

**UNIVERSAL SERVICE: WHAT ARE
WE SUBSIDIZING AND WHY?
PART 1: THE HIGH-COST FUND**

HEARING
BEFORE THE
SUBCOMMITTEE ON TELECOMMUNICATIONS
AND THE INTERNET
OF THE
COMMITTEE ON ENERGY AND
COMMERCE
HOUSE OF REPRESENTATIVES

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CONTENTS

	Page
Testimony of:	
Marron, Dr. Donald B., Acting Director, Congressional Budget Office.....	18
Navin, Tom, Chief, Wireline Competition Bureau, Federal Communications Commission.....	32
Clark, Tony, President, North Dakota Public Service Commission, on behalf of National Association of Regulatory Utility Commissioners	39
Frantz, Skip, Chairman, United States Telecom Association.....	44
Cimerman, Richard, Vice President, State Government Affairs, National Cable and Telecommunications Association	49
Crothers, David, Executive Vice President, North Dakota Association of Telephone Cooperatives, on behalf of National Telecommunications Cooperative Association...	54
Garnett, Paul, Director, Regulatory Affairs, CTIA – The Wireless Association	58
Pies, Staci, Vice President, PointOne Communications, on behalf of Voice on the Net (VON) Coalition.....	65
Feiss, Geoff, General Manager, Montana Telecommunications Association.....	72
Cooper, Dr. Mark, Director of Research, Consumer Federation of America	81
Additional material submitted for the record:	
Marron, Dr. Donald B., Acting Director, Congressional Budget Office, response for the record.....	109
Navin, Tom, Chief, Wireline Competition Bureau, Federal Communications Commission, response for the record.....	112
Clark, Tony, President, North Dakota Public Service Commission, on behalf of National Association of Regulatory Utility Commissioners, response for the record..	114
Frantz, Skip, Chairman, United States Telecom Association, response for the record	116
Cimerman, Richard, Vice President, State Government Affairs, National Cable and Telecommunications Association, response for the record.....	119
Crothers, David, Executive Vice President, North Dakota Association of Telephone Cooperatives, on behalf of National Telecommunications Cooperative Association, response for the record.....	122
Garnett, Paul, Director, Regulatory Affairs, CTIA – The Wireless Association, response for the record.....	128
Pies, Staci, Vice President, PointOne Communications, on behalf of Voice on the Net (VON) Coalition, response for the record.....	135
Feiss, Geoff, General Manager, Montana Telecommunications Association, response for the record	139
Cooper, Dr. Mark, Director of Research, Consumer Federation of America, response for the record	149

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WEDNESDAY, JUNE 21, 2006

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON TELECOMMUNICATIONS AND THE INTERNET,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:03 p.m., in Room 2123 of the Rayburn House Office Building, Hon. Fred Upton (Chairman) presiding.

Members present: Representatives Stearns, Gillmor, Cubin, Shimkus, Wilson, Pickering, Radanovich, Bass, Walden, Terry, Sullivan, Blackburn, Barton (ex officio), Wynn, Gonzalez, Inslee, Boucher, Stupak, and Dingell (ex officio).

Staff present: Howard Waltzman, Chief Counsel for Telecommunications; Anh Nguyen, Legislative Clerk; Jaylyn Jensen, Senior Legislative Analyst; Will Nordwind, Policy Coordinator; Johanna Shelton, Minority Counsel; David Vogel, Minority Research Assistant; and Chris Treanor, Minority Staff Assistant.

MR. UPTON. Good afternoon.

Thank you all for being prompt. We are expecting votes at about 2:30, so I am hoping that we can finish the Members' opening statements and get into our large panel's opening statements, or at least get into them before we have the votes. And then it is my understanding that these will be the last votes of the day, so hopefully the hearing will proceed well.

And I would like to say that with ten witnesses, I am going to be brief with my opening statement.

Today's hearing is focused on the High-Cost Program of the Universal Service Fund. The High-Cost Program makes payments to eligible local telephone companies that serve customers in rural areas where the cost of providing service comparable to that available in urban areas is substantially greater than the national average.

As a member who represents a number of rural communities in southwest Michigan, I have seen the tremendous upside of the universal service funding by way of the affordable telecommunications services

provided in those rural communities by companies like the Bloomingdale Telephone Company in Bloomingdale, Michigan.

But, as we all know, the High-Cost Program and the Universal Service Fund is paid for, in large part, by mandatory payments from all providers of interstate and international telecommunication services, and those providers pass those costs on to their consumers, all of our constituents.

Today, we will hear from CBO about its recent report which highlights that outlays and receipts flowing through USF have grown substantially in recent years. The CBO suggests that disbursements for the High-Cost Program have doubled since 2000, from \$1.9 billion to \$3.8 billion. CBO estimates that such spending could continue to increase rapidly depending upon legislative and regulatory decisions. To the extent that all of this cost gets passed along to the consumer--that is a grave warning sign that we can no longer ignore as legislative and regulatory decisions get made here in Washington, D.C.

This is the first, and perhaps, not the last hearing which the subcommittee will hold on the Universal Fund. I look forward to hearing from today's witnesses, and I thank them for their participation, particularly in sending their statements up last night so we could take them home.

And I would yield, at this point, to the gentleman from Virginia, Mr. Boucher, for an opening statement.

[The prepared statement of Hon. Fred Upton follows:]

THE PREPARED STATEMENT OF THE HON. FRED UPTON, CHAIRMAN, SUBCOMMITTEE ON
TELECOMMUNICATIONS AND THE INTERNET

With 10 witnesses, I will be brief with my opening statement. Today's hearing is focused on the High Cost Program of the Universal Service Fund. The High Cost Program makes payments to eligible local telephone companies that serve customers in rural areas where the cost of providing service comparable to that available in urban areas is substantially greater than the national average.

As a Member who represents a number of rural communities, I have seen the tremendous upside of Universal Service funding by way of the affordable telecommunications services provided in those rural communities by companies like the Bloomingdale Telephone Company.

But, as we all know, the High Cost Program of the Universal Service Fund is paid for, in large part, by mandatory payments from all providers of interstate and international telecommunications services, and those providers pass these costs on to their customers - all of our constituents.

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This is the first, and not the last, hearing which the Subcommittee will hold on the Universal Fund. I look forward to hearing from today's witnesses, and I thank them for their participation.

MR. BOUCHER. Well, thank you very much, Mr. Chairman. I appreciate your scheduling this very important hearing on a subject on which it is my hope that the Congress will act before the end of this year.

Universal service support is more needed now than ever before. In an era when electronic communications are at the heart of the national economy, it is more essential than ever before that all Americans remain connected. Affordable telephone service not only benefits the individual users of the service, but at a time when electronic commerce is central to national economic growth, affordable telephone service for all is essential for our national economic success. And so all of us, urban, suburban, and rural residents alike, have a stake in assuring that everyone can afford basic telephone service.

Now the importance of affordable rural service has increased. The Universal Service Fund that assures it has come under increasing pressure, and reform of that fund across a broad basis is now necessary. New technologies and new business plans are combining to diminish the long-distance revenues that have been relied upon historically for the Universal Service Fund's support. In reforming the Universal Service Fund, other funding sources must now be tapped and new controls must be placed on distributions from the fund.

In an effort to achieve these goals in a manner that is fair to both the rural telephone companies who are the major beneficiaries of Universal Service Fund financing and to the large regional telephone companies who are the net contributors into the fund, my colleague from Nebraska, Mr. Terry, and I have engaged in a long consultative process with dozens of interested parties and have introduced, following that long series of conversations, H.R. 5072, which we believe reflects a consensus among the various competing interests. No one will agree with all of the bill's many provisions, but most will agree that it meets the principal needs of virtually all of the parties. For those who are looking for a middle line between the Bell companies and the rural carriers, H.R. 5072 occupies that middle ground. For those who seek a sensible modernization of the Universal Service Fund to account for the dramatic changes that have transformed telecommunications during the past decade, we offer H.R. 5072 for your consideration.

It will promote broadband deployment, helping to lift our Nation's currently unenviable international ranking. It expands the revenue base to Voice over Internet Protocol, to a connection to the Internet and to, for the first time, intrastate revenues. But it also imposes strict limitations on Universal Service Fund growth, assuring that the only growth is in

accordance with an inflationary growth factor. We fixed the phantom traffic problem. We make rural exchanges more marketable for telephone companies who may desire to sell them. And we base payments from the fund on the carrier's actual cost, rather than upon the cost of the incumbent telecommunications provider in that region, which inevitably will be higher than those of the new entrant.

I would like to thank Mr. Terry for his excellent work in the partnership that we have embarked upon to reform universal service, and I hope that members will consider our bill as the subcommittee looks for practical answers to the challenges that we currently face.

Thank you, Mr. Chairman.

MR. UPTON. Mr. Gillmor.

MR. GILLMOR. Thank you, Mr. Chairman.

And I am glad to see that we are moving forward on looking into this important subject. Over the last several months, the debate over the Universal Service Fund has greatly intensified, and many different reform proposals have been proposed. And I am in agreement with those that say the system needs to be fixed; however, it is more difficult to say exactly what reforms are best to employ in order to assure that districts like my rural northwest Ohio district, receive the best telecommunication service possible.

These funds are an important part in helping rural Americans gain access to mainstream telecommunication services that they might otherwise not have due to the high costs associated with reaching these areas of the country.

Additionally, the USF funding is an important part in spurring economic development in rural areas, especially in the global economy that is relying on telecommunications technology to rapidly share information to meet consumer demands. Just as the telecommunications industry continues to evolve, so too should the Universal Service Fund. And before measures are discussed and debated, it would be wise to take into account the fact that traditional telephony service is becoming less and less the service of choice. As Americans continue to migrate to more advanced telecommunication services, we need to take a hard look at the stated function of the USF and if it still serves its intended purpose or if we have to adapt it to meet future telecommunication needs and technologies. Access to advanced telecommunication services is a key component to a strong economy to the effect of sharing of ideas and increased access to essential information.

I look forward to legislation to assure that the telecommunication needs of rural America are met in order to prevent the divide from rapidly increasing, and I appreciate all of the expert knowledge and testimony that we have before the subcommittee.

Thank you, Mr. Chairman.

MR. UPTON. Thank you.

Mr. Dingell.

MR. DINGELL. I thank the Chairman for this series of hearings.

This committee has a vital responsibility to ensure that proper implementation and ongoing integrity and sustainability are there for Universal Service Programs. Providing high quality telecommunication services affordable for all Americans, regardless of geographic differences or income, has long been a cornerstone of our Nation's telecommunications policies. But universal service imposes a significant and growing cost on consumers and also on the economy. It has grown by 50 percent in the past 5 years and now exceeds \$7 billion. The main source of growth is the High-Cost Program, which we are examining today.

Much has changed in the telecommunications landscape since 1996. The revenue, subject to universal service fees has declined. This has caused the assessment on consumer bills to rise from less than 6 percent in 2000 to more than 10 percent now. Indeed, the Federal Communication Commission's, FCC's, decision that could drop telephone broadband revenue out of the funding pool in August leaves consumers paying more or at least looking at the prospect of doing so.

Given the increasing consumer costs, we are appropriately focusing on ways to restructure and to improve the program. There are a number of questions that we need to focus on, and amongst them, Mr. Chairman, first, who should contribute to the Universal Service Fund? All companies who offer telephone services, whether over the Internet or through a traditional network should carry the same obligation to support universal service. The FCC took an interim step this morning to broaden the base by requiring VoIP providers to pay and raising the safe harbor for wireless carriers.

But let me be clear. Even with the debate over the proper percentages, the FCC has done only the easy part. The true test will be whether the FCC could muster the will to require questions amongst industry participants who have benefited handsomely, and to do so without finding consumers' pockets easy prey.

Second, who should be subject to the Universal Service Fund and who should be subsidized by it? The hefty increase in the High-Cost Fund is attributable to the competitive eligible telecommunications carriers, typically wireless companies. Federal and State regulators have grappled with the proper mechanisms and the eligibility requirements to fund carriers who enter rural areas to compete against incumbent providers.

With multiple providers, how can we ensure that the program is properly disciplined or that the monies are properly spent? With different technologies, how can we guarantee that providers offer the service quality and the coverage that the American public should expect of those it is funding? Another important question is whether to subsidize broadband service. Broadband networks are integral to a company's economic development. But funding broadband would represent a massive new commitment of resources, and we are not sure whether those resources are or can be made available there. Can the program support broadband without skyrocketing consumer contributions or jeopardizing the affordability of basic telephone services for rural or working poor Americans?

Third, how can we best protect the integrity of the High-Cost Fund? As with other Universal Service Programs, the High-Cost Fund must be rooted in rigorous accountability. We have seen clear examples of abuse and goal-cutting of businesses across rural American. To remain worthy of the taxpayers' trust, universal service expenditures must have tough accountability measures, including regular audits, detailed reporting requirements, and other things showing that the American public is having their support used for its proper and intended purposes. Universal telecommunication service has been fundamental to this country's economic and social development and growth. It will be equally important in the coming decades.

