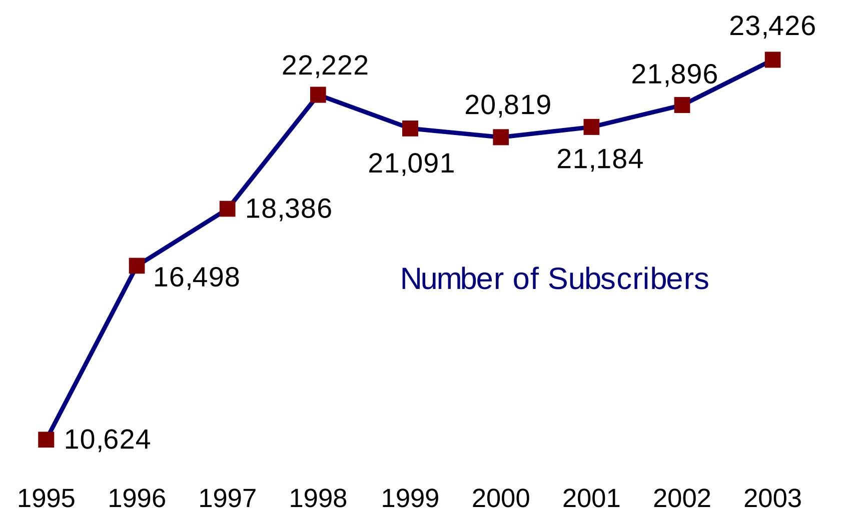
Low-Income Support

Universal service supports the goal that telephone service be affordable to all. Though telephone service is generally affordable to most consumers (see p. 13), South Carolina has a continuing need to provide assistance to low-income telephone subscribers. Both the federal and state USFs provide assistance to low-income individuals through discounts on the monthly cost of telephone service (Lifeline) and initial costs of beginning service (Link Up). Federal law establishes these programs and gives the states limited flexibility in setting the qualification criteria. A consumer qualifies for assistance based solely on income or factors related to income.

The South Carolina USF provides $3.50 per customer per month to match the federal low-income support. The payments from the federal USF to South Carolina carriers have increased from $1.7 million in 1999 to $2.7 million in 2003. The number of subscribers receiving low-income support has also increased as seen in Graph 2.7.

The South Carolina USF provides low-income support totaling approximately $873,000 annually for an average of about 20,000 customers per month. However, this amount has not been adjusted as the number of subscribers has changed (see p. 29). Due to the growing number of subscribers receiving low-income support, the need for the continuation of this support in South Carolina is obvious. Kentucky has a USF that only provides low-income assistance.

Graph 2.7: S.C. Federal Lifeline Assistance



Source: Federal Communications Commission.

Conclusion

There is no long-term need for the current South Carolina Universal Service Fund. In order to ensure that this fund supports the goals of universal service and access to phone service at affordable rates, the state USF should be scaled back to include supplements for low-income subscribers and support for those lines for which companies can provide evidence that costs are excessive. Other states have supported universal service without a separate state fund and their rates are comparable to South Carolina. By changing the state USF, the goals of universal service could be advanced more directly and the funds would be used to reach the neediest customers.

Consumers would benefit from reduced charges on their telephone bills. USF payments to support the low-income programs, which would be continued, have accounted for approximately 2% of fund distributions. Some customers could experience increases in their bills due to redistribution of costs for service. However, customers would be paying directly for services they receive instead of subsidizing companies' overall revenues.

Recommendations

1. The General Assembly should amend S.C. Code §58-9-280(E) to scale down the universal service fund to provide support for low-income subscribers and for those lines for which companies can provide evidence that costs are excessive, and to require the Office of Regulatory Staff to make annual adjustments to the contribution and distribution levels based on yearly reconciliations.

2. The General Assembly should pass legislation giving telephone companies more flexibility in adjusting rates.

3. The Public Service Commission should require telephone companies seeking additional funding from the state universal service fund to file with the Office of Regulatory Staff detailed cost studies to show the need for USF support.

4. The Public Service Commission should require wireless providers to contribute to the USF.

5. The Public Service Commission should require USF contributions to be based on intrastate revenues only.

Interim LEC Fund Should Be Phased Out

The state's interim LEC fund provides subsidies that should be eliminated or transitioned into the universal service fund for those recipients that could demonstrate need. The statutory purpose of the fund has been accomplished.

Fund Established in Response to a One-Time Revenue Loss

In 1996, Act 354 established the interim LEC fund to replace revenues lost by incumbent local exchange telephone carriers (LECs) when they reduced their access charges, charges paid by long distance companies to use their networks. Participants agreed to immediately lower their access rates to equal the rates of the largest incumbent LEC in the state, BellSouth. Act 354 provided that the lost revenue would be replaced from two sources:

- Incumbent LECs were allowed to raise their rates for basic local service as high as the statewide average ($14.85) over a five-year period.
- Companies that benefited from the access rate reduction would pay into the fund, and these payments would be distributed to fund participants.

After delay caused by opposition of the state's consumer advocate over the way in which consumers were notified of the rate increases, the rate increases were fully implemented over a seven-year period, which ended in 2003. It was envisioned that the amount of the fund would decrease during this period as the companies raised basic local service rates to the state average. As revenue was replaced by the rate increases, less would be needed from the fund.

Increases in Size of Interim LEC Fund

We found that although basic rates increased, the size of the fund did not decrease as expected (see Table 2.8). In fact, the amount of the fund increased for two reasons:

- When BellSouth lowered its access rates in 1999 and 2002, the participating companies lowered theirs also, with the lost revenue recouped from the fund.
- A company's distribution from the fund increases if the company gains customers or minutes of use.

