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Rural Telecom Operators Take on Risks for Their Communities, But for How Long?

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Inside...

- Introduction* 1
- Keeping Americans Connected* 1
- Financial Risks*..... 2
- Funding Still Lacking*..... 3
- Conclusion* 5

Key Points:

- Rural telecommunication operators are taking on business and financial risks to ensure their communities remain connected during the COVID-19 pandemic.
- Many are providing free service and setting up free Wi-Fi hot spots, exposing them to cash flow risks.
- COVID-19 has exposed the vulnerability of the unserved in rural America as remote learning and working from home become the norm.
- Because of these vulnerabilities, rural communities have an increased sense of urgency to bridge the digital divide.
- The current Universal Service Fund (USF) architecture, intended to help fund the bridge, may not be a sustainable model. New sources of revenue, such as applying fees to broadband services, may be a solution.

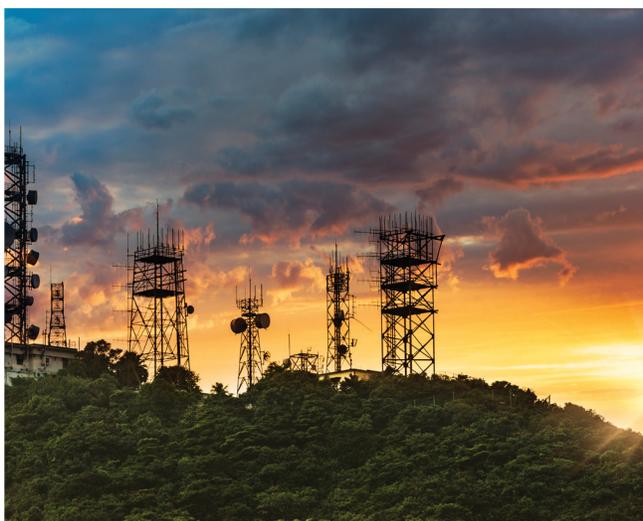
Introduction

COVID-19 is wreaking havoc on all Americans but has clearly exposed the vulnerability of the underserved and unserved. It has also shown the commitment of rural communication providers to their communities. Numerous rural operators are going above and beyond to keep their communities connected. However, in doing so, these operators are taking on increased cash flow risks which could impact their ability to expand network coverage.

For those who lack broadband access, the sense of urgency to bridge the digital divide is palpable. Universal Service Fund (USF) contribution reform may have a material impact in preparing rural America for any similar occurrence.

Keeping Americans Connected

Many rural operators have signed the FCC’s Keep Americans Connected Pledge, which says for 60 days they will not cancel service for anyone who cannot pay their bill, will waive late fees for late payments, and will make their Wi-Fi hot spots available to anyone who needs them. The pledge, initially set to expire in mid-May, has been extended through June 30, 2020.



Supporting remote learning has been a top priority. For example, immediately after the stay-at-home orders were issued, Nex-Tech, based in Kansas, proactively reached out to school districts to locate students who didn't have internet access. They contacted every household the districts identified and provisioned them for service free of charge through the end of the school year. And for the unserved, operators set up large Wi-Fi hot spots in public areas like fairgrounds and parking lots where students could access the internet free of charge from their car. These include New York-based DFT Communications, Eastern Oregon Telecom, and Totah Communications, based in Kansas and Oklahoma, to name a few. These examples, and others, show how rural service providers are helping their communities stay connected.

On the enterprise side, Gorge Networks in eastern Oregon set up a 50-seat call center in three days to support a makeshift central command center in Wasco and Sherman County. Normally, such a setup would take 14-45 days to order equipment and add licenses, but Gorge was able to repurpose existing equipment and licenses to accommodate the request in record time.

Rural operators are also helping their communities in ways they never envisioned. For example, DFT Communications has promoted local restaurants on its website and Facebook page, making sure residents know they are open for takeout. Nex-Tech even helped a local healthcare institution by helping it write a grant

proposal. These examples demonstrate how ingrained rural operators are in the social and economic fabric of their communities.