Again, Mr. Chairman, I thank you for this hearing today. I thank the witnesses for their testimony. And I hope we will get to some answers to the questions that concern me in this committee.

Thank you, Mr. Chairman.

MR. UPTON. Mr. Barton.

CHAIRMAN BARTON. Thank you, Mr. Chairman, for holding this very important hearing. I have looked forward to this for several months now, and I am glad that we have our expert panel of witnesses here today.

The Universal Service Fund, as we know it today, consumes more than \$7 billion, "b," as in boy. In 1996, when we passed the Telecommunications Act, that same fund spent less than \$1 billion, so it has grown 7,000 percent, or something seeming like that, in the last 10 years.

In just one aspect of the program, the E-Rate Program, we have held numerous hearings in this committee and our Oversight and Investigations Subcommittee where they detailed the waste, fraud, and abuse of that particular party, the Universal Service Fund, and that is only a \$2 billion program. The E-Rate Program is probably the one program in Universal Service that is in most need of reform, but it is not the only one.

The High-Cost Fund has swollen considerably since the passage of the 1996 Telecommunications Act. In 1998, the fund distributed approximately \$1.5 billion. This year, it is expected to distribute \$4.2 billion, and that is almost a \$3 billion increase in less than 8 years. We are probably going to hear from the Congressional Budget Office today that that particular fund is in jeopardy of growing even larger unless effective reforms are put into place.

More importantly, reforms are necessary to rein in the High-Cost Fund. In my opinion, only one connection per household or business should be eligible for Universal Service Fund support. There is no reason that telephone users who pay into the fund should have to subsidize extra phone lines in the house or a mobile phone in addition to a wireline connection.

Second, communications providers should receive support, if at all, based upon the cost of the lowest cost provider of telephone service in a particular area. Wireless carriers should receive universal service support, but they should do so based on the cost of putting up towers in rural areas and getting connections back, not based on the cost to the existing wireline provider who has no incentive to control their costs. There is a perverse incentive today that exists in the High-Cost Program in which wireless carriers gets as much money as the wireline carriers to provide telephone service, even though their cost of service is considerably less.

In my opinion, this policy should be reversed. No provider should receive more support than what is necessary for the lowest-cost provider in an area to provide basic, voice-grade service. This should be about making certain that anyone in rural America can have at least one telephone. It shouldn't be about making sure that they have a gold-plated system and multiple subsidies on that one system. It is not about providing every house with cell phones, computer hookups, and the opportunity to chat on two or three lines at once.

What has occurred in the High-Cost Fund is unacceptable, unsustainable, and unnecessary. With the right reforms, that particular program could be brought under control. This would ensure that the program can continue to do what it is supposed to do: provide people in rural areas with affordable voice-grade telephone service over one telephone line.

I look forward to working with the Chairman and the rest of my colleagues to determine the best way to reform this program.

Before I yield back, Mr. Chairman, let me give you some examples from my State of Texas. Sometimes I am accused that I don't pick on the hometown team too much, so I asked the staff to research Universal Service Funds in Texas.

Let me give you some examples.

Big Bend, Texas. Big Bend is out in West Texas. It is in Alpine, Texas. One of my former football players from Waco High School has a ranch out there. Big Bend Telephone has 6,000 customers. Last year, Big Bend Telephone Company, with 6,000 customers, got \$9.6 million in Federal Universal Service Funds, \$3.3 million in State Universal Service Funds, and \$18 million in access fees. That is \$28 million dollars. Less than 5 percent of their revenue came from the local 6,000 subscribers. That utility posted a 12.8 percent return on equity last year. It paid its shareholders a \$3 million dividend. That is a pretty good dividend. However, in 2002, it shelled out \$13 million in dividends that also runs a hunting ranch to entertain rural phone lobbyists at the cost of \$80,000 a year.

That is in West Texas. Let us go up to the panhandle of Texas where we have XIT, a rural telephone cooperative. It serves 1,500 ranchers, farmers, and others in the Texas panhandle. And I am sure it does an excellent job. It did so well last year that it paid back in dividends more than the cost it charged its phone subscribers. And it got by on only \$2.6 million in Federal subsidies last year.

I could go down to Houston, Texas. There is a subdivision out near Katy, Texas, which is one of the most affluent areas of West Houston. The subdivision set up its own telephone company so that they qualify for rural telephone subsidies in a high-cost area. These are homes that go between \$250,000 and \$1 million, and they have their own cooperative there. They are getting huge Federal and State subsidies. That is in my home State. Now I am not saying that we shouldn't have some Universal Service Fund, but the current system is game-able. It is not fair. It is out of date. If we can't kill it, we ought to really, really work together on a bipartisan basis to seriously reform it.

With that, Mr. Chairman, I yield back.

[The prepared statement of Hon. Joe Barton follows:]

THE PREPARED STATEMENT OF THE HON. JOE BARTON, CHAIRMAN, COMMITTEE ON
ENERGY AND COMMERCE

Mr. Chairman, thank you for holding this hearing today. The federal universal service support system now consumes more than \$7 billion. This system is bloated, it is growing, and it is not sustainable.

The Energy and Commerce Committee has held multiple hearings on the waste, fraud, and abuse that permeate the \$2.25 billion e-rate program, which is part of the federal universal service support system. While the e-rate program is also in need of reform, today's hearing will focus on the federal high-cost fund.

The high-cost fund has swollen considerably since the passage of the 1996 Telecommunications Act. In 1998, the fund distributed approximately \$1.5 billion. In 2006, the fund is projected to distribute \$4.2 billion. As we will hear from the

Congressional Budget Office today, the high-cost fund is in jeopardy of growing even larger unless effective reforms are put in place.

There are important reforms that are necessary to rein in the high-cost fund. First, only one connection per household or business should be eligible for support. There is no reason that the telephone users who pay into the fund should have to subsidize extra phone lines in the house or a mobile phone in addition to a wireline connection.

Second, communications providers should receive support, if at all, based upon the costs of the lowest-cost provider of telephone service in a particular area. Wireless carriers should receive universal service support. But they should do so based on the costs of putting up towers in rural areas and getting connections back to the local loop. There is a perverse incentive that exists today in the high-cost program in which wireless carriers get as much money as wireline carriers to provide telephone service in a rural area.

This policy should be reversed. No provider should receive more support than what is necessary for the lowest-cost provider in an area to provide basic, voice-grade service. This is about making certain that anyone in rural America can call the doctor when they're sick. It's not about providing every house with cell phones, computer hookups, and the opportunity to chat on two or three lines at once.

The growth that has occurred in the high-cost fund is unacceptable, unsustainable, and unnecessary. With the right reforms, the program can be brought under control. This would ensure that the program can continue to do what it is supposed to do: provide people in rural areas with affordable voice-grade telephone service.

I look forward to working with the Chairman and the rest of my colleagues to determine the best way to reform the universal service system. I yield back.

MR. UPTON. Mr. Wynn.

MR. WYNN. I waive my opening.

MR. UPTON. Mr. Gonzalez.

MR. GONZALEZ. I waive opening.

MR. UPTON. Mr. Terry.

MR. TERRY. Thank you, Mr. Chairman.

I appreciate you holding today's hearing on the Universal Service Fund. I especially appreciate that you have limited it to one panel. I just hope that we have more members than panelists today.

But for our full committee Chairman, my friend, Mr. Barton, let me just say, that as you outlined through your opening statement, you actually gave me room to be enthusiastic about our bill for the first time, because many of the reforms that you suggest by principle are actually part of the bill that Mr. Boucher and I have been working on. And I will also just state that I have talked with probably literally 100 different rural telephone companies, and I have yet to run across one example as egregious as that in West Texas, in the Texas panhandle, so perhaps it is just a Texas thing.

Sorry, Mr. Chairman.

But certainly, none of us would agree, on the surface of the report that Mr. Barton wrote, that we would, in any way agree with that: shareholders getting millions of dollars back in their dividends. I would

say that that is the rare exception, but certainly one that we should look at reforming.

But let us talk about this in the general sense, and in today's economy, geographic boundaries for business are limitless. A smart business owner in western Nebraska can do business with a person across town as easily as doing business with someone in Kalamazoo, Michigan or India. The only obstacle preventing them from opening new markets is the lack of broadband access.

Broadband is as important today as the rail lines and roads through the western half of America from the 1800s to 1950s that opened up commerce. A failure to deliver broadband to rural America is like holding out the promise of opportunities for economic growth and prosperity but instead denying them the ability to succeed. As elected officials, we have the public duty to make sure that all of our constituents are given every tool to participate and succeed in this 21st Century global economy.

The Universal Service Fund is the answer to ensuring that broadband is delivered to rural America. USF has provided universal telephone service to all Americans in all the corners of our Nation for the past 80 years. Now it is time to revisit that program and modernize it for the 21st Century.

My bill, or what is H.R. 5072, the Universal Service Reform Act of 2006, which I think has been more eloquently dubbed the Terry-Boucher bill, which we introduced, does not discriminate against platforms that makes broadband an eventual requirement for receiving USF monies. In addition, this bill demonstrates the fiscal constraint mentioned by our good chairman by capping the fund to not exceed the current level. This bill has been carefully vetted with the industry for well over a year. Mr. Boucher and I have worked very hard to take all interested parties' comments into consideration. Much of the feedback has been incorporated into this final version.

I am also pleased that Chairman Stevens has used H.R. 5072 as the base for his USF legislation in the Senate rewrite bill now being considered by the Senate Commerce Committee this week. It is my hope that the committee will also act promptly on H.R. 5072.

I look forward to hearing from today's witnesses and want to especially thank our Chairman, Mr. Upton, for moving this process forward.

MR. UPTON. Thank you.

Mr. Stearns.

MR. STEARNS. Thank you, Mr. Chairman.

There are ten witnesses here, and I hope to hear a lot of information this afternoon.

You know, in light of this program not being sustainable, and I think we all realize that this is not a program that is costing the taxpayers, so to speak, in terms of us voting on it. It does not increase the Federal budget deficit, but it imposes costs on consumers, on the economy. It creates rising charges to telephone companies, which, in turn, are reflected to the customers, and these costs continue to go forward. And as Chairman Barton has pointed out, we have egregious examples where people are gaming the system. And the system is unsustainable in terms of its funds, so the question is what are we going to do. And that is why we are having this hearing.

In light of the recent FCC actions, they adopted two modifications to assessing contributions which are going to make more costs. First of all, the Commission raised existing wireless safe harbor percentage from 28.5 percent to 37.1 percent. The second, the Commission expanded the base of the Universal Service Fund by extending universal service contribution obligations to providers of interconnected VoIP service. Now here we have VoIP providers that are now going to be involved. Their safe harbor percentage of interstate revenue is at 65 percent of total VoIP service revenue. So this is a program that is going to cost the consumers more money, whether they are going to be through the Internet or not.

And we all know what the universal service originally was designed for: to establish and help the people in the rural areas that were difficult to get these services so that people who were providing it would go into those areas. There would be some incentives. But again, over the years, this has just continued to get more and more expensive, and now it is no longer sustainable.

You know, I have partial rural Florida, north central Florida in my district, and I am sensitive to this, but we need to examine, frankly, how this service is currently defined, how the policies are funded, who should receive the funding. Again, go back and look at it to ensure our proper management and oversight of the fund. The FCC has taken these two actions. We need to understand the ramifications of those.

So I think, Mr. Chairman, it is appropriate that we have this hearing. And I commend you for having it.

Thank you.

MR. UPTON. Thank you.

Mrs. Blackburn.

MRS. BLACKBURN. Thank you, Mr. Chairman.

I did want to thank you for holding the hearing today and allowing us the opportunity to look at the USF, and I thank our witnesses for being with us.

You know, I have heard from a lot of the stakeholders in this situation. Our rural providers are telling me about the necessity for a fund. They want more of it for enhanced services and broadband. Our wireless service providers believe that they contribute far more than they receive, so they want to be able to access funds and enhance their wireless capabilities in underserved areas. Then I hear from consumers who want to know exactly what is the universal service line item on their telephone bill. They want to get rid of it just like they are getting rid of the excise tax. They are waiting for this to disappear. And they do not see enhanced telephone systems, enhanced telecommunications as a right. And they don't think that it is something that should be paid for in their tax dollars.

Now you will have some who want to scrap the program altogether and start over while others want to put a disbursement cap on overall expenditures and shift the funding to a numbers-based system. There are those who have asked us to even expand the contribution base. So as you can see, the people that are talking with me all have opinions, and there are more opinions to go around than there probably are solutions and ways to use this fund, but that is normal when you have got the pot of money that we have before us, and anything that grows from \$955 million annually to \$7 billion in 10 years is a big pot of money, and that is why people are fussing about it. A 633 percent increase over 10 years is pretty healthy, even by Federal government standards.