Table 2.8: Interim LEC Fund Payments by Fund Year

Fund Year*	Payments
1997	$30,492,107
1998	$27,218,039
1999	$26,699,603
2000**	$33,435,521
2001	$35,168,277
2002	$32,960,593
2003**	$33,090,289
2004***	$31,376,030

* Fund year runs from April to March of each year and disbursements are based on minutes of use from the preceding calendar year.
** Participating companies lowered rates to match BellSouth's 1999 and 2002 reductions.
*** Fund size adjusted $1.7 million downward after PSC staff discovered errors in determination of fund size.

Source: Public Service Commission.

The size of the interim LEC fund is not adjusted for negative growth. If a company gains minutes of use or access lines, the amount it receives from the fund increases, but if it loses access lines and minutes of use, its distribution is not lowered. For example, in 2003, one company had 1,531 fewer access lines and 7.7 million fewer minutes of use than the previous year, but its 2004 allocation was not reduced for negative growth.

Once the period of rate increases ended in 2003, the fund could not become smaller. The disbursements that incumbent LECs receive are based on revenue losses experienced in 1996 and will continue indefinitely unless the General Assembly enacts change.

Continuing the subsidy provided by the fund indefinitely does not allow for the effects of changing conditions. As discussed on page 16, the telecommunications market is rapidly changing. Companies are expanding the number of services they sell, and revenues from new services could lessen the need for the fund subsidies. Also, the interim LEC fund duplicates the function of the state USF. The interim LEC fund replaces revenue lost due to access rate reductions by the companies in an effort to make implicit subsidies explicit. The USF also reimburses companies for reducing access charges.

Statutory Change Needed

S.C. Code §58-9-280(M) requires that the obligations of the interim LEC fund transition into the universal service fund when "…funding for the USF is finalized and adequate to support the obligations of the interim LEC Fund." This transition has not occurred, and is not possible without statutory change. Under the current structure the USF will never be adequate to support the obligations of the interim LEC fund, and the differing fund contributors would make a merger difficult.

USF Obligations

The state USF fund subsidizes companies when they reduce rates that contain implicit subsidies (see p. 4). The amount of the USF is calculated to cover projected revenue loss from specific rate reductions. The USF does not contain excess funds other than what is currently obligated to participating telephone companies.

Fund Contributors Differ

The interim LEC fund and the USF have different contributors which would make combination under the current structure impossible. As discussed, the interim LEC fund is funded only by the carriers (mostly long distance) that benefited from the access rate reductions. In 2004 there were 57 contributors to the interim LEC fund. The USF is funded by all telecommunications providers (approximately 190), with charges passed on to consumers through a surcharge on telephone bills. If the current obligations of the interim LEC fund were to become a part of the USF, customers would see an increase in their telephone bills.

Impact of Discontinuing Fund

In many cases, companies receiving funding from the interim LEC fund would not suffer significant per line losses if it were discontinued, and revenue losses could be recovered by increasing rates. Based on the amount they receive from the fund and the number of customers they have, we calculated the loss of revenue per customer (access line) (see Table 2.9). On average the revenue loss would be $3.13 per line per month. One carrier would lose just 1¢ per line per month.

In addition, those incumbent LECs that provide long distance calls (within South Carolina) also pay into the fund, as they receive reduced access charges for these calls. In 2003, incumbent LECs paid $3,357,248 into the fund, which would reduce the estimated revenue loss from ending the fund to an average of $2.80 per line per month. We noted that three companies paid more into the fund than they were allocated in fund distributions for the next year. In 2003 these companies paid $809,628, and they were allocated just $62,355 for 2004, a difference of $747,273.

Table 2.9: Impact on Companies From Ending Interim LEC Fund

NUMBER OF COMPANIES	REVENUE LOSS PER LINE PER MONTH
16	< $5
6	$5 – $10
2	>$10

Options for Phase Out

As noted, some carriers could compensate for loss of interim LEC fund revenues by increasing their rates for basic local service. In 2004, the monthly rates charged by the incumbent LECs for basic residential service ranged from $8.60 to $18.83. In many cases, the increase would not be significant. Carriers that could not or did not want to make up revenue losses through rate increases could apply for funding from the USF. As discussed on page 20, we recommend that USF recipients should file detailed cost studies prior to receiving support.

Recommendations

6. The General Assembly should amend S.C. Code §58-9-280(M) to eliminate the interim LEC fund and to provide that companies could recover resulting revenue losses by (1) adjusting rates, or (2) filing for USF assistance by submitting detailed cost studies and revenue information.

7. The Public Service Commission should require that interim LEC fund payments be adjusted for negative growth.

Administration of the State Universal Service Fund

Introduction

The Public Service Commission has not implemented adequate controls over the management of the state universal service fund (USF). We reviewed the administration of the fund since its inception in 2001. As shown in Table 3.1 below, the USF currently processes more than $48 million per year that is ultimately paid by South Carolina's consumers.

Table 3.1: Contributions and Distributions of the State Universal Service Fund for FY 01-02 Through FY 03-04

Year	Contributions to State USF	Distributions from State USF
FY 01-02	$29,720,989	$27,270,133
FY 02-03	$41,074,180	$40,895,116
FY 03-04	$48,089,178	$48,268,797

The fund began operations in October 2001. Therefore, the amounts for FY 01-02 show only nine months of operation.

Source: Public Service Commission.

We found the following deficiencies in the PSC's administration of the fund:

- Lack of proper follow-up to determine whether companies comply with requirements or have a need for the subsidies.
- Failure to provide an independent third-party audit.
- Inadequate internal policies and procedures.
- No established system to audit participant information.
- Information system weaknesses.
- A conflict of interest with the administration and auditing of fund participants.

In addition, we discuss the options to improve controls over the USF by hiring an experienced, outside fund administrator.