Financial Risks

It's one thing for a large company like Comcast or AT&T to live up to the Keep Americans Connected Pledge, it's an entirely different story for small rural operators. These concessions and sacrifices will bear significant financial risks for small rural operators if the pandemic lingers for an extended period. For example, giving away free service to those who can't pay their bill because of COVID-19 introduces the risk that nonpayers could include those who can pay their bill but choose not to over fears about future household cash flow.

We're seeing this type of behavior in the mortgage market where forbearance claims are trending much higher than officials initially projected. The mortgage forbearance program, like the Keep Americans Connected Pledge, does not require proof of hardship. When the mortgage forbearance program was introduced in the CARES Act, the Federal Housing Finance Agency projected that 2 million mortgages would be in forbearance at the end of April. As of April 30 more than 3.8 million homeowners were in forbearance, according to Black Knight, a mortgage data and analytics firm. So, either unemployment assumptions by the Federal Housing Finance Agency were too conservative or employed borrowers are opting to skip payments to conserve cash. A similar market response is expected to occur for broadband providers.

The extension of credit to enterprises adds another level of risk for rural operators should their customer companies shut down. Not only will the operators lose the money owed to them by the failed enterprises, but the economic fallout will also be felt by employees of these companies and hamper their ability to pay outstanding debts.

All of these cash flow and bad debt risks could impact rural operators' ability to invest in their networks and bridge the digital divide. Many network builds have been on hold during the pandemic, but these build delays could linger if lost cash flows are not replaced.

EXHIBIT 1: \$115B Needed to Bridge the Digital Divide

Given current circumstances, this may be an opportune time to implement long-term structural changes that will help ensure operators in rural America have the support required to bridge the digital divide, and prevent the chaos pandemics like COVID-19 wreak on the underserved and unserved. There is hope that Congress will pass stimulus legislation to support rural operators. However, several industries are looking for support so there is no guarantee that rural telecom operators will get everything they are asking for.

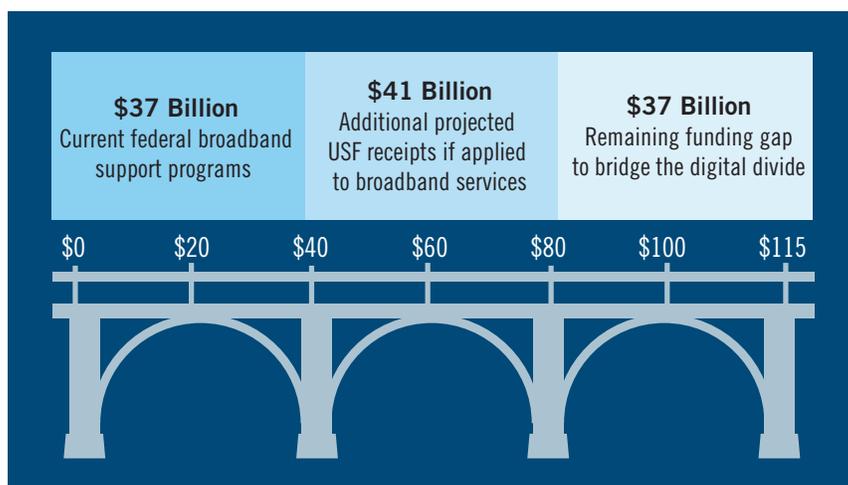
Funding Still Lacking

COVID-19 and the associated stay-at-home orders have exposed the vulnerability of those without broadband access. While rural operators are going to great lengths to connect the underserved and unserved through the crisis, more must be done – especially as leading infectious disease experts say we'll be dealing with COVID-19 for a while.