This coupled with the FCC's Office of Inspector General and the GAO reports stating the difficulty associated with auditing the program, the waste, fraud, and abuse, the mismanagement of E-Rate, as our Chairman said, I think that it could be time to stop, to do a very good inventory, to get someone to help them audit their books, and then to start over with a clean slate when it comes to this program.

So thank you for your input.

Mr. Chairman, thank you for the hearing.

[The prepared statement of Hon. Marsha Blackburn follows:]

PREPARED STATEMENT OF THE HON. MARSHA BLACKBURN, A REPRESENTATIVE IN
CONGRESS FROM THE STATE OF TENNESSEE

Mr. Chairman, I want to thank you for holding this hearing today about the future of the Universal Service Fund. I've heard from many of the stakeholders in this debate.

Our rural ILECs are telling me about the necessity of the fund.

Our wireless service providers believe they contribute far more than they receive.

Consumers want to know what exactly the Universal Service line item on their telephone bill is for.

Some want to scrap this program all together and start over, while others want to put a disbursement cap on overall expenditures and shift the funding to a numbers based system. There are those who have asked us to expand the contribution base.

I know there are concerns that the funds growth has increased from \$955 million annually to \$7 billion in ten years.

A 633% increase over ten years is pretty healthy even by federal government standards.

When I see this coupled with the FCC's Office of Inspector General and GAO reports stating the difficulty associated with auditing the program and the waste, fraud and abuse -- I think it could be time to with a clean slate when it comes to this program.

MR. UPTON. Thank you.

Mr. Shimkus.

MR. SHIMKUS. I will waive.

MR. UPTON. Mr. Sullivan. Mr. Bass.

MR. BASS. Mr. Chairman, I have a 15-minute opening statement, but in the interest of time, I will submit it for the record.

MR. UPTON. Good.

I would ask unanimous consent that all members have the right to put into the record an opening statement.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF THE HON. BARBARA CUBIN, A REPRESENTATIVE IN CONGRESS
FROM THE STATE OF WYOMING

Thank you, Mr. Chairman.

I am pleased that you have scheduled this important hearing on an issue that so directly affects my constituents. That the Universal Service Fund is facing a financial crisis is not in dispute, and neither is the need for some type of reform that would bring financial solvency back to this important program. It is the goal of this subcommittee to improve the Universal Service Program.

Improvement, however, should not mean the abandonment of the original intent of Congress regarding Universal Service -- that every American should have access to telecommunication services at reasonable prices. We have decided that the policy of universal service only serves to benefit the entire nation as a national network of telecom services is desirable for every citizen. Fundamentally altering the program to the detriment of rural communities in my home state of Wyoming and elsewhere would erode that intent.

As technologies continue to advance at a breathtaking pace, America has entered into a new era of telecommunications that includes much more than just picking up a phone attached to the kitchen wall when it rings. Communities of every size must embrace this information age to remain vibrant, and we should renew our commitment to a truly national network by ensuring universal access to these new technologies at a reasonable price. The entire nation is served by such a policy as it encourages community improvement and allows for the freedom of living in a sparsely populated state without being unduly punished with high rates or no service at all.

I look forward to hearing the opinions of the witnesses today on how best to improve the Universal Service Fund. I am particularly interested to hear any proposals offered by the advanced telecom industry about how, if they continue to receive USF dollars, they plan to ensure those funds are used to improve service to rural America. Secondly, I am interested to know what contribution level the advanced telecom industry feels is appropriate to pay into the USF.

I am hopeful that today's hearing will bring us to at least a few points of common ground so we can begin the difficult task of reforming this critical program. Again, thank

you Mr. Chairman for holding this important hearing. I yield back the balance of my time.

PREPARED STATEMENT OF THE HON. ANNA G. ESHOO, A REPRESENTATIVE IN CONGRESS
FROM THE STATE OF CALIFORNIA

Thank you Mr. Chairman for holding this hearing.

I welcome the Subcommittee embarking on an effort to examine the Universal Service Fund and look for ways to improve the program and make it more responsive to the modern telecommunications marketplace.

The questions before us are fairly simple:

1. Who should pay?
2. Who should benefit?
3. How do we assure accountability in the program?

There is a wide range of ideas about the answers to these questions, however, and I'm eager to hear from the witnesses today about their views on these issues, as well as in the weeks ahead as we hold additional hearings.

I think the key issue will be what policies we can adopt that will promote the adoption of advanced telecommunications nationwide.

This is exactly what our predecessors did in the *1934 Communications Act* when the adopted the concept of universal service and made it a priority for our country.

Their vision and their commitment helped us develop the most advanced, expansive communications infrastructure in the 20th Century.

In the 21st Century, however, we've fallen behind and the U.S. is now 16th in the world in broadband penetration.

As the country that has led the world in innovation for the past century, invented the telephone and developed the Internet, this is a sad state of affairs.

Telecommunications is the "central nervous system" of the Information Age economy, and high-speed, always-on broadband Internet communications will enable a vast array of advanced Internet applications and services including Voice over IP, video on-demand, electronic health, and distance education.

The United States' ability to deploy this advanced communications infrastructure is crucial to our future productivity and will in large part determine our ability to succeed in the global information economy.

We need to change course drastically. We have to develop policies that will keep us competitive and ensure that our telecommunications system is on the same level as our economic competitors.

Universal service policies could play a significant role in ensuring broadband access and adoption in areas that are not now being served.

I look forward to the witnesses' testimony and I'm eager to work with my colleagues on the Committee to create effective universal service policies for the 21st Century.

This now concludes the opening statements. As we all heard the many buzzers, votes have occurred, and I think, at this point, we will adjourn and come back in about 20 minutes. We have two votes. This is a 15-minute, so we will be able to vote, vote quickly on the second vote, and then come back and we will start with Dr. Marron at that point.

We stand adjourned.

[Recess.]

MR. UPTON. Just for the record, I note 13 members were here for opening statements, so we beat Mr. Terry's number of members on the panel.

We are done voting on the House floor for the day, so we shouldn't be interrupted, and I know Members have a number of different things. I walked back with a couple of them who are doing a quick little errand here or there and many of them will be back. But I will note that we are joined on our panel by: Dr. Donald Marron, Acting Director of CBO; Mr. Tom Navin, Chief of the Wireline Competition Bureau from the FCC; Mr. Tony Clark, President of the North Dakota Public Service Commission; Mr. Skip Frantz, Chairman of the USTelecom Association; Mr. Richard Cimerman, Vice President, State Government Affairs of the NCTA; Mr. David Crothers, Executive VP of North Dakota Association of Telephone Cooperatives, North Dakota is well represented today; Mr. Paul Garnett, Director of Regulatory Affairs of the CTIA; Ms. Staci Pies, Vice President of PointOne Communications in Austin, Texas on behalf of the Voice on the Net Coalition; Mr. Geoff Feiss, former member of the Great State of Michigan team, the General Manager now for the Montana Telecommunications Association; and Dr. Mark Cooper, Director of Research for Consumer Federation of America.

Ladies and gentlemen, your statements were made part of the record in their entirety, and we would like it if you could take no more than 5 minutes to summarize those, and then we will go to questions of members of the panel.

Dr. Marron, please start.

STATEMENTS OF DR. DONALD B. MARRON, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE; TOM NAVIN, CHIEF, WIRELINE COMPETITION BUREAU, FEDERAL COMMUNICATIONS COMMISSION; TONY CLARK, PRESIDENT, NORTH DAKOTA PUBLIC SERVICE COMMISSION, ON BEHALF OF NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS; SKIP FRANTZ, CHAIRMAN, UNITED STATES TELECOM ASSOCIATION; RICHARD CIMERMAN, VICE PRESIDENT, STATE GOVERNMENT AFFAIRS, NATIONAL CABLE AND TELECOMMUNICATIONS ASSOCIATION; DAVID CROTHERS, EXECUTIVE VICE PRESIDENT, NORTH DAKOTA ASSOCIATION OF TELEPHONE COOPERATIVES, ON BEHALF OF NATIONAL TELECOMMUNICATION COOPERATIVE ASSOCIATION; PAUL GARNETT, DIRECTOR, REGULATORY AFFAIRS,

CTIA - THE WIRELESS ASSOCIATION; STACI PIES, VICE PRESIDENT, POINTONE COMMUNICATIONS, ON BEHALF OF VOICE ON THE NET (VON) COALITION; GEOFF FEISS, GENERAL MANAGER, MONTANA TELECOMMUNICATIONS ASSOCIATION; AND DR. MARK COOPER, DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA

DR. MARRON. Thank you, Mr. Chairman, members of the subcommittee.

It is a pleasure to be here today to discuss CBO's recent report on the Universal Service Fund.

Mr. Chairman, as you mentioned in your opening statement, spending by the High-Cost Program has increased rapidly in recent years. Outlays in the program grew from \$1.9 billion fiscal year 2000 to \$3.8 billion in fiscal year 2005. That doubling of High-Cost support accounted for more than 80 percent of the overall USF spending growth during that period.

Looking backward, two main factors have accounted for most of the spending growth that we have seen in the High-Cost Program in recent years. There has been a rapid increase in the number of carriers, particularly wireless carriers that are eligible for High-Cost subsidies, and there was also a regulatory change that transformed some subsidies that were previously implicit in telecommunications prices into explicit subsidies that are now paid through the High-Cost Program.

Looking ahead are a variety of forces: growth of competitive providers, possible regulatory changes, and possible legislative changes could cause High-Cost spending to continue to grow rapidly in the future. One key factor is the potential for further increases in the number of competitive telephone carriers that are eligible through a sea of universal service subsidies in high-cost areas. Funding for incumbent service providers has been nearly constant in the past 3 years while funding for competitive entrants has more than quadrupled, rising from \$130 million in 2003 to about \$640 million in 2005. That growth has been driven by a rapid increase in the number of competitive telecommunications carriers, primarily wireless ones.

That growth appears likely to continue. In the absence of policy changes, more cellular providers in rural areas may choose to become eligible for High-Cost support and, at the same time, the number of wireless customers in those areas is likely to increase. Taken together, these factors suggest that under current policies, payments to competitive providers could double or triple in coming years, raising annual costs by \$600 million to \$1.2 billion per year by 2011.

Regulatory changes may also increase USF spending. The FCC is considering proposals to reduce payments for intercarrier compensation, the rates telephone companies charge one another for the interconnection and transferring of calls. Such rates are currently set above the cost of providing those services. In practice, this provides a significant subsidy for local telephone companies for whom intercarrier compensation is an important source of revenue. If the FCC lowers intercarrier compensation, the impacts on rural telephone companies could be offset to some degree by increasing support through the USF. This is exactly what happened when a previous regulatory change reduced long distance access charges, another important revenue source for local telephone companies. The cost of such compensation would depend on the size of the new support. Based on a review of several proposals by industry groups and State regulators, it appears that the costs could be in the range of \$800 million to \$2.9 billion per year.

And thirdly, legislative changes may also increase USF spending. Most notable in this regard are legislative proposals to add broadband to the list of services covered by the Universal Service Fund. CBO has not estimated the potential cost of adding broadband to the High-Cost Program at this time. The potential cost would ultimately depend on the specifics of any such legislation.

As a final point, it is important to note that even though the USF does not increase the Federal budget deficit, revenues are aligned with costs over time, it does impose costs on the economy. The benefits provided by the Universal Service Fund come at the cost of higher charges to telephone companies which are then reflected in higher charges to consumers for some services. Such costs will continue to increase if the funding needs of the USF continue to grow.

Thank you. I would be happy to answer any questions.

[The prepared statement of Dr. Donald B. Marron follows:]

PREPARED STATEMENT OF DR. DONALD B. MARRON, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman and Members of the Subcommittee, I am pleased to be here today to discuss the Universal Service Fund (USF) and its High-Cost Program. Spending by the High-Cost Program doubled from \$1.9 billion to \$3.8 billion between fiscal years 2000 and 2005; that increase accounted for more than 80 percent of the total growth in spending by the USF over that period. My testimony today addresses factors that may increase the budgetary pressures facing the High-Cost Program in the future.

My testimony makes the following major points:

- Further growth in the number of wireless telephone carriers that become eligible to receive USF support for providing service in rural areas could increase annual spending for the High-Cost Program by between \$0.6 billion and \$1.2 billion.
- Using the Universal Service Fund to compensate rural telephone companies for income lost from the reduction of certain regulated telephone rates could raise annual USF spending by another \$0.8 billion to \$2.9 billion.
- Including broadband (high-speed) Internet access in the services explicitly supported by the High-Cost Program would also increase spending; the magnitude of that rise would depend on the specific policy changes made.
- Although the USF's programs do not increase the federal budget deficit, they impose costs on the economy. The benefits provided by the Universal Service Fund come at the cost of rising charges to telephone companies, which are often reflected in charges to consumers. Such costs will continue to increase if new demands are put on the USF.