Follow-Up of USF Subsidies Lacking

The Public Service Commission has not ensured that companies that receive distributions from the USF comply with requirements for receiving the funds or have an ongoing need for the funds received. Instead, most companies continue to receive USF funding based on information submitted as of 2000. The PSC has disregarded the potential effect of changes in demand for service and changes in the telecommunications industry in order to maintain a constant flow of funds to the recipient companies. Improved controls over fund distribution are needed to ensure that consumers' payments are warranted.

No Follow-Up of Information Used to Determine Fund Distributions

Companies receive distributions from the USF on the condition that they will lower access rates and other rates that contain implicit subsidies (see p. 9). However, we found no evidence that the Public Service Commission staff has reviewed USF distributions to determine if companies' rates were actually lowered or whether information used to determine distributions was accurate (see p. 33).

The PSC did not obtain updated information required by the procedures it adopted to administer the fund. S.C. Code §58-9-280(E)(7) gives the PSC the authority to "…make adjustments to the contribution or distribution levels based on yearly reconciliations…." The USF administrative procedures require participating companies to report annually information relating to their USF distributions. However, the commission did not request this information from the companies on a yearly basis after implementing the USF. In June 2004, the commission's staff requested that the participating companies provide updated information for the years ending December 31, 2001, through December 31, 2003. We found that this information did not provide figures that would allow the commission to appropriately update the distributions paid to the participating companies.

In the initial phase of the state USF, the PSC ordered companies to reduce intrastate access charges from 6¢ to 3¢ per minute. In order to calculate the amount of USF support companies would receive, the PSC used minutes of use submitted by the companies for the year 2000. However, the information requested by the PSC in 2004 does not require companies to submit updated minutes of use for 2001 through 2003. The commission did not attempt to adjust state USF distributions based on the fluctuations in minutes of use for access charges.

Eighteen of the twenty-six companies receiving state USF support have not asked for an increase in their support. Therefore, they continue to receive a subsidy for lowering access charges based on minutes of use from the year 2000. The commission is allowing a subsidy to be paid to companies without any follow-up as to the need or justification for the subsidy. Allowing the amount of USF support to remain the same regardless of changes in demand for services or changes in the telecommunications industry does not adequately protect consumers.

Low-Income Assistance Component Not Updated

The PSC has not updated USF distributions for the Lifeline program (see p. 20). Therefore, the participating companies are receiving USF support for the number of low-income subscribers based on data submitted in 2001.

As discussed above, the yearly reporting requirements pertaining to the state USF have not been enforced. These required reports would provide the PSC with an updated number of low-income customers for each participating company each year. This information could be used to update the distributions to companies for low-income customers. Our review of the three years of information requested by the commission in June 2004 revealed that the number of low-income customers has fluctuated widely for several companies. By updating distributions for the Lifeline program, the PSC would provide assistance to ensure that the state's low-income population has access to basic telephone service.

Funding Increases Based on Projected Revenue Loss

The PSC has based distributions to companies on projected revenue losses without attempting to determine whether the losses have actually occurred. The commission has rejected the possibility that lowered rates could increase demand for the services. Company revenues could be greater than projected. Also, based on ongoing change in the telecommunications market, company revenues could increase from new sources of revenue, making USF support unneeded.

The Public Service Commission has not monitored current or considered future demand for services for companies receiving increases in their universal service funding. The commission granted USF funding increases to seven companies that requested increased support for lowering certain rates for services. Based on commission documents, it appears that these reductions were based on the level of customer usage of these services at the time of the requests, May 2002, and September 2003.

During the proceeding initiated in 2002, six companies asked for additional USF support. The South Carolina Consumer Advocate presented the testimony of an economic consultant who testified that the effect of increased demand should be taken into account when determining the appropriate state USF funding for participating companies. However, in its ruling, the commission rejected this argument stating that "[d]emand stimulation is hypothetical at best." Without a follow-up procedure, current or future demand for services is never reported to or analyzed by the PSC staff. Therefore, the commission has allowed companies to recover projected lost revenues based on outdated information without any monitoring to determine the effect on demand for services.

In fact, the PSC's order to award additional USF support dated September 2004, states that "Universal service support programs identify implicit support and convert it to explicit support so that the support will remain constant and not erode even if the demand for those services erodes." This order further states that if a company's minutes of use does decline, that is "…precisely the reason why State USF should remain static so that the support that keeps basic local exchange service affordable does not disappear with the access revenues." The PSC's actions obligate the state's consumers to subsidize certain telephone companies without regard for the appropriateness or necessity of these subsidies. Particularly, while the telecommunications market is in a state of constant change (see p. 16), the PSC should monitor and follow up on subsidies to determine whether they are needed.

Recommendations

8. The Office of Regulatory Staff should enforce the yearly data requirements to ensure that companies provide current and relevant information necessary to administer the state universal service fund.

9. The Office of Regulatory Staff should implement procedures to update the low-income assistance component of the state universal service fund.

10. The Office of Regulatory Staff should regularly monitor company earnings to determine whether subsidies paid by consumers are necessary.

Financial Audits of USF

Both the guidelines and administrative procedures adopted by the PSC for the USF require that annual financial audits of the state USF be performed. Although the fund has been operating since 2001, no financial audits performed by an independent third party have been done.

One of the responsibilities of the administrator of the state USF is to file with the commission "…the results of an annual audit of the fund performed by an independent third party…." This audit would provide information concerning the proper operation of the fund and would provide feedback in areas such as the appropriate segregation of duties, the safeguarding of assets, or any deficiencies in the design or operation of the fund's internal control environment. This information could assist management or oversight officials in the proper administration of the state USF.

We found that other states operating universal service funds, such as Kansas and Wisconsin, and the company administering the federal universal service fund have the financial statements of these funds audited by an independent auditor. These audits provide assurance that the financial position of these funds are presented fairly and properly show the results of operations and changes in fund balance.

The state USF accounts for more than $48 million a year that is ultimately paid by consumers of telecommunications services. In the absence of an annual financial audit performed by an independent third party, the operations of the state USF have not been comprehensively and objectively evaluated.