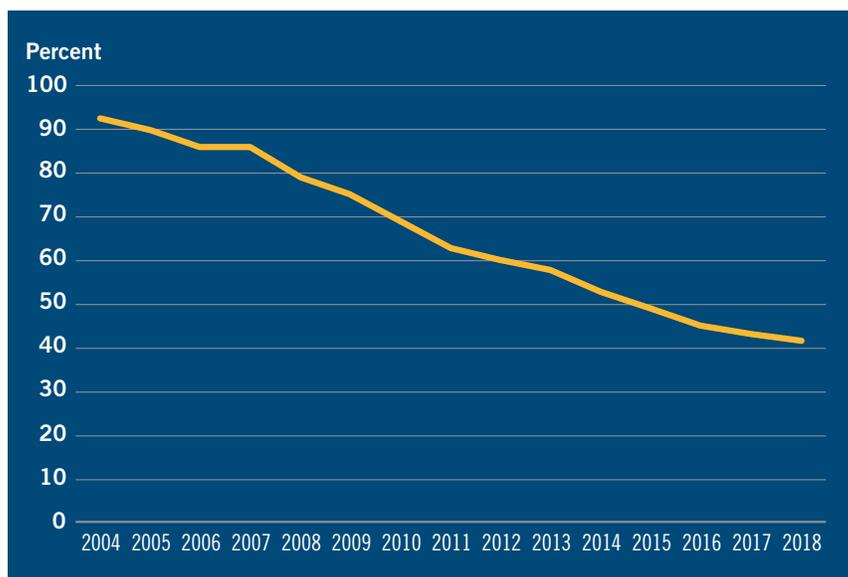
At the federal level, a number of government programs help build and maintain rural broadband networks. These programs total approximately \$37 billion that will be distributed over the next 10 years. The FCC has estimated it would cost \$80 billion to bridge the digital divide. Land O' Lakes CEO Beth Ford, who is championing efforts to bridge the divide, believes the number is closer to \$150 billion.

The FCC's estimate is arguably too low given its flawed methodology for estimating the number of unserved and underserved Americans. For example, in May 2019 the FCC said that 93.7% of Americans had broadband access, leaving only 21.3 million Americans without it. But

when researchers at Broadband Now manually checked broadband availability, they found that almost twice that number of Americans lacked broadband access. In reality, the actual number is probably somewhere in between. Also, the FCC's \$80 billion estimate likely includes a mix of fiber and fixed wireless as they have taken a technology agnostic approach to bridging the divide.



Source: CoBank estimates

EXHIBIT 2: Percent of Households With a Landline Phone

Source: Statista; CDC



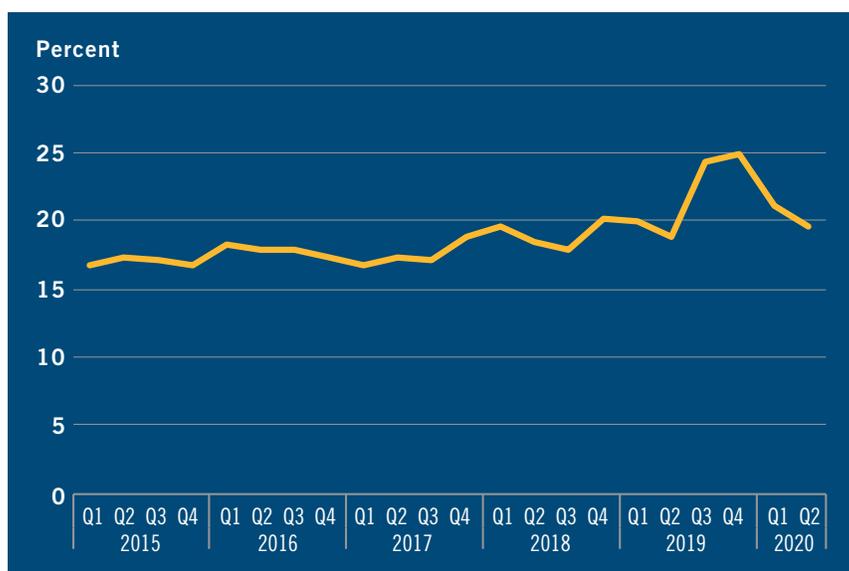
EXHIBIT 3: USF Rates

The Land O'Lakes estimate might be on the high end of what it would cost as it appears to suggest an all fiber, or a fiber heavy approach. Fiber is more costly to deploy in sparsely populated areas versus fixed wireless. So, if we take the midpoint of the range, it would peg the cost at \$115 billion.