The Universal Service Fund's Structure and Financing

The USF subsidizes certain producers and consumers of telecommunications services. Under its High-Cost Program, a majority of the USF's spending goes to companies that provide voice telephone connections in areas where the cost of offering such service is higher than the nationwide average. That program aims to ensure that the prices charged to telephone customers in such high-cost areas—mainly rural and insular (island) locations—are comparable to prices charged to urban customers. Smaller USF programs subsidize telephone service for qualified low-income people (urban or rural) as well as Internet and other advanced telecommunications services for schools, public libraries, and rural nonprofit health care providers.

The Universal Service Fund operates by collecting mandatory payments from all providers of interstate and international telecommunications services in order to subsidize local services and providers. Those payments are based on a percentage

of the revenue that telecommunications companies derive from providing interstate and international services (subject to certain adjustments).¹ Companies may recover all or part of their payments to the USF by passing the cost on to their customers.

Because the payments that the USF transfers between telecommunications providers and parties receiving support are required by law, monies coming into and out of the USF are counted as revenues and outlays in the federal budget. However, USF fees are adjusted regularly to match expected spending, so the fund is basically budget-neutral. (In practice, the USF runs a small surplus because of the lag between making commitments to projects and paying for them.)

The benefits provided by the USF's programs come at a cost to the economy, regardless of how those programs are treated in the budget. Both consumers' purchasing decisions and providers' investment decisions are distorted by the way the USF collects its receipts and spends its resources. As is the case with any tax or fee, the effects of USF fees vary with their size and structure.

Current Spending and Future Pressures on the Universal Service Fund

The outlays and receipts flowing through the USF have grown substantially in recent years. Between fiscal years 2000 and 2005, annual outlays from the fund rose from \$4.0 billion to \$6.3 billion, while receipts grew from \$4.5 billion to \$7.0 billion (see Table 1). Outlays may not be the best measure of the yearly claims that universal service programs make on the telecommunications sector. The revenues from USF fees are a better measure because they take into account commitments that have been made but not yet paid for.

In the past six years, growth in spending for the High-Cost Program has accounted for 83 percent of the rise in USF outlays, or roughly \$1.9 billion of the total \$2.3 billion increase. Growth in the Low-Income Program has accounted for another \$300 million, whereas spending for the other support programs has not changed significantly.

Two main factors have caused the growth in spending for the High-Cost Program. Increases since 2003 represent additional resources being devoted to rural telecommunications, mainly to support cell phone companies that are new competitive entrants to rural markets. Earlier increases in spending were essentially accounting changes mandated by the Telecommunications Act of 1996. That law

1. For more information, see Congressional Budget Office, *Financing Universal Telephone Service* (March 2005).

Table 1.

Receipts and Outlays for Universal Service Fund Programs, 2000 to 2005

(By fiscal year, in billions of dollars)

	2000	2001	2002	2003	2004	2005
Receipts	4.5	5.2	5.4	5.7	6.4	7.0
Outlays						
High-Cost Program	1.9	2.6	2.8	3.3	3.4	3.8
Low-Income Program	0.5	0.6	0.7	0.7	0.8	0.8
Schools and Libraries Program	1.6	1.7	1.6	1.6	1.5	1.7
Rural Health Care Program	*	*	*	*	*	*
Total	4.0	4.9	5.1	5.6	5.7	6.3

Source: Congressional Budget Office based on data from the Federal Communications Commission.

Notes: * = less than \$50 million.

The numbers shown here are for receipts and outlays of the Universal Service Administrative Company, which administers Universal Service Fund (USF) programs. Actual USF program commitments differ from these figures.

required telephone regulators to convert subsidies that had been included in the prices of long-distance and other services (called implicit subsidies) into payments from the USF (explicit subsidies).

Possible Sources of Future Spending Growth

Disbursements for the High-Cost Program have doubled since 2000, from \$1.9 billion to \$3.8 billion. The Congressional Budget Office (CBO) estimates that such spending could continue to increase rapidly depending on legislative and regulatory decisions about three potential sources of budgetary pressure on the program:

- Further increases in the number of telephone carriers—predominantly wireless telephone companies—eligible to receive universal service subsidies for high-cost areas;
- Possible changes in the structure of the rates that telephone companies charge one another for connecting and transferring calls (known as inter-carrier compensation); and
- Possible inclusion of broadband Internet connections in an expanded definition of universal service.

The first two factors could add between \$1.4 billion and \$4.0 billion to the annual outlays of the High-Cost Program by 2011, CBO estimates (see Table 2). The lower end of that range represents an increase of about one-third from current spending; the higher end implies that spending would double. If, instead, outlays for the High-Cost Program continued to grow at the average annual rate of the 2000-2005 period, they would be roughly \$2.2 billion higher by 2011—or in the middle of that range.

CBO's 10-year baseline budget projections for the Universal Service Fund account for some of the budgetary pressures described above, but not others.² The baseline assumes moderate growth in funding for wireless companies entering the market in high-cost areas, on the basis of trends from previous years and anticipated increases. However, because CBO's baseline is predicated on current law and policies, it does not account for new legislative or regulatory actions, such as a restructuring of intercarrier compensation rates and payment flows or new initiatives in rural broadband.

Continued Increases in the Number of Eligible Telephone Companies. Following the 1996 Telecommunications Act, the Federal Communications Commission (FCC) made more telephone companies eligible for support under the High-Cost Program, and a growing number of companies began to apply to be designated as eligible to receive USF funds. The result is that the amount of funding going to new "competitive eligible telecommunications carriers" has risen dramatically. Funding for those carriers accounts for about 94 percent of the increase in spending by the High-Cost Program since 2003.

Both the number of carriers receiving payments under the High-Cost Program and the amount of funding given to competitive entrants have grown over the past several years. In 2000, just two competitive telecommunications carriers were eligible for high-cost support. By 2005, that number had risen to 263 (some carriers are counted more than once in that figure because of the way the data are tallied). Similarly, funding for competitive entrants has grown from \$130 million in 2003 to an estimated \$640 million in 2005. Typically, about 95 percent of that funding in any given year goes to wireless companies. By contrast, funding for the first carrier in each market (the "incumbent" service provider) has been nearly constant in the past three years at between \$3.1 billion and \$3.2 billion, probably because of the cap currently imposed on one type of high-cost support for incumbents. Early projections for 2006 suggest a substantial rise in spending for new entrants and continued stability in spending for incumbents.

2. Those projections were published in Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016* (January 2006), Tables 3-3 and 4-9.

Table 2.

**Additional Spending for the High-Cost Program in 2011
from Various Sources**

(Billions of dollars)

	Estimated Range of Additional Spending	
	Low End of Range	High End of Range
Further Growth in the Number of Wireless Companies Entering High-Cost Markets	0.6	1.2
Restructuring of Inter-carrier Compensation Rates ^a	<u>0.8</u>	<u>2.9</u>
Total (Excluding broadband)^b	1.4	4.0

Source: Congressional Budget Office.

- a. The numbers shown here are CBO's extrapolations of estimates by the National Exchange Carrier Association.
- b. Increased spending for broadband (high-speed) Internet access in rural areas is likely to be determined through legislative activity, which CBO has no basis for predicting.
-

In the absence of policy changes, that pattern appears likely to continue. Less than one-third of cellular telephone connections in rural areas currently receive USF subsidies. If the companies serving the unsubsidized connections apply for funding, subsidies for those competitive entrants may increase substantially. The main source of uncertainty about the extent and timing of that increase is how rapidly all of the potentially eligible carriers will apply for and be granted eligibility.

On the basis of data from the Bureau of Labor Statistics, CBO projects that rural cell phone subscribers will number about 22 million in 2011. Competitive entrants received subsidies on some 4.6 million rural cellular connections last year. The most likely scenarios are that the current level of subsidized connections could double or triple by 2011. If subsidy costs moved in tandem with subscription counts, USF spending to support competitive entrants would also double or triple, rising by between \$600 million and \$1.2 billion (see Table 2).

Changes in the Structure of Inter-carrier Compensation Rates. Regulators have often set some of the per-minute rates that telephone companies charge one another to interconnect and transfer long-distance and other calls above the cost of those activities in order to provide an implicit subsidy to local telephone companies and their customers. Such payments flow primarily from long-distance companies to local telephone companies.

The level of intercarrier compensation has declined in recent years. One reason is that consumers are increasingly substituting e-mail and wireless long distance (which often bypasses the landline system) for traditional long-distance calling. Another reason is that regulators have reduced some of the rates charged for intercarrier compensation.

At the same time, technological improvements in telecommunications equipment have decreased the costs that carriers incur in routing and connecting telephone calls. Because the prices that customers pay—which include intercarrier compensation payments—have not fallen as rapidly, those prices do not reflect the underlying economic costs of providing different types of service and thus distort consumers' choices. For example, consumers may choose to make long-distance calls on a cell phone despite its inferior coverage or voice quality because their plan offers such calls at no extra cost, whereas their landline service costs them 5 cents or 10 cents per minute. However, the difference in actual costs to the telephone network between completing a long-distance call from a landline and completing one from a wireless telephone is not as great as the difference in prices charged to customers. That disparity has prompted a number of proposals to restructure intercarrier compensation rates.

Most of the restructuring proposals that are being discussed would reduce revenues to the smaller companies that often serve high-cost and insular areas. One way to offset those companies' revenue losses would be to provide supplemental payments through the Universal Service Fund. In the past, when cuts in long-distance access rates reduced the income flowing to rural telephone companies, the USF increased its payments correspondingly. As in earlier instances, such a change in intercarrier compensation would convert regulated payments among carriers into regulated payments into and out of the Universal Service Fund and could alter the distribution of costs and subsidies among consumers.

Restructuring intercarrier compensation has substantial budgetary implications for USF spending. Depending on the proposal selected, changing the intercarrier compensation system could add between \$800 million and \$2.9 billion to annual outlays for the High-Cost Program by 2011 (see Table 2). Much of that increase could occur under current law. The FCC has the legal authority to alter the interstate portion of intercarrier compensation. However, there is disagreement about whether it could adjust intercarrier compensation rates within a state without additional legislation.³

3. See National Association of State Utility Consumer Advocates, *Initial Comments of the National Association of State Utility Consumer Advocates Before the Federal Communications Commission in the Matter of Developing a Unified Intercarrier Compensation Regime*, CC Docket No. 01-92 (May 23, 2005), pp. 40-43, available at www.nasuca.org/Intercarrier%20Compensation%20Comments.pdf.

In a filing to the FCC, the National Exchange Carrier Association (NECA) compared various proposals for restructuring intercarrier compensation to determine how they would split the burden among the different revenue sources—intercarrier compensation itself, telephone subscribers, and the Universal Service Fund. NECA's analysis looked at the records of a sample of its member companies and calculated how much of the \$8.0 billion in income they received in 2003 came from subscribers' fees, intercarrier compensation, and universal service subsidies. (Those NECA members, which are incumbent telephone companies, received about three-quarters of the subsidies paid by the High-Cost Program that year.) The association then modeled the various proposed rate changes to determine the extent to which they would lower revenues relative to a baseline estimate of the calls and minutes handled by NECA members.

In the three proposals that NECA modeled, the majority of the revenues lost from restructuring intercarrier compensation would be made up through increases in spending by the Universal Service Fund. For example, under the first proposal, intercarrier compensation payments were estimated to fall from \$2.3 billion to \$1.4 billion. To compensate, the proposal would raise subscribers' rates to collect an additional \$0.3 billion in revenue and would increase USF payments by \$0.6 billion, a 25 percent rise. The increase in USF support would be much higher under the other two proposals that NECA examined: more than 60 percent. (The analysis was static and did not account for changes from the 2003 baseline in the number of calls and minutes of use.)

To estimate the total impact on USF spending from restructuring intercarrier compensation, CBO adjusted NECA's estimates to account for carriers that were not in the sample. That extrapolation suggests that the three proposals analyzed by NECA would increase spending for the High-Cost Program in 2011 by \$0.8 billion to \$2.9 billion. (The latter figure includes \$0.8 billion in additional USF spending from removing the cap on certain high-cost support payments to incumbent providers, which was part of one of the proposals.)

Inclusion of High-Speed Internet Access in Universal Service. The 1996 Telecommunications Act requires that the basket of services included in the definition of universal service—and thus eligible for USF support—be reviewed and updated periodically. The law assigns that task to the Federal-State Joint Board on Universal Service (composed of regulators from the FCC and the states), which makes recommendations to the FCC. Many analysts and interested parties have argued that broadband Internet access should be one of the residential services paid for by the High-Cost Program. (It is already subsidized by the much smaller Schools and Libraries and Rural Health Care Programs.)

Broadband is penetrating into rural areas at a rapid pace, albeit more slowly than in urban and suburban areas. Currently, some 920 rural telephone carriers offer broadband service under terms set forth by NECA. Only one-quarter of the carriers participating in the association do not yet offer broadband service. Furthermore, according to one recent survey, rural areas are only about two years behind urban areas in their broadband subscription rates.⁴

Some of that rural expansion is already being supported by the High-Cost Program. Investments in telephone networks subsidized by the program often allow for both conventional telephone service and broadband, because most modern telephone equipment is capable of providing voice and data services. In addition, the Department of Agriculture's Rural Utilities Service has begun making low-interest loans to companies that invest in broadband. (The Agriculture Department's credit program for conventional telephone service has long made low-interest loans to carriers that invest in telephone networks capable of providing broadband as well as voice telephone service. Many of those loans were made for equipment that subsequently formed part of the cost basis for USF support.)

Including broadband in the definition of universal service would represent a new commitment of economic resources, as well as an increase in the amount of funds transferred among different groups of consumers. Those new resources could come directly from the USF (as was the case in the Schools and Libraries Program) or indirectly, through the expansion of other initiatives, such as the Rural Utilities Service's program of loans and loan guarantees for rural broadband. Even the expansion of such indirect programs, however, could ultimately increase USF spending if those programs were used to expand the broadband-capable telephone networks of carriers that receive USF support.

Members of Congress have introduced various proposals to increase the availability of broadband in rural areas. One approach would be to spend a limited amount each year on supporting the deployment of broadband and distribute that funding among unserved areas through a competitive selection process, as is done in the Schools and Libraries Program. A bill before the Congress, S. 2686, would direct the FCC to collect and spend up to \$500 million a year in that way to encourage the spread of broadband service.

Paying for Spending Increases

The possibility of future increases in USF spending raises the question of how such expenditures would be paid for. At present, the USF is financed through a

4. John Horrigan, "Rural Broadband Internet Use" (data memo, Pew Internet and American Life Project, Washington, D.C., February 2006), available at http://207.21.232.103/pdfs/PIP_Rural_Broadband.pdf.

percentage fee on the value of interstate telecommunications services, including long-distance revenues, a portion of cell phone revenues, and part of the basic subscriber charges that customers pay to local telephone companies. That fee is calculated quarterly and is generally set to keep the USF budget-neutral.

Telecommunications spending is rising in the economy as a whole, but the revenues that are subject to universal service fees have declined since 2000. Because USF spending has been growing while the telecommunications base from which its receipts are drawn has been shrinking, the percentage used in calculating the fee on eligible telecommunications revenues has risen. In 2000, the quarterly fee rate never exceeded 6 percent; in 2005, it never fell below 10 percent.

Further increases in spending by the USF would drive up the fee percentage even higher, unless either a different revenue mechanism was devised or the base of telecommunications services subject to the fees was broadened. Higher fee levels might cause consumers to shift more of their spending to telecommunications services that are not subject to USF fees—such as e-mail and instant messaging—thus reducing receipts for the fund.

Options for Curtailing the Growth of USF Spending

To illustrate how lawmakers or regulators might alleviate some sources of budgetary pressure on the Universal Service Fund, CBO examined several policy options, each geared toward one of the aforementioned sources of spending growth:

- Under the structure of the High-Cost Program, more wireless carriers are likely to be designated as eligible to receive support payments for providing service in high-cost areas. Spending for that program could be curbed by limiting high-cost support to one connection per household, by basing support on each carrier's own costs rather than on a cost standard set by the incumbent carrier, or both.
- In other instances, regulatory processes can put pressure on the USF, as is the case with intercarrier compensation. Reducing the subsidies that are implicit in current intercarrier compensation rates would create pressure for higher explicit USF support. However, that support could be structured in such a way as to reduce the flow of resources from the USF.
- The legislative process can also create budgetary pressures on the USF, as would be the case if pending legislation was enacted to accelerate the deployment of broadband into high-cost areas. The growth of USF spending could be slowed by not adding special programs, such as one for

broadband, to the Universal Service Fund but rather by keeping any such programs part of discretionary spending.

**Limit Support to One Connection per Household or
Base Support on Carriers' Own Costs**

Two of the most commonly discussed options for curbing growth in the funding for wireless entrants are restricting support to only one telecommunications connection per household or basing support on the actual costs incurred by the eligible carrier, regardless of whether it is the incumbent telephone company or a competitive entrant.

In response to prospective growth in spending for the High-Cost Program, the Federal-State Joint Board on Universal Service recommended in 2004 that the FCC limit support to one telecommunications connection for each household. Before the FCC could act, however, the Congress restricted the commission from carrying out the board's recommendation, thus allowing the USF to fund multiple connections to a single household.

In addition, under current policy, a company that is entering the market to provide service in a high-cost area receives an amount of subsidy per connection equal to that received by the existing telephone company. Because the competitive entrants are almost all wireless companies—whose cost of providing service is likely to be lower than that of the incumbent landline provider—the subsidy paid to new entrants is likely to be higher than the amount needed to attract new providers who will offer services in rural areas at rates comparable to those charged in urban areas.

Proposals that would peg subsidies to a provider's own cost of offering service would thus probably lower payments to new entrants. The FCC could make that change without any legislative action being required. However, basing support on a company's own costs might lessen the incentive that current policy gives wireless entrants to expand their telephone networks and to produce services at the lowest possible cost.

**Restructure Intercarrier Compensation and USF Payments to
Reduce Cross-Subsidies**

The more that intercarrier compensation rates are reduced by eliminating the subsidy element they contain, the more pressure there is to increase USF payments to telephone companies serving rural areas. As noted above, CBO estimates that under the proposals being considered, restructuring intercarrier compensation rates could increase annual costs for the USF by \$800 million to \$2.9 billion. Those proposals have been put forth by groups of large and small telephone com-

panies and other concerned parties, such as regulators. So far, those groups have not reached a consensus on the best way to restructure rates.

Lowering intercarrier compensation rates would improve economic efficiency in that prices for long-distance service would more closely match the actual cost of providing that service. In general, resources are allocated better when people base their decisions about how much to consume on the cost of the service provided. But the increase in USF fees that would be imposed to pay for USF support would introduce distortions of its own on consumers' choices, offsetting much of the gain in economic efficiency.⁵

Restructuring intercarrier compensation rates would also alter which groups make payments to rural telephone companies. Under the current structure, only people or companies that originate or terminate calls on the networks of rural telephone companies make intercarrier compensation payments to those companies. If intercarrier compensation payments were converted to USF support, long-distance customers as a whole would pay for it.

In addition, converting intercarrier compensation payments into USF support could fix the transfer of funds to rural telephone companies at current levels, even though competition from other telecommunications providers and technologies is gradually reducing such payments. Thus, restructuring intercarrier compensation could protect rural telephone companies from the competition that is occurring in other telecommunications markets and thereby deny consumers the benefits of that competition.

If USF payments increased because of reductions in intercarrier compensation, however, the payments could be structured in such a way as to avoid committing any new resources to cross-subsidies or even to reduce cross-subsidy amounts. Currently, competitive entrants are eligible for the same per-line payments from the USF as the incumbent serving the same area. That equivalence means that wireless entrants receive payments from the USF that were originally designed to compensate incumbents for reducing their long-distance access rates during a period before most new entrants had entered the market. Careful design of USF payments to partly replace lost intercarrier compensation could result in a reduced flow of resources to competitive entrants, on net. That change would require at least partly decoupling the support given to incumbents from the support given to competitive entrants.

5. One option under consideration at the FCC and in the Congress is to convert USF fees from the current revenue-based charge into an access-based charge, such as one based on telephone numbers or connection capacity. That shift would reduce such price distortions. For more details, see Congressional Budget Office, *Financing Universal Telephone Service*.

Limit Broadband Subsidies

The discussion now taking place about how best to promote rural broadband spans a wider range of policy options than the USF budget. Under current law, for a new telecommunications service to qualify for USF support, a substantial majority of residential consumers nationwide must subscribe to it—a condition not yet achieved by broadband. Consequently, new legislation would be necessary to expand USF subsidies for rural broadband beyond those currently provided to schools, libraries, and rural nonprofit health care providers. Such legislation has been proposed.

One option for controlling USF spending would be to keep special programs such as broadband separate from the Universal Service Fund. USF programs are not subject to the annual scrutiny of the Congressional appropriation process, as discretionary spending programs are. As a result, the size of USF programs can grow or remain stable while discretionary programs' funding is altered as national priorities change.

Even if lawmakers do not explicitly authorize the expansion of rural broadband service, the USF will continue to provide financing for the development of broadband in rural areas. Such funding goes to pay for infrastructure investments by carriers that let them provide both conventional telephone service and advanced digital services, including broadband.

MR. UPTON. Thank you.
Mr. Navin.

MR. NAVIN. Good afternoon, Chairman Upton and members of the subcommittee.

Thank you for the opportunity to speak about the Universal Service High-Cost Program.

As you know, in Section 254 of the Communications Act, Congress directed the Commission to promote universal service to ensure that all Americans have access to affordable, quality telecommunications services. In particular, in Section 254, Congress articulated a national goal that consumers in all regions of the Nation, including consumers in rural, insular, and high-cost areas, shall have access to telecommunication services at rates that are affordable and reasonably comparable to those provided to consumers in more urban areas.

Today, I will provide a brief overview of the Commission's actions implementing the Universal Service High-Cost Support Program in response to Section 254 of the Act and pending proceedings in which the Commission is examining ways to improve the High-Cost Program.

In implementing the Universal Service High-Cost Support Program, the Commission has taken into consideration the differences between large, price-cap regulated non-rural carriers and small, rate-of-return rural carriers. Universal service support is provided today to defray both the intrastate and interstate network costs through the following five mechanisms: high-cost loop support, local switching support, high-cost non-rural support, interstate access support, and interstate common line support.

Consistent with Section 254 of the Act, the rural and non-rural support mechanisms support the intrastate network costs of carriers to ensure that those in high-cost and rural areas have access to telecommunication services at rates that are affordable and reasonably comparable to those customers in urban areas. Although incumbent local exchange carriers may qualify as rural carriers based on other criteria, a carrier generally is eligible for high-cost loop support if it serves less than 100,000 lines in a service area.

The rural high-cost loop support mechanism, which was last modified by the Commission in 2001, provides support for embedded intrastate network costs to rural incumbent local exchange carriers in service areas where the cost to provide service exceeds 115 percent of the national average cost per line. The Commission has recognized that rural carriers serve more sparsely populated areas, serve fewer subscribers, and do not typically benefit from economies of scale and scope. In addition to high-cost loop support, carriers with 50,000 or fewer access lines are also eligible to receive local switching support, which provides intrastate support for switching costs. In 2005,

approximately \$1.2 billion was distributed in rural high-cost loop support and \$445 million was distributed in local switching support.

The non-rural high-cost mechanism was established by the Commission in 1999 to support intrastate network costs for non-rural carriers based on forward-looking economic costs. The non-rural mechanism determines the amount of Federal High-Cost support to be provided to non-rural carriers by comparing the statewide average non-rural, forward-looking cost per line to a nationwide cost benchmark. In 2005, approximately \$292 million was distributed in the non-rural, High-Cost support program.

Consistent with Congress's directive that universal service support be explicit, in July 2000, the Commission adopted the interstate access support mechanism to provide explicit universal service support to price-cap carriers to replace implicit subsidies that were eliminated from the access charge rate structure. The precise amount of interstate access support provided each year may vary but is targeted to be \$650 million for all carriers, both incumbents and competitors. In 2005, approximately \$691 million was distributed in interstate access support.

The interstate common line support mechanism, which was implemented beginning July 1, 2002, provides explicit universal service support to rate-of-return carriers in exchange for removing implicit subsidies from access charges. Each rate-of-return carrier receives enough support to ensure that it can recover its interstate loop costs while charging subscriber line charges no higher than the cap, which is \$6.50 for residential customers and \$9.20 for multi-line business customers. In 2005, approximately \$1.18 billion was distributed in interstate common line support.

As a final matter, I would like to note that the Commission has initiated various proceedings to consider potential reform of the High-Cost Program. For example, the Commission is examining rural high-cost reform, changes to the non-rural high-cost mechanism, and changes to the administration and oversight of the entire Universal Service Fund, including the High-Cost Program.

Again, thank you for the opportunity to discuss Universal Service High-Cost issues. I look forward to working with this subcommittee, other Members of Congress, Chairman Barton, and the Commission as further reform to the High-Cost Program is considered.

[The prepared statement of Thomas J. Navin follows:]

PREPARED STATEMENT OF THOMAS J. NAVIN, CHIEF, WIRELINE COMPETITION BUREAU,
FEDERAL COMMUNICATIONS COMMISSION

Good morning Chairman Upton, Ranking Member Markey and members of the Subcommittee. Thank you for the opportunity to speak about the universal service high-cost program.

As you know, in Section 254 of the Communications Act of 1934, Congress directed the Commission to promote universal service to ensure that all Americans have access to affordable, quality telecommunications services. In particular, in section 254, Congress articulated a national goal that consumers in all regions of the nation, including consumers in rural, insular, and high-cost areas, as well as low-income consumers, should have access to telecommunications services at rates that are affordable and reasonably comparable to those provided to consumers in more urban areas. Section 254 further provides that federal universal service support mechanisms should be specific, predictable, and sufficient to preserve universal service. Today, I will provide a brief overview of the Commission's actions implementing the universal service high-cost support program in response to section 254 of the Act and pending proceedings at the Commission examining ways to improve the high-cost program.

In implementing the universal high-cost support program, the Commission has proceeded in stages to consider which universal service support mechanism is appropriate for a particular carrier. Specifically, the Commission has taken into consideration the differences between large, price-cap regulated non-rural carriers and small, rate-of-return regulated rural carriers in establishing its high-cost programs. Universal service support is provided today to defray both the intrastate and interstate network costs through the following mechanisms: high-cost loop support; local switching support, high-cost non-rural support, interstate access support, and interstate common line support.

Consistent with section 254 of the Act, the rural and non-rural support mechanisms support the intrastate network costs of carriers to ensure those in high-cost and rural areas have access to telecommunications services at rates that are affordable and reasonably comparable to urban areas. Although incumbent local exchange carriers may qualify as rural carriers based on other criteria (*e.g.*, less than 15 percent of the incumbent's lines are in communities of more than 50,000), a carrier generally is eligible for high-cost loop support if it serves less than 100,000 lines in a service area. Non-rural carriers generally are those that serve more than 100,000 lines in a service area.

The rural high-cost loop support mechanism, which was last modified by the Commission in 2001, provides support to carriers for their embedded intrastate network costs to rural incumbent local exchange carriers in service areas where the cost to provide service exceeds 115 percent of the national average cost per-line. The Commission has recognized that rural carriers serve more sparsely populated areas, serve fewer subscribers, and do not typically benefit from economies of scale and scope. In addition to high-cost loop support, carriers with 50,000 or fewer access lines are also eligible to receive local switching support which provides intrastate support for switching costs. In 2005, approximately \$1.2 billion was distributed in rural high-cost loop support and \$445 million was distributed in local switching support.

The non-rural high-cost support mechanism was established by the Commission in 1999 to support intrastate network costs for non-rural carriers based on forward-looking economic costs. The non-rural mechanism determines the amount of federal high-cost support to be provided to non-rural carriers by comparing the statewide average non-rural, forward-looking cost per line to a nationwide cost benchmark. Federal support is provided to non-rural carriers in states with costs that exceed the benchmark, which currently is set at two standard deviations

above the average, or approximately 131 percent of the national average cost per line. In 2005, approximately \$292 million was distributed in non-rural high-cost support.

The interstate access support and interstate common line support mechanisms provide support to offset the interstate portion of carriers' networks, for which the FCC has primary responsibility for regulating rates and cost recovery. Each of these explicit universal service support mechanisms replaced implicit subsidies in the interstate access rate structure. Additionally, these mechanisms enable carriers to provide telecommunications services to consumers while charging Subscriber Line Charges at capped rates.

Consistent with Congress' directive that universal service support be explicit, in July 2000, the Commission adopted the interstate access support mechanism to provide explicit universal service support to price-cap carriers to replace \$650 million annually in implicit subsidies that were eliminated from the access charge rate structure. The precise amount of interstate access support provided each year may vary, but is targeted to \$650 million for all carriers, both incumbents and competitors. In 2005, approximately \$691 million was distributed in interstate access support.

The interstate common line support mechanism, which was implemented beginning July 1, 2002, provides explicit universal service support to rate-of-return carriers in exchange for removing implicit subsidies from access charges. Each rate-of-return carrier receives enough support to ensure that it can recover its interstate loop costs while charging Subscriber Line Charges no higher than the cap, which is \$6.50 for residential customers and \$9.20 for multi-line business customers. In 2005, approximately \$1.18 billion was distributed in interstate common line support.

The Commission has initiated proceedings to consider potential reform of the program. For example, in the Commission's *Rural Review Proceeding*, the issue of whether to continue to distinguish the receipt of high-cost support based on carrier size or type is being contemplated or whether other factors should be considered such as geography of a service area, or the type of carrier receiving support. Currently, the Federal State Joint Board on Universal Service, a group of FCC commissioners, state utility commissioners and a consumer advocate representative, is considering these issues. The Joint Board will provide a recommendation to the Commission concerning any rural high-cost support modification. The Commission will carefully consider the Joint Board's recommendations as it contemplates changes to the high-cost program in this proceeding.

In addition, in response to the United States Court of Appeals for the Tenth Circuit's remand, the Commission is reviewing its rules relating to the high-cost universal service support mechanism for non-rural carriers. Specifically, the Commission sought comment on: (1) how the Commission should define the statutory term "sufficient" to take into account all the principles enumerated in section 254; (2) how the Commission should define "reasonably comparable" under section 254, consistent with its concurrent duties to preserve and advance universal service; and (3) how, in light of the interpretation of the key statutory terms, the Commission should modify the high-cost funding mechanism for non-rural carriers. The Commission further sought comment on whether it should adopt a non-rural insular universal service mechanism.

The Commission is also considering how to improve the universal service high-cost program in other ways. For example, the Commission has a pending proceeding examining ways to improve administration and oversight of the Universal Service Fund (USF) in order to

improve the operation of the program for its beneficiaries and contributors and to enhance program integrity and protect against waste, fraud, abuse. The Commission is also examining whether to establish more aggressive sanctions and debarment procedures in all the USF programs, including the high-cost program. Moreover, the Commission is considering ways to modify the high-cost program's reporting requirements, strengthen its audit processes, and establish additional criteria for recovering funds that were disbursed or used incorrectly.

Again, thank you for the opportunity to discuss universal service high-cost issues with you today. I look forward to working with this Subcommittee, other Members of Congress, Chairman Martin and the Commission as further reform to the high-cost program is considered.

MR. UPTON. Thank you.

Mr. Clark.

MR. CLARK. Thank you, Mr. Chairman and subcommittee members.
It is a pleasure to testify before you today.

I am Tony Clark, President of the North Dakota Public Service Commission and Chairman of the Telecommunications Committee of the National Association of Regulatory Utility Commissioners. NARUC represents state commissions in all 50 States, the District of Columbia, U.S. Territories with jurisdiction over telecommunications, electricity, natural gas, water, and other utilities.

This particular hearing is especially important to me because of the impact that Universal Service Programs have on rural States like mine. North Dakotans are eager to embrace the power and promise of VoIP, new video services, wireless, broadband, and other innovative products, but we know that all of these technologies require underlying infrastructure, wires, switches, towers, and routers, and those require real investments to build and maintain, especially in rural markets.

We are here today because universal service is at a crossroads. On the contribution side, there is a growing chasm between the services and carriers that sustain the fund and those who interconnect to the network supported by it. The end result is that the contribution requirement is falling ever more heavily and unfairly on a shrinking number of carriers. This means that the charge the end user has to pay on interstate and international toll calls has risen to close to 11 percent recently, which is a result of the growing demands on a shrinking revenue base of interstate and international calls. On the distribution side, Universal Service Fund has grown tremendously in the past few years, and these two trends are on a crash course, making the status quo unsustainable.

On both sides, the Universal Service Funds faces a number of existential questions, and I have outlined a number of those in my written testimony. Perhaps we can get into that during the question-and-answer period.

Each of these choices carries both costs and opportunities, and a decision on any one of them will have a ripple effect on all others. To be perfectly frank, the costs and benefits of different options will vary from State to State, as will the individual State Commissions' advice that they give you. But at the end of the day, we must all find common ground. Each of your home State Commissions is an excellent resource for you and your staff to utilize in researching the impact of Universal Service Funds on your districts. It is a contact that is well worth making.

On a practical level, NARUC believes that whatever the Federal Universal Service Fund is intended to accomplish, it should be done as efficiently as possible, and to that end, we support a permanent exemption of the Federal Universal Service Programs from the Antideficiency Act.

Under Section 214(e) of the Act, State Commissions help the FCC administer the Federal Universal Service Fund by designating eligible

telecommunications carriers, ETCs, in each State that receives support. In March 2005, acting on a recommendation of the Federal-State Joint Board on Universal Service, the FCC issued a set of permissive guidelines for the States to use in their ETC designations, partially in response to the growing role and prominence of competitive ETCs. A major policy goal of those guidelines was to ensure that all ETCs used any Universal Service disbursements to invest in infrastructure and defray consumer costs in the appropriate service area.

At this writing, at least 24 State Commissions have either implemented the new guidelines or initiated rulemakings to incorporate some or part of these suggested guidelines. There are, of course, some natural tensions to work through. One such potential major tension is currently contained within Chairman Stevens' Senate draft of the telecom bill, which, in its current iteration, would preempt all State oversight of terms and conditions of wireless carriers.

Many State Commissioners are asking how a State can possibly certify compliance with service quality and consumer protection standards for wireless competitive ETCs if Federal legislation ultimately puts jurisdiction over the terms and conditions of these carriers beyond our reach. Put another way, if wireless carriers want to be treated like all other carriers when receiving Universal Service Fund money, then they should not expect to receive special exemptions from consumer protection laws that all other ETCs follow.

NARUC supports efforts to more equitably distribute the funding base of the Federal Universal Service Fund in a technology-neutral manner, and we appreciate the provisions in H.R. 5072, the Universal Service Reform Act of 2006, that would empower the FCC to do so. Broadening the contribution base for universal service is not a question of how much is collected but rather fairness in how it is collected. We also believe that such efforts at the Federal level must be accommodated by similar efforts to ensure the long-term sustainability of State programs.

Today, universal service is a jointly-shared responsibility between States and the Federal government. This joint approach benefits both net donor and net recipient States because it lessens the burden on an already sizeable Federal program and permits another option when Federal disbursement programs do not work in a particular State or community.

Ultimately, we believe the best solution is to stabilize the contribution base of the State Universal Service Programs at the same time that the base is stabilized for the Federal program.

Finally, I would be remiss if I didn't say just a few words about intercarrier compensation, an issue that is joined at the hip with universal service.

NARUC's leaders have been brokering a dialogue among every segment of the industry for almost 2 years designed to produce an approach with as much consensus support as is possible, especially since this plan governs largely how these carriers will relate economically to each other. For today, my only caution to members of this subcommittee is to be aware that whatever approach is ultimately adopted by the FCC or Congress, it is likely to, once again, have a big impact on universal service.

Thank you.

[The prepared statement of Tony Clark follows:]

PREPARED STATEMENT OF TONY CLARK, PRESIDENT, NORTH DAKOTA PUBLIC SERVICE
COMMISSION, ON BEHALF OF NATIONAL ASSOCIATION OF REGULATORY UTILITY
COMMISSIONERS

Chairman Upton, Ranking Member Markey and members of the Subcommittee, thank you for the opportunity to testify today. I am Tony Clark, President of the North Dakota Public Service Commission and Chairman of the Telecommunications Committee of the National Association of Regulatory Utility Commissioners (NARUC). NARUC represents State commissions in all 50 States, the District of Columbia and US territories, with jurisdiction over telecommunications, electricity, natural gas, water and other utilities.

This particular hearing is especially important to me because of the impact that Universal Service programs have on rural States like mine. North Dakotans are eager to embrace the power and promise of VoIP, new video services, wireless broadband and other innovative products, but we know that *all* of those technologies require underlying infrastructure: wires, switches, towers and routers – and those require real investment to build and maintain, especially in rural markets.

In his recent book, "The World is Flat," author Thomas Friedman writes about how an interlocking network of undersea optical fiber cables and global satellite connections has, for business purposes, erased the distance between New York, Los Angeles, Bangalore and Beijing, creating new types of both collaboration *and* competition among professionals in every part of the globe. In North Dakota, we like the idea of Fargo, Valley City and even tiny Mandaree (pop. 558, on the Fort Berthold Indian Reservation) being part of that global information economy too – a concept that would be unthinkable without a first class communications infrastructure. So the Telecommunications Act's promise of reasonably comparable rates and services for high cost areas means a lot to States like mine.

Beyond their economic value, telecommunications networks are also critical infrastructure. As telephone companies in the Gulf Coast region issue press releases now about their readiness for the 2006 hurricane season, we are reminded of how the importance of reliable communications was magnified during past disasters, when first responders and relief organizations had to coordinate thousands of volunteers in real time.

An existential question for USF.

The title of this hearing, "What are we subsidizing and why?" raises a good point, which is that a national dialogue about the purpose and scope of universal service is appropriate as Congress seeks to update many of its communications laws.

We're here today because Universal Service is at a crossroads. On the contribution side, there is a growing chasm between the services and carriers that sustain the fund, and

those that interconnect to the network supported by it. The end result is that the contribution requirement is falling ever more heavily, and unfairly, on a shrinking number of carriers. This means that the charge the end user has to pay on interstate and international toll calls has risen to close to 11 percent recently, which is a result of the growing demands on a shrinking revenue base of interstate and international calls. On the distribution side, the Universal Service Fund has grown tremendously in the past few years. These two trends are on a crash course, making the status quo unsustainable.

On both sides, the Universal Service Fund faces a number of existential questions:

- Should it explicitly fund broadband infrastructure and services?
- What is the optimal size of the fund and does it need to be capped?
- Should it fund competition in high cost markets?
- How many networks should it be used to fund in high cost markets?
- On what cost basis should carriers be reimbursed?
- How many access lines per customer should be funded?
- Is it intended for networks or for individuals?
- Should contributions be pegged to network usage, use of numbers, connections or some other methodology?
- Should Universal Service continue to be a shared Federal-State responsibility, or should the federal government take on the entire burden?

Each choice carries both costs and opportunities, and a decision on any one of them will have a ripple effect on all the others. In addition, Universal Service programs are inextricably intertwined with intercarrier compensation and larger impacts on the entire communications market. To be perfectly frank, the costs and benefits of different options will vary from State to State, as will the advice of your individual State commissions, but at the end of the day, we must all find common ground. Each of your home State commissions is an excellent resource for you and your staffs to utilize in researching the impact of universal service on your districts. It is a contact that is well worth making.

On a practical level, NARUC believes that whatever the federal Universal Service Fund is intended to accomplish, it should be done as efficiently as possible. That is why we support a permanent exemption of federal Universal Service programs from the Antideficiency Act.

State designation of Eligible Telecommunications Carriers

Under Section 214(e) of the Act, State commissions help the FCC administer the federal Universal Service Fund by designating eligible telecommunications carriers (ETCs) in each State that receives support. The Act requires a finding that each designated carrier will offer the services supported by Universal Service throughout the service area, through its own facilities or with a combination of its own facilities and resale of another carrier's facilities, and that it will advertise the availability of those services using media of general distribution.

The Act also requires an ETC designation to be consistent with the public interest, convenience and necessity, but did not set forth specific criteria to be applied under the public interest tests in Sections 214 and 254 of the Act. For service areas already served by a rural telephone company, the Act specifically requires a public interest determination to be made before a State commission designates a competitive ETC for that service area.

In some States, standards were interpreted to allow a degree of latitude in ETC designations. Our experience in North Dakota allowed for very little. Prior to my tenure, the Public Service Commission (PSC) once denied ETC status to a competitive applicant, citing the public interest standard and a number of policy concerns, including impact on the federal fund. The carrier sued the PSC, and the court ruled that questions of federal fund sufficiency were outside the scope of any State PSC inquiry. Lacking the ability to

take into consideration this factor, the public interest standard became a relatively easy burden for a competitive ETC to meet.

In March 2005, acting on a recommendation of the Federal-State Joint Board on Universal Service, the FCC issued a set of permissive guidelines for the States to use in their ETC designations, partially in response to the growing role and prominence of competitive ETCs. A major policy goal of those guidelines was to ensure that *all* ETCs used any Universal Service disbursements to invest in infrastructure and defray consumer costs in the appropriate service area. Specifically, the guidelines call for each carrier seeking ETC status to do the following:

- a. Provide a five-year plan demonstrating how high-cost Universal Service support will be used to improve its coverage, service quality or capacity in every wire center for which it seeks designation and expects to receive Universal Service support;
- b. Demonstrate its ability to remain functional in emergency situations;
- c. Demonstrate that it will satisfy consumer protection and service quality standards;
- d. Offer local usage plans comparable to those offered by the incumbent local exchange carrier (ILEC) in areas for which it seeks designation; and
- e. Acknowledge that it may be required to provide equal access if all other ETCs in the designated area relinquish their designations pursuant to Section 214(e)(4) of the Act.

The Order also encouraged States to apply a public interest standard, including consideration of a cost-benefit analysis and potential “creamskimming” effects in instances where an ETC applicant seeks designation below the study area level of a rural incumbent LEC. And to make sure the guidelines were applied uniformly, the FCC encouraged States to require annual certifications from all ETCs, even those previously designated, including progress reports on coverage and service quality improvements.

At this writing, at least 24 State commissions have either implemented the guidelines or initiated rulemakings to incorporate some or part of these suggested guidelines. There are, of course, some natural tensions to work through, such as how a State can certify compliance with service quality and consumer protection standards for some competitive ETCs if federal legislation ultimately puts jurisdiction over the terms and conditions for some carriers beyond our reach.

Contributions to Federal and State universal service.

NARUC supports efforts to more equitably distribute the funding base of the federal Universal Service Fund (USF) in a technology-neutral manner, and we appreciate provisions in HR 5072, the Universal Service Reform Act of 2006, that would empower the FCC to do so. Broadening the contribution base for universal service is not a question of how much is collected, but rather of fairness in how it is collected.

We also believe such efforts at the federal level must be accommodated by similar efforts to ensure the long-term sustainability of State programs. Today, Universal Service is a jointly shared responsibility between the States and the federal government, with 26 State programs distributing about \$1.3 billion, or nearly 20 percent of the overall national commitment to Universal Service. This joint approach benefits both “net donor” and “net recipient” States because it lessens the burden on an already sizable federal program and permits another option when federal disbursement formulas that “work” in the aggregate do not adequately serve a particular State or community.

Unfortunately, State universal service funds face the same structural funding challenges as the federal program, with many new services that rely on a ubiquitous network (and exchange traffic with the PSTN) failing to contribute equitably to either one. For this reason, we believe that any efforts to expand the federal contribution base,

especially to include intrastate revenues, must also clarify State authority to assess against the same broad base, including total revenues for subscribers within a State. Preserving State programs is also a question of fairness between the states. The 1996 Act explicitly contemplated that universal needs would be met by both State and federal programs and, for this reason, did not attempt to accomplish everything through the federal program. For that reason, I suspect that if Congress ever chose not to preserve State programs, those 26 States would expect to be made whole in the federal distribution formula, creating even more upward pressure on the fund, especially on “net donor” states.

Ultimately, we believe the best solution is to stabilize the contribution base of State universal service programs at the same time the base is stabilized for the federal program, by making State USF assessment authority co-extensive with that of the federal program, allowing for the use of numbers, connections, total revenues or whichever approach is ultimately chosen. We appreciate the provisions in HR 5072 that would hold State programs harmless when the federal fund is expanded to include intrastate revenues and we look forward to working with all the members of this Subcommittee on those issues.

Intercarrier compensation: Inseparable from USF.

Finally, I’d be remiss if I didn’t say a few words about intercarrier compensation, an issue that is joined at the hip with universal service and one that some people call the “elephant in the room.” As the members of this Subcommittee know, the federal Universal Service Fund was created as a vehicle to eliminate implicit subsidies in the telecommunications industry and make at least some of them into explicit subsidies that could be sustained in a competitive environment. Perhaps the single largest source of those subsidies was above-cost charges to originate and terminate calls – intercarrier compensation.

Many of the accounts within Universal Service were created as part of past plans to lower access charges, such as the “CALLS” plans and the “MAG” plan, and many State universal service funds were created to reduce or eliminate implicit subsidies in intrastate access charges. Even today, the collective amount of funds received from intercarrier compensation is estimated to be around \$10 billion, more than State and federal universal service programs combined.

NARUC’s leaders have been brokering a dialogue among every segment of industry for almost two years, designed to produce an approach with as much consensus support as possible, especially since this is a plan that governs largely how these carriers will relate to each other economically. For today, my only caution to members of this Subcommittee is to be aware that whatever approach is ultimately adopted by the FCC or Congress, it is likely to once again have a big impact on universal service.

Conclusion:

Beyond universal service programs, States have also taken numerous measures to encourage expeditious availability of broadband and telephonic infrastructure, including numerous bills that deregulated incumbent phone companies in return for promises to offer broadband, cooperative agreements to purchase broadband services in return for commitments to build out to surrounding business and residential areas, and in some cases, public builds of broadband infrastructure.

Ultimately, NARUC’s members share each of your concerns about delivering the best, most efficient, advanced and affordable communications services to each of your communities. As you consider changes to Universal Service, both State and federal, we offer ourselves as partners, especially when it comes to impact of national policies on each individual State.

MR. UPTON. Thank you.

Mr. Frantz.

MR. FRANTZ. Good afternoon, Mr. Chairman and members of the committee.

My name is Skip Frantz. I am the chairman of the newly-formed Windstream Corporation. This company is the result of the pending spin-off by Alltel Corporation of its wireline, voice, data, and video business and the concurrent merger of that business with Texas-based Valor Communications Group. Upon completion of this transaction, Windstream will be the largest telecommunications provider focused on delivering voice, data, and entertainment services to rural America.

I am proud of this new company. I appear before you today, however, as Chairman of USTelecom. USTelecom represents more than 1,000 companies, from small, rural phone companies to some of the largest communications providers in the world.

I appreciate the opportunity to speak with you today on behalf of USTelecom about the continuing importance of universal service.

Allow me to begin by thanking this committee, particularly Chairman Barton, Subcommittee Chairman Upton, and Congressmen Pickering and Rush for your efforts toward updating the Nation's communications laws.

Our members' companies and our customers appreciate your efforts to advance video choice legislation. Real video choice will deliver billions of dollars in consumer savings and incentivize vigorous investment in the Nation's broadband infrastructure.

As this committee well understands, the communications landscape is undergoing rapid and dramatic change as previously distinct technologies evolve and platforms come into direct competition.

In this environment, our members are unified in their commitment to two legislative principles: first, market-based competition that ensures that consumer choices, rather than outdated government policies, determine marketplace success; and second, universal service reform to ensure affordable, reliable telecommunications for all Americans in the 21st Century.

This hearing is significant. USTelecom is unique in its diverse membership. We represent providers of all sizes, including companies utilizing multiple technology platforms and companies serving urban, suburban, and rural America. Our members have differences, but we share a commitment to working with Congress to advance video choice and a secure future for universal service.

Universal service ensures that all Americans, regardless of geography or income, have access to affordable, reliable communications. The High-Cost Fund is essential to this vision because it makes possible the availability of affordable service in sparsely

populated areas. Rural markets have much lower population densities than urban markets, which creates a straightforward challenge: the significant expense of building, maintaining, and upgrading a large geographic network and few customers from which to recover costs. The result, in the absence of universal service support, would be phone bills that are anything but reasonable and affordable. In a very real sense, universal service is more important today than ever before, given the information age in which we now live.

In spite of its urgent importance, however, universal service is in peril. The historic core of funding, long-distance revenues, is shrinking as consumers reap the benefits of low-cost nationwide calling plans, not to mention free alternatives, like e-mail, instant messaging, and PC-to-PC calling.

At the same time, demand on the High-Cost Fund is rising as a result of needed reform of intercarrier compensation as well as increased use by many States of universal service to subsidize not only service but competition in areas where just one company would struggle to exist in the absence of subsidies.

USTelecom believes that the current system needs immediate reform. Our suggestions are: first, broaden the base of contributors; second, carefully target recipients; and third, cap government resources to speed broadband deployment. Overall, both the Boucher-Terry legislation and the universal service provisions in Senator Stevens' legislation are consistent with USTelecom principles.

Mr. Chairman, we appreciate your time and attention today. We are grateful for the hard work of the committee and staff. We believe universal service has a vital ongoing role advancing rural America, and we look forward to working with you on sound policies that ensure that all Americans have access to affordable and reliable communication services.

Thank you very much.

[The prepared statement of Skip Frantz follows:]

PREPARED STATEMENT OF SKIP FRANTZ, CHAIRMAN, UNITED STATES TELECOM
ASSOCIATION

USTelecom thanks the committee, particularly Chairman Barton, Subcommittee Chairman Upton and Congressman Rush, for its efforts toward updating the nation's communications laws. Real video choice in America would deliver more than \$8 billion in consumer savings in the first year alone. Removing barriers to competition in this area also would incent further vigorous investment in the nation's broadband infrastructure.

The communications landscape is undergoing rapid change. In this competitive environment, our diverse membership is united behind two guiding legislative principles:

- (1) Market-based competition that ensures consumer choices, rather than outdated government policies, dictate marketplace success; and

- (2) Universal service reform to ensure affordable, reliable telecommunications for all Americans in the 21st century.

Universal service is a shared commitment to ensuring that all Americans—regardless of geography or income—have access to affordable, reliable communications.

High-cost support offsets the exceptional expense of serving sparsely-populated areas. Rural markets have much lower population densities than urban markets. The challenge: The expense of building, maintaining and upgrading a large geographic network—and few customers from which to recover costs. The result, in the absence of universal service support, would be phone bills that are anything but “reasonable and affordable.”

Universal service is more important today than ever before given the information age in which we now live. However, it is in significant peril. The historic core funding base—long-distance revenues—is rapidly shrinking. At the same time, demand on the high-cost fund has increased both from needed reform of intercarrier compensation and rising use of the fund to subsidize not only service, but competition.

The increasingly precarious revenue base and the concurrent rising demand for resources have combined to drive the USF contribution factor from 5.9% in the first quarter of 2000 to 10.9% in the first quarter of this year. USTelecom has long believed that the current system needs immediate reform. Our primary suggestions include: (1) broadening the base of contributors; (2) carefully targeting recipients; and (3) tapping government resources to speed broadband deployment.

Overall, both the Boucher-Terry legislation and universal service provisions in Sen. Stevens’ communications legislation are consistent with the principles embraced by the USTelecom Board. We also thank Chairman Barton for accepting the Gutknecht/Stupak amendment to the COPE Act and express our appreciation for this acknowledgement of the broad support in the House for sustaining universal service.

Good afternoon, Mr. Chairman, members of the committee. My name is Skip Frantz. I am Chairman of the newly-formed Windstream Corporation. This company is the result of the pending spin-off by Alltel Corporation of its wireline voice, data and video business and the concurrent merger of that business with Texas-based Valor Communications Group. Upon completion of this transaction, which is scheduled to occur in mid-July, Windstream will be the largest telecommunications provider in the U.S. focused on delivering voice, data and entertainment services to rural America. I am proud of the new company, its mission and its plans to deliver innovative services to customers across our market areas in 16 states.

But I appear before this committee today in a different capacity—as Chairman of the USTelecom Association. USTelecom represents more than 1,000 communications companies—from the smallest rural telephone cooperatives in America to some of the largest communications service providers in the world. I feel privileged to appear in that capacity on behalf of our industry trade association and to have this opportunity to speak with you today about the future of communications in our country and the ongoing value of universal service.

Allow me to begin by thanking the members of this committee, particularly Chairman Barton, Subcommittee Chairman Upton and Congressman Rush, for your efforts toward updating the nation’s communications laws. Our companies, our customers—and, I suspect, even many of the cable companies, as well—appreciate your efforts to advance video choice legislation. The House floor vote two weeks ago was a beneficial, bipartisan vote in favor of competition and consumer choice and has helped generate real momentum, particularly in the Senate, where a mark-up now appears likely on video choice legislation this month.

It is estimated that real video choice in America would deliver more than \$8 billion in consumer savings in the first year alone. Removing barriers to competition in this area also would incent further vigorous investment in the nation's broadband infrastructure.

As this committee well understands, the communications landscape is undergoing rapid and dramatic change as previously distinct technologies evolve and platforms come into direct competition. In this competitive environment, our member companies are united in our commitment to two guiding legislative principles:

- (1) We believe in reforms that advance market-based competition to ensure consumer choices, rather than outdated government policies, dictate which technologies and companies succeed in the marketplace; and
- (2) We believe the time has come to reform universal service to ensure affordable, reliable telecommunications for all Americans in the 21st century.

Mr. Chairman, this unity is significant and, I believe, noteworthy in terms of your efforts today. USTelecom is unique in the breadth and diversity of its membership. We are the industry's central forum, representing small, mid-sized and large communications providers, including companies utilizing multiple technology platforms and companies serving urban, suburban and rural America. Although our member companies have differences, we stand united in our commitment to working with Congress to achieve these two objectives of delivering video choice to consumers and ensuring a stable, sustainable future for universal service.

Mr. Chairman, your hearing today asks a central and timely question: What are we subsidizing and why? In its purest form, universal service is a shared commitment to ensuring that all Americans—regardless of geography or income—have access to affordable, reliable communications. As our transition into an information-based society accelerates, this basic access becomes more and more important to the nation's economy and the opportunities it affords to our citizens.

The high-cost fund is essential to this vision of a ubiquitous network across a landscape as vast as the United States. It is a pact between the government and the private sector: Telecommunications companies provide essential communications services at reasonable and affordable rates...and high-cost support makes that possible by offsetting the exceptional costs of serving sparsely-populated areas.

In targeting sparsely-populated rural areas, high-cost support advances the goal of universal service in communities with costs that are significantly above the national average. Rural markets have much lower population densities than urban markets, often as little as 13 phone lines per square mile. This, of course, creates a straightforward economic challenge: The significant expense of building, maintaining and upgrading a large geographic network—and very few customers from which to recover its costs. The result, in the absence of universal service support, would be phone bills that are anything but “reasonable and affordable.” Prices in many parts of rural America would skyrocket and in a number of areas, service would be cost-prohibitive.

So if you believe in the goal of keeping the country connected through affordable, essential communications services, then universal service is, in a very real sense, more important today than ever before given the information age in which we now live. In spite of its urgent importance, however, it is in significant peril. Traditional sources of revenue are in steep decline. The historic core base of funding—long-distance revenues—is rapidly shrinking as consumers reap the benefits of much lower national and international calling plans—not to mention free alternatives, such as email, instant messaging and PC-to-PC calling. From 2000-2004 alone, long-distance revenues declined by \$5 billion in the U.S.

At the same time, demands on the high-cost fund have increased. These demands result from needed reform of intercarrier compensation as well as the more expansive

view taken by many states in recent years that universal service should subsidize not only service in remote areas—but competition. This latter view has often left the fund to subsidize not one provider, but two or more competing providers in areas where one provider would struggle to exist in the absence of subsidies.

The increasingly precarious revenue base of universal service and the concurrent rising demand for resources have combined to drive the USF contribution factor from 5.9% in the first quarter of 2000 to 10.9% in the first quarter of this year. USTelecom, alongside many on Capitol Hill, has grown increasingly concerned with the fund's diminished financial stability. We have long believed that the current system needs immediate reform. Our primary suggestions include: (1) broadening the base of contributors; (2) carefully targeting recipients; and (3) tapping government resources to speed broadband deployment.

Overall, both the Boucher-Terry legislation and universal service provisions in Sen. Stevens' communications legislation are consistent with the principles embraced by the USTelecom Board. And, Chairman Barton, we also thank you for accepting the Gutknecht/Stupak amendment to the COPE Act and express our appreciation for this acknowledgement of the broad support in the House for sustaining universal service.

The amendment, as you know, preserves the FCC's authority to require VoIP providers to contribute to universal service alongside their other voice competitors. Just a few years ago, very few people had even heard the acronym VoIP. Today in North America, there are more than 1,100 VoIP providers offering service and more than 7.4 million VoIP subscribers. It is important that all providers contribute in the same way to this shared national commitment to universal service.

Mr. Chairman, we appreciate your time and attention today. We appreciate the hard work of the committee and the staff on updating the nation's communications laws. We believe universal service has a vital, ongoing role to play ensuring that rural America has every opportunity to reap the full benefits of this new world of communications, and we look forward to working with you on sound policies that will ensure all Americans have access to affordable and reliable communications services.

MR. UPTON. Thank you.

Mr. Cimerman.

MR. CIMERMAN. Thank you.

Mr. Chairman, members of the committee, thank you for inviting me to testify here today.

My name is Rick Cimerman. I am the Vice President of State Government Affairs for the National Cable and Telecommunications Association, NCTA, which is the principal trade association representing the cable industry in the United States. Our members include cable operators serving more than 90 percent of the Nation's cable television subscribers as well as more than 200 programming networks. Our members also include suppliers of equipment and services to the cable industry. We are, as an industry, the Nation's largest broadband provider of high-speed Internet access after investing \$100 billion of private risk capital over the last 10 years to build out a two-way interactive network with fiber optic technology. We also provide state-of-the-art digital telephone service to millions of American consumers.

We appreciate your giving the cable industry the opportunity to share our views. We strongly support the goals and purposes of the Universal

Service Fund, but at the same time, we share the concerns of policymakers, industry stakeholders, and the public that, in its current form, the Universal Service Program is not sustainable. There appears to be a general consensus that all aspects of the system, including contributions, eligibility, and level of support are in need of reform.

But at the outset, I want to be clear that cable operators that offer VoIP services pay millions of dollars into the current Universal Service Fund and we support making that obligation clear in the law. In addition, cable companies that offer traditional circuit switched service pay into the fund exactly the same as all other incumbent and competitive local exchange carriers that offer circuit switched service.

So in discussing High-Cost Universal Service reform today, I want to make three main points. First, we believe that a telephone number-based contribution mechanism should be adopted for Universal Service assessments. Broadband services, however, should not be assessed for universal service purposes. And all Universal Service distributions should be competitively and technologically neutral and encourage efficiency.

So as for a number-based system, we understand that the current contribution mechanism, which relies on the assessment of interstate telecommunications revenues only, virtually guarantees that the fund will continue to shrink. To address that problem, we have long advocated a telephone number-based system, a simple yet effective reform that we believe will sustain the long-term health of the fund while adapting to the evolving technology and economics of voice telephony. Using phone numbers would be a relatively simple means of determining who should contribute as well as when contributions were owed and in what amount. There will be no need to apportion provider revenues into interstate versus intrastate or determine which portion of a bundled offering represents interstate telecommunications or telecommunication services versus information services or which portion of the bundle is telecommunications versus video versus data. So it would make no difference which way these services were defined. Also, under a telephone number-based system, all that would matter is whether the service uses a phone number or not. It would be simple to understand for consumers, unlike today's system.

We don't believe, however, that universal service fees should be imposed on broadband service, particularly at the same time as policymakers seek to encourage more widespread deployment and service penetration. We believe such a fee would be counterproductive and would raise the price of high-speed Internet services for current and potential broadband customers. An appropriately crafted number-based plan would raise the revenue necessary to put the Universal Service Fund

on solid and stable ground. According to the FCC, there are now 565 million telephone numbers in use. If each number were assessed \$1 a month, we would raise \$6.8 billion a year, an amount that exceeds the 2005 expenditures of \$6.3 billion. But all of the various number-based proposals before the FCC also call for retaining an appropriate contribution from non-number-based services, most particularly special access and private line services used by businesses. Now there are various proposals on how to assess those services: capacity base, connections base, revenue base. In any case, as long as those contributions were retained, the revenue raised would reduce the required number-based assessment below \$1 per month. So the assessment of broadband service is unnecessary to the goal of a stable, sufficient, and predictable fund.

Finally, I want to say just a few words about USF distributions. We believe that any reform must address disbursements as well as contributions, and that disbursements ought to be fair, equitable, and efficient. So in terms of the eligibility to receive funds, we believe that VoIP service providers ought to be eligible to receive funds, even if the service is classified as an information service. There are additional restrictions on ETC, or eligible telecommunications carrier, eligibility. For example, offering local usage plans comparable to those offered by the incumbent, or matching the service area of the incumbent local exchange area. We don't believe that competitors should have to mimic the service offerings of an ILEC in order to receive funds.

Finally, Congress should consider the possibility of promoting more efficient use of universal service funds by establishing a cost benchmark and supporting no more than one line per household.

So, Mr. Chairman, thank you for inviting me here to testify, and I will be happy to answer any questions.

[The prepared statement of Richard Cimerman follows:]

PREPARED STATEMENT OF RICHARD CIMERMAN, VICE PRESIDENT, STATE GOVERNMENT
AFFAIRS, NATIONAL CABLE AND TELECOMMUNICATIONS ASSOCIATION

Chairman Barton and members of the committee thank you for inviting me to testify today. My name is Rick Cimerman and I am the Vice President of State Government Affairs for the National Cable & Telecommunications Association (NCTA), which is the principal trade association representing the cable industry in the United States. Its members include cable operators serving more than 90% of the nation's cable television subscribers, as well as more than 200 cable programming networks. NCTA's members also include suppliers of equipment and services to the cable industry. The cable industry is the nation's largest broadband provider of high speed Internet access after investing \$100 billion over ten years to build out a two-way interactive network with fiber optic technology. Cable companies also provide state-of-the-art digital telephone service to millions of American consumers.

The Cable Industry Supports Universal Service

Thank you for inviting me to comment on universal service issues. We appreciate your giving the cable industry the opportunity to share its views. The cable industry strongly supports the goals and purposes of the universal service fund (USF). Universal service is a longstanding component of national telecommunications policy and we share the concerns of policymakers, industry stakeholders and the public that, in its current form, the universal service program is not sustainable. While there is general consensus that all aspects of the system, including contributions, eligibility and level of support are in need of reform, there are a wide range of views as to how the program should be restructured.

At the outset I want to be clear that cable operators that offer VoIP services pay millions of dollars into the current universal service fund and we support making that obligation clear in law. In addition, cable companies that offer traditional circuit switched service pay into the fund exactly the same as all other incumbent and competitive local exchange carriers that offer circuit switched service.

In discussing high