Recommendation

11. The Office of Regulatory Staff should ensure that annual audits of the state universal service fund are done by an independent third party as required by the guidelines and administrative procedures adopted by the Public Service Commission.

Policies and Procedures

The Public Service Commission did not have adequate written policies and procedures to administer the state USF. Although the commission adopted "Administrative Procedures" in 2001, these procedures do not contain detailed information for the routine operation of the fund. In fact, the section pertaining to the responsibilities of the administrator contains only four brief entries comprising a half-page of information. Given the complexities of administering the $48 million fund, these brief procedures are not adequate for identifying and billing fund contributors or for properly disbursing funds to recipients. For example, procedures are needed in the following areas:

Correction of Errors

PSC staff became aware that one company that contributes to the USF reported incorrect revenue figures and had been overbilled for over a year. When PSC staff learned of this problem, they had no written procedures in place to determine how to correct the error. Since the contributing companies are billed based on a percentage of total revenues, this type of error results in all contributors being billed incorrectly.

Identification of Contributors

PSC staff who administer the fund stated they are supposed to be notified when a new telecommunications carrier is certified to operate within the state. However, no written procedures guide the process of identifying new fund contributors.

Reporting of Revenue by Contributors

In order to be appropriately billed for state USF contributions, telecommunication carriers must report their annual revenues to the PSC. If these reports are not filed in a timely manner, PSC staff make telephone calls to determine the reason. Again, there is no standard procedure for staff to follow in documenting their actions to ensure that all contributors are identified and report their revenue. In the absence of policies, it is likely that some companies that should contribute to the fund may not report and may not contribute. Obtaining accurate information about the revenues of fund contributors is particularly important since PSC staff use this information to calculate the new USF percentage rate to be passed along to telephone customers. This rate must be accurately calculated in time for telephone companies to update their billing systems each year.

Penalties for Delinquent Accounts

There are no clear procedures for PSC staff to follow for companies that habitually pay late into the state USF. Although the Administrative Procedures require a late payment charge to be assessed (see p. 34), there are no procedures for further action to be taken against companies that consistently do not pay on time. Actions such as canceling a company's certificate to operate within the state could be taken. A policy containing a range of penalties for repetitive delinquent accounts could act as a deterrent.

Written procedures provide a system of operating controls and are also necessary to ensure continuity of action when staff turnover occurs. The absence of written policies may result in inconsistent actions and inadequate controls over USF resources.

Recommendation

12. The Office of Regulatory Staff should supplement the "USF Guidelines and Administrative Procedures" adopted by the Public Service Commission with adequate written internal policies and procedures to assist in the daily administration of the fund.

Audits of Participant Information

The PSC has not established an adequate system to audit information provided by state USF participants. The administrative procedures covering the state USF allow the PSC, as administrator, to annually audit USF participants "…to ensure that all contributions are accurately assessed and distribution claims are valid." The PSC has made minimal efforts to audit fund participants.

The primary objective of establishing an effective audit program of participant information would be to ensure the reliability and integrity of information reported by the 190 companies that contribute to the state USF as well as the 26 companies that receive USF distributions. The PSC has not audited the distributions from the fund to ensure they are appropriately updated for changes (see p. 27), and audits of contributions have been few. From April through September 2003, only 21 audits were performed, and since some audits included two years of information, only 15 different companies were actually audited.

The 190 companies that contribute to the state USF self-report revenue information to the PSC which is used to calculate each company's contribution. The PSC has no way of ensuring that this information is accurately reported without auditing each company's books and records. In the absence of a continuous monitoring system to verify the self-reported data, companies may not provide accurate and timely information.

Recommendation

13. The Office of Regulatory Staff should implement a system of auditing the self-reported data from participant companies in order to ensure accurate reporting by companies.

Information System Weaknesses

The Public Service Commission has used inadequate computer systems to administer the state USF and does not have appropriate data entry controls. Approximately 190 companies are billed each month for a yearly total of more than $48 million. Despite the large volume of transactions, the PSC first used a billing program set up in a simple spreadsheet. This spreadsheet software was not suitable for handling the numerous billings that were sent out monthly. In 2003, the commission developed an in-house database billing program. However, this billing program does not calculate late payment charges and has limited reporting capabilities.

No Late Payment Charges

Since October 2003, the commission has not been charging late payment fees to USF contributors that do not pay on time. The billing program does not automatically calculate late payment charges. Formerly, staff manually calculated and entered late payment charges into the spreadsheet program that was used to calculate monthly billings. We reviewed late payment charges for the six-month period January through June 2002 and found that $7,295 was billed to delinquent companies. According to the Administrative Procedures adopted by the PSC, "[l]ate payments to the USF will be assessed at the rate of .0493% per day" (18% per year).

Proper controls for administering outstanding balances require that late payment notices and monthly account statements be mailed to each contributor with a balance for the current month. We found that the commission does not send either of these documents to late payers. Instead, the monthly USF bills reflect a prior balance due line item which is added to the current month's billing amount.

The PSC uses the amount collected from contributors to determine the amount distributed to recipients in the following month. The South Carolina Telephone Coalition, which represents 21 companies receiving distributions from the state USF, commented that "…payments into the fund apparently are not being made on a timely or regular basis and monthly receipts fluctuate, which has resulted in somewhat erratic and unpredictable payments to recipients." The PSC does not have adequate methods in place to ensure timely collections (see p. 32).

Inadequate Reporting Capabilities

The current USF billing system does not have capabilities to generate late payment reports. We requested a report that would provide information identifying companies that pay late. However, PSC staff stated that the system does not require that a payment date be recorded. As the system is currently designed, there is no way to know when a payment arrives. Therefore, a late payment report cannot be generated from the data in the billing system. A billing system should capture information that allows for the analysis of outstanding accounts through the use of overdue account reports. Without proper reporting, the commission does not have a reliable method to track companies that do not pay on time.

Data Entry Controls

The PSC's system does not have adequate checks and controls on the accuracy of information used to administer the USF. A single employee is responsible for calculating the monthly billing amounts for contributors, determining the percentage that customers will pay on their bills, and the amounts of distributions to recipients. As discussed on page 31 , the PSC does not have adequate policies and procedures for fund operations. Such policies could provide a system of verification of the data used and calculations made to ensure that billings and distributions are accurate.

Recommendations

14. The Office of Regulatory Staff should develop an appropriate billing program which will encompass all necessary billing applications including calculating late payment charges and generating late payment reports.

15. The Office of Regulatory Staff should develop a system of verification of the calculations made and the data used in the administration of the state universal service fund.

Fund Administered and Audited by Same Staff

The state USF was initially administered by the Public Service Commission's audit department even though the audit department had responsibilities to audit as well as manage the fund. The audit department administered the fund until fall 2003, when the administrative department assumed this responsibility.

The PSC's management assigned the agency's audit department to establish and administer the USF. These duties included determining amounts to be billed to contributors and distributed to participants. The Administrative Procedures adopted by the PSC provided for annual audits of state USF participants. These audits would "…ensure that all contributions are accurately assessed and distribution claims are valid." The commission's audit staff was responsible for setting up the USF billing procedure. In addition, they conducted a limited number of audits of contributions to the fund (see p. 33).

It is not appropriate for auditors to be responsible for reviewing activities they have managed. According to the Government Auditing Standards, "Auditors and audit organizations have a responsibility to maintain independence so that opinions, conclusions, judgments, and recommendations will be impartial and will be viewed as impartial by knowledgeable third parties." Auditors should be independent in fact and appearance in order to maintain credibility for their work.

Recommendation

16. The Office of Regulatory Staff should ensure that auditors who review USF contributions and distributions do not have managerial responsibilities for the fund.

Options for Improved Controls

The Public Service Commission administered the state USF since its inception in 2001. However, beginning in January 2005, the administration of the state USF is the responsibility of the newly created state agency, the Office of Regulatory Staff (ORS). Two options could be considered for administering this fund: an in-house operation similar to the PSC's, or contracting with an outside administrator.

Some benefits that an outside fund administrator could provide are:

- Software designed to meet the needs of the fund, including proper backup systems and disaster recovery plans.
- Internal control (written) policies covering collection, disbursement and administration procedures.
- Independence of the fund administration from the staff who would audit the fund.
- Bonding of key employees and the maintenance of appropriate insurance coverage.

We found that most other states that have universal service funds use an independent fund administrator rather than administering the fund within the state agency. The 2002 NRRI survey (see p. 15) found that 15 of the 25 funds reporting used a private contractor to administer the fund. In addition, the federal universal service fund is administered by the Universal Service Administrative Company (USAC). The USAC is comprised of six divisions, including such divisions as internal audit, strategic planning and operations and finance, which assist in carrying out the company's mandate to properly account for and oversee billions of dollars for the federal universal service fund.

The administrative procedures adopted by the PSC for the state USF include a provision for the fund's administrative costs. A part of the fund was designated for "…costs incurred by the Commission-designated Administrator of the SC USF in the administration of the SC USF, including the audit expenses of an independent third party." According to PSC officials, the agency has not taken administrative costs from the fund, and an independent audit has not been completed (see p. 30). The costs for the PSC staff to administer the fund have been assumed by all of the regulated industries that provide funding for the PSC's operations.

By using an experienced fund administrator, established operational and administrative methods would already be in place and would not need to be established. The USF fund was designed to cover the cost of hiring a fund administrator. Based on the difficulties experienced by the PSC, proper administration of the $48 million state USF should be a top priority of ORS.

Recommendations

17. The Office of Regulatory Staff should investigate the costs and benefits of hiring an experienced fund administrator to properly administer the state USF.

18. The Office of Regulatory Staff should use the resources of the USF to cover the costs of administration.

Glossary

Access Charge — The per-minute charges a long distance telephone company pays to both the caller's local telephone company and the local telephone company of the party being called.

Access Line — The circuit connecting the customer's place of residence or business to the local exchange carrier's switching center. A telephone company's number of access lines is approximately its number of customers.

CLEC — Competitive local exchange carrier. A telephone company in competition with incumbent local exchange carriers to provide the same services.

Explicit Subsidies — Payments made to a company to provide support for a specific purpose. Shown as a specific charge (for example, on consumers' telephone bills).

Federal Communications Commission — An independent U.S. government agency charged with regulating interstate and international communications by radio, television, wire, satellite, and cable.

ILEC — Incumbent local exchange carrier. Telephone companies with defined service areas within which they must provide service. South Carolina has 25 ILECs.

Implicit Subsidies — Implicit subsidies occur when companies use the profits they earn from one service (such as a business telephone line) to offset the loss they incur in providing another service (such as basic local residential service). Implicit subsidies are not shown on customers' bills.

Interstate — Between two or more states.

Intrastate — Within the same state.

LATA — Local access and transport area. With the break-up of AT&T, a U.S. court divided the country into LATAs. The Bell operating companies are permitted to carry toll calls only within LATAs.

LEC — Local exchange carrier. A local telephone company.

Lifeline Program — A program through which low-income customers can have their monthly charges for basic local telephone service reduced.

Link-up Program — A program through which low-income customers can obtain a reduced telephone service installation charge and pay for that charge over time.

Minutes of Use — The measurement in minutes of the time a local exchange carrier's network or equipment is in use. Long distance carriers pay access charges based on the number of minutes they use the LEC's network.

Universal Service — Public policy objective designed to make telecommunications service affordable and accessible to all citizens.

VoIP — Voice over Internet Protocol. VoIP involves the transmission of telephone calls over a data network like the Internet rather than through the regular telephone network.

Agency Comments

The Public Service Commission State of South Carolina

RANDY MITCHELL
CHAIRMAN

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February 18, 2005

Mr. George L. Schroeder
Director
Legislative Audit Council
1331 Elmwood Avenue, Suite 315
Columbia, South Carolina 29201

Re: *A Review of the South Carolina Universal Service Fund.*

Dear Mr. Schroeder:

Thank you for allowing the Public Service Commission ("PSC") the opportunity to comment on the Legislative Audit Council's report entitled *A Review of the South Carolina Universal Service Fund*.

The Legislative Audit Council ("LAC") makes several recommendations in this report regarding the Universal Service Fund ("USF"), the Interim LEC Fund, and the PSC's administration of these funds. The LAC's policy recommendations include scaling back the size of the USF and changing the nature of its subsidy of basic local telephone service. These recommendations represent a significant departure from the statutory framework adopted by the General Assembly in South Carolina Code Ann. § 58-9-280, and would require statutory change to be implemented. As a quasi-judicial body charged with oversight of the USF and the Interim LEC Fund, the PSC does not have a position in regard to these policy choices. The PSC will exercise its oversight capacity to faithfully implement any changes that the General Assembly should decide to implement.

The LAC's report also identifies several shortcomings in the PSC's administration of the USF during the 2003-04 fiscal year. The PSC has recognized the same issues, and has been working to resolve them both internally and with the Office of Regulatory Staff, which assumed administration of the USF on January 1, 2005. The administrative shortcomings arose because the PSC lacked adequate resources and personnel to administer a fund of this size and complexity. Also, the PSC will soon consider substantial revisions of its administrative guidelines which will help ensure that the USF is administered in an efficient and professional manner.

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The following comments clarify several of the findings in the LAC's report.

1. The General Assembly established the state USF both to *maintain* and extend basic telephone service.

The purpose of the USF is to continue *"South Carolina's commitment to universally available basic local telephone service at affordable rates and to assist with the alignment of prices and/or cost recovery with costs…to a carrier(s) of last resort."* S.C. Code Ann. § 58-9-280(E). [1]

A fundamental premise of the LAC's report appears to be that the USF should be scaled back because *"the goals of universal service have largely been met"*. p. v. The LAC observes that "*Ninety-three percent of S.C. households have telephone service." Id.* Yet, when the General Assembly established the USF, wireline telephone service was virtually ubiquitous in the state of South Carolina, with a penetration rate of 91.3%.[2] Clearly, the General Assembly was at least as concerned with the maintenance of affordable universal service as it was with the extension of basic telephone services to new households.

Prior to the state USF, telephone companies set their rates following the principle that universal service should be supported by long distance, business services, optional services and directory advertising. As the LAC acknowledges, when the General Assembly created the USF in 1996, deregulation of the telephone industry was making it increasingly difficult for incumbent local exchange carriers ("ILECs") to implicitly subsidize service to the state's high cost areas with revenues from more lucrative services. The opening of the long distance market, the end of the ILECs' equipment rental and the creation of competitive local exchange carriers, rendered implicit subsidies obsolete.

Therefore, in the newly deregulated environment, the high, embedded and unrecovered cost of providing residential and single line business service throughout much of South Carolina was a major obstacle to maintaining universal service. The anticipated loss of revenues due to regulatory and competitive pressures on the

[1] The state USF is a parallel mechanism to the federal USF. While it is a complement to the federal universal service fund, their functions are distinct. The federal USF fund only replaces subsidies from interstate services while the state USF replaces subsidies from intrastate services. Unless the federal fund is redesigned, it cannot perform the functions that the General Assembly assigned to the state USF.

[2] *Telephone Subscribership in the United States*, Federal Communications Commission, January 1997 (Data through November 1996).

ILECs was another obstacle. Thus, the General Assembly established the state USF in order to maintain the state's current levels of universal service, as well as to extend service to new customers.

The LAC points out that other states in the BellSouth service area have similar basic telephone rates to those charged in South Carolina, but do not have comparable universal service funds. However, a review of subscribership rates in the BellSouth states, as reported by the FCC Wireline Competition Bureau, does indicate that South Carolina has moved from sixth place in household penetration to a tie for third place since the state USF was initiated.[3]

State	1996 % User	2004 % User	Change	Average Residential Rate
Alabama	92.2 %	91.4 %	-0.8 %	15.87
Florida	93.1 %	93.3 %	0.2 %	10.33
Georgia	89.7 %	90.8 %	1.1 %	16.09
Kentucky	92.3 %	91.9 %	-0.4 %	16.43
Louisiana	91.1 %	90.7 %	-0.4 %	12.19
Mississippi	87.5 %	89.2 %	1.7 %	16.98
North Carolina	93.5 %	93.5 %	0.0 %	13.33
South Carolina	**91.3%**	**93.3 %**	**2.0 %**	**14.85**
Tennessee	94.0%	94.0 %	0.0 %	10.95

A number of factors can affect penetration rates. For instance, the states with higher penetration rates than South Carolina have average BellSouth residential rates that are as much as 30.4 % lower than BellSouth's average residential rate in South Carolina. A more detailed study of the markets in these states is needed in order to determine their implications for the effectiveness of state USF subsidies.

2. The PSC may consider whether wireless providers should be required to contribute to the USF as recommended by the LAC. However, this could only be done if, after a hearing, wireless providers are found to be competitive with landline companies.

The LAC recommends that the PSC require wireless providers to contribute to the USF. Currently, wireline local carriers are the only carriers of last resort in

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[3] *Id.* and *Telephone Subscribership in the United States*, Federal Communications Commission, October 2004, (Data through July, 2004).

South Carolina.[4] Cellular providers are not regulated by the state of South Carolina, and do not contribute or receive support from the USF.

As stated by the LAC, the PSC has the authority to consider the question of whether wireless providers should be required to participate in the USF. This determination would require the presentation of evidence in a proceeding before the Commission. The Commission would have to determine whether or not the wireless providers are in competition with a local telecommunications service provided in this State. *See* S.C. Code Ann. Section 58-9-280(E)(3). If the Commission determines that there is such competition, it can require wireless carriers to contribute to the Universal Service Fund. The Commission has considered this question in a previous proceeding, but found that no such competition existed at that time, although the Commission reserved the right to revisit the issue. *See* Commission Order No. 2001-419 at 36-37.

It should be noted that if wireless providers were required to pay into the USF fund, they would also be entitled to apply for subsidies from the USF. Therefore, the LAC's assertion that customers of landline providers would pay less if wireless providers were included in the USF[5] is not a foregone conclusion.

3. The LAC's recommendation that USF subsidies be restricted to *Lifeline* and *Linkup* customers and to telephone companies who demonstrate revenue losses requires statutory change before it can be implemented.

The LAC also proposes that the USF subsidies should be restricted to individual customers who are eligible for *Lifeline* and *Linkup* subsidies, and to telephone companies that show a need for subsidies when providing service to high cost areas. *See* p. v.

However, the PSC is bound by S.C. Code Ann. § 58-9-280 (4) and (5) in this regard. These sections read, in part, as follows:

> (4). The size of the USF shall be determined by the commission and shall be the sum of the difference, for each carrier of last resort, between its costs of providing basic local exchange services and the maximum amount it may charge for the services…….
>
> (5). Monies in the USF shall be distributed to a carrier of last resort upon application and demonstration of the amount of the difference

[4] The term "Carrier of last resort" means a facilities-based ILEC which has the obligation to provide basic local exchange service, upon reasonable request, to all residential and single line business customers within a defined service area. S.C. Code Ann. § 58-9-10(10).

[5] See p. 25 of the Report.

between its cost of providing basic local exchange services and the maximum amount it may charge for such services.

In effect, the General Assembly has presumed that a company which can demonstrate eligibility under S.C. Code Ann. § 58-9-280(5), has a need for funding from the USF. Once a carrier of last resort demonstrates that its cost of providing basic local exchange services exceeds its maximum rates for such services, this difference must be paid to that carrier from the USF. The General Assembly did not condition this payment on a showing that the company's overall financial health would suffer without USF funding, and the PSC does not have the independent authority to impose this condition.

However, under this statute, companies seeking USF funds do have to file cost studies with the PSC, and the requirement has also been addressed by the PSC. The PSC ordered that the results from the cost models be updated by each local exchange carrier before that local exchange carrier's USF withdrawal exceeds one-third of its company-specific USF amount. Order No. 2001-419 at 40, 42. Also, the PSC does require companies requesting reimbursement from the USF to show a reduction in rates for services priced above cost as a condition for receiving monies from the USF. Order 2001-419 at 42. The LAC has noted that, in past years, the PSC did not systematically audit the companies' rates. The PSC did not have sufficient personnel to conduct these audits. However, the telephone companies are required to post their rates as part of their tariff filings, and these tariffs are subject to review and challenge by ORS, competing companies, and the general public.

The LAC is critical of the PSC because *"The Commission did not attempt to adjust state USF distributions based on the fluctuations in minutes of use for access charges".* p. 28. However, the USF does not subsidize switched access minutes of use, nor was it intended to do so. The switched access minutes of use in question are created by interconnecting companies' traffic, not local use by the ILEC's customers. The ILECs only submitted switched access minutes of use information in 2000 as part of their initial applications for withdrawal from the USF. At that time, information regarding switched access minutes of use was necessary to verify the initial "revenue neutrality" of their request. In other words, the minutes of use information was used to determine the amount of the implicit subsidy that switched access was providing to the high cost lines, and the amount of revenue (and, hence, subsidy) they would lose by lowering switched access rates.

However, once reductions in the rates charged for switched access have been made, a company's entitlement to USF funding corresponds to the number of access lines maintained by the company, not to the company's number of switched access minutes of use. This is because the access lines represent the fixed cost of servicing the high cost area, which must be borne by a telephone company. The fixed cost of a line remains the same, regardless of how much access traffic it bears for the ILEC.

Once switched access rates are reduced to rates that do not provide subsidy, additional USF withdrawal applications are based on reductions in other rates not associated with switched access. Therefore, subsequent information regarding a telephone company's switched access minutes of use would not be relevant.

4. The PSC agrees that new legislation would facilitate the merger of the Interim LEC Fund and the USF.

State law calls for the Interim LEC fund to be merged with the USF. The PSC agrees with the LAC, that further statutory changes could facilitate merger of the two funds.

5. The PSC is working to address the shortcomings in administration of the USF and will adopt revised administrative guidelines in the near future.

Since the fund was implemented in 2001, the PSC has attempted to administer the USF in a manner consistent with the spirit and letter of the law. While the PSC had the authority to charge an administrative fee to the USF, the PSC sought to ensure that all monies paid into the USF were paid out to qualified telephone companies and therefore it did not charge fees to the fund to cover the costs of administration. This decision led the PSC to rely on its limited staff to administer the USF. In retrospect, it is evident that, at least in some respects, the PSC lacked the equipment, training, and resources to administer the USF.

Many of the shortcomings in the administration of the USF identified by the LAC occurred because the PSC did not have adequate resources and staff to administer the fund. The PSC has already identified these deficiencies and has taken steps to correct them. For instance, the PSC recognized that inadequate follow up information was obtained from participating companies during much of the time relevant to this audit; therefore it began gathering this information from companies in July of 2004.

The PSC also agrees that its computer software was not adequate for the administration of the USF, and that the agency had inadequate billing capabilities and procedures. As noted by the LAC, the PSC sought to address the problem by developing an in-house database billing program in 2003, but that program proved to have flaws as well. In February of 2004, the General Assembly enacted legislation which transferred the USF and Interim LEC Fund to the newly created Office of Regulatory Staff ("ORS"), and that agency is implementing its own accounting and billing procedures. The PSC staff has been working with ORS to accomplish an efficient transfer of the funds to ORS.

Furthermore, the PSC agrees with the LAC's finding that the USF should have regular independent financial audits. The PSC would welcome an independent audit of the USF fund, and expects that such audits will be conducted in the future.

As noted above, the PSC is reviewing its administrative guidelines for the USF and Interim LEC Fund, and it will amend them in the near future, in order to implement the changes brought about by recent legislation. As part of this process, the PSC will also address the LAC's findings that various aspects of the current guidelines are inadequate.

CONCLUSION

In its oversight role, the PSC will work diligently to ensure the administration of the USF and the Interim LEC Fund in whatever form the General Assembly deems appropriate. The PSC will continue to work with ORS to ensure that the funds are administered in an efficient and professional manner.

With kind regards, I am,

Sincerely yours,

Randy Mitchell
Chairman

February 17, 2005

Mr. George L. Schroeder, Director
Legislative Audit Council
1331 Elmwood Avenue, Suite 315
Columbia, SC 29201

Dear Mr. Schroeder,

Thank you for the opportunity to respond to the Legislative Audit Council's report on the South Carolina Universal Service Fund. As the new administrators of the fund, we appreciate the insight this document provides relative to improvements that can be made in the operation of the fund. The attached document contains our responses to the recommendations that concern the Office of Regulatory Staff.

Once again, thank you for the opportunity to respond to this report. If you have any questions, please do not hesitate to contact me.

Sincerely,

C. Dukes Scott
Executive Director

Attachment.

Office of Regulatory Staff
Response to Recommendations made by
The Legislative Audit Council
Regarding
A Review of the
South Carolina Universal Service Fund

The following is the Office of Regulatory Staff's response to the recommendations made by the Legislative Audit Council pertaining to the Office of Regulatory Staff.

Recommendation 3: The Public Service Commission should require telephone companies seeking additional funding from the state universal service fund to file with the Office of Regulatory Staff detailed cost studies to show the need for USF support.
ORS Response: The Office of Regulatory Staff will review these cost studies and present to the Public Service Commission its findings in order that the PSC can make a final determination as to the size of the fund.

Recommendation 8: The Office of Regulatory Staff should enforce the yearly data requirements to ensure that companies provide current and relevant information necessary to administer the state universal service fund.
ORS Response: ORS concurs with this recommendation.

Recommendation 9: The Office of Regulatory Staff should implement procedures to update the low-income assistance component of the universal service fund.
ORS Response: ORS concurs with this recommendation. ORS has developed a plan, contingent on funding, to provide outreach to those citizens eligible for the Lifeline program and to certify eligible participants in the program. This plan has been approved by the Regulation of Public Utilities Review Committee and an application for funding has been made to the Public Service Commission.

Recommendation 10: The Office of Regulatory Staff should regularly monitor company earnings to determine whether subsidies paid by consumers are necessary.
ORS Response: Under the current structure, the USF is not driven by earnings, it is driven by revenue.

Recommendation 11: The Office of Regulatory Staff should ensure that annual audits of the state universal service fund are done by an independent third party as required by the guidelines and administrative procedures adopted by the Public Service Commission.
ORS Response: The ORS concurs with this recommendation. ORS has been in contact with the State Auditor's Office in order to secure the services of an independent third party auditor. A scope of work has been developed and staff is quickly pursuing the development of a Request for Proposals.

Recommendation 12: The Office of Regulatory Staff should supplement the "USF Guidelines and Administrative Procedures" adopted by the Public Service Commission with adequate written internal policies and procedures to assist in the daily administration of the fund.
ORS Response: The ORS concurs with this recommendation and will develop the necessary written internal policies and procedures to administer the fund.

Recommendation 13: The Office of Regulatory Staff should implement a system of auditing the self-reported data from participant companies in order to ensure accurate reporting by the companies.
ORS Response: The ORS concurs with this recommendation and will establish a process by which company information will be audited on a systematic basis.

Recommendation 14: The Office of Regulatory Staff should develop an appropriate billing program which will encompass a necessary billing applications including calculating late payment charges and generating late payment reports.
ORS Response: The ORS is exploring the use of the GAFRS accounting system to handle the financial management of the fund. GAFRS does not currently have the ability to incorporate late charges and penalties; however, ORS is working with the Budget and Control Board's Chief Information Officer to add this feature.

Recommendation 15: The Office of Regulatory Staff should develop a system of verification of the calculations made and the data used in the administration of the state universal service fund.
ORS Response: The ORS concurs with this recommendation.

Recommendation 16: The Office of Regulatory Staff should ensure that auditors who review USF contributions and distributions do not have managerial responsibilities for the fund.
ORS Response: The ORS is dividing responsibility for the fund among three distinct groups in the staff. The Accounting staff will manage the accounts billing and payment process. The Auditing staff will be responsible for auditing the financial information submitted by the companies. The Telecommunications staff will be responsible for overall fund management and all technical issues.

Recommendation 17: The Office of Regulatory Staff should investigate the costs and benefits of hiring an experienced fund administrator to properly administer the state USF.
ORS Response: The ORS will investigate the possibility of hiring an external fund administrator. However, before a decision to outsource this function is made, a cost/benefit analysis will be conducted.

Recommendation 18: The Office of Regulatory Staff should use the resources of the USF to cover the cost of administration.
ORS Response: The ORS generally concurs with this recommendation as to the costs incurred in the administration of the fund which are not included in ORS' operating budget for which the telephone utilities have been assessed.