With just \$37 billion coming from current federal programs, the real funding gap is \$78 billion (*Exhibit 1*).

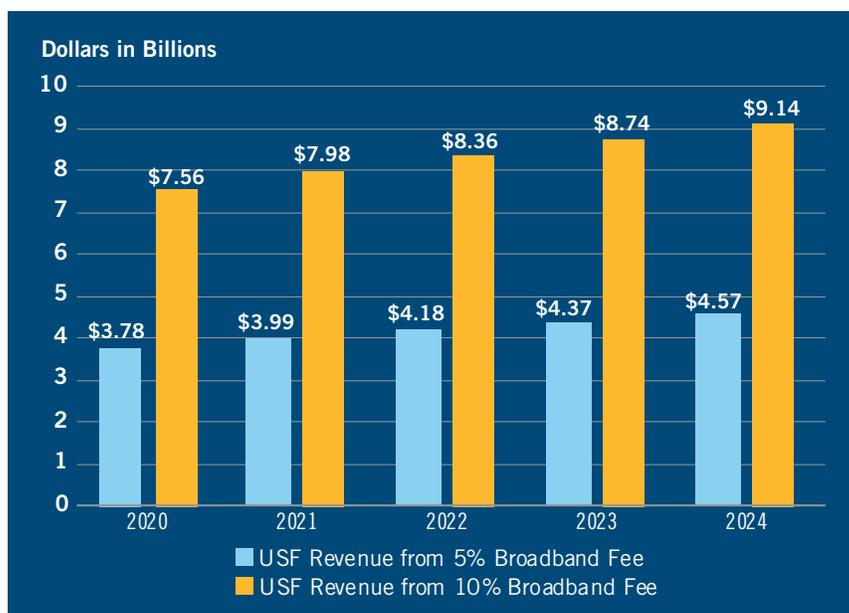
One of the ways to bridge this funding gap is via contribution reform. Today the \$37 billion in federal programs is partially funded by the Universal Service Fund (USF). The USF gets its money from fees applied to telecom services, which is problematic. Given the decrease in landline subscriptions (*Exhibit 2*) the pool of money the USF fees are charged against is shrinking. To compensate, USF fee rates have been increasing (*Exhibit 3*). Over time, this appears to be an unsustainable model.

One solution is to apply USF fees against broadband bills as well as voice service. For example, a 5% USF charge applied to broadband bills would increase USF receipts by over 44%. A 10% USF charge on broadband would almost double USF receipts, bringing in an additional \$41 billion over the next 5 years (*Exhibit 4*). This additional revenue from broadband fees would cover over one-third of the \$115 billion needed to bring high-speed broadband to most of rural America and bridge the digital divide.



Source: AT Conference

EXHIBIT 4: Projected Additional USF Revenue from Fees on Broadband



Source: S&P Market Intelligence; CoBank estimates

Based on broadband annual revenue forecasts of \$75.60B in 2020; \$79.79B in 2021; \$83.60B in 2022; \$87.44B in 2023; and \$91.41B in 2024.

Conclusion

Rural operators are supporting their fellow rural Americans in innovative ways during the COVID-19 pandemic. But the sacrifices being made by these companies come at a cost and have a finite lifetime. COVID-19 has demonstrated that reliable broadband is critical and exposed the vulnerability of those living in rural America without broadband access. Setting up hot spots for school children to use while in the parking lot of a fairground is admirable, but this is not a sustainable model for rural operators or the community – and neither is the USF funding mechanism that only levies fees against telecom bills. Contribution reform that includes applying fees to broadband bills could stabilize the USF program and ensure that more money is available to help bridge the digital divide. ■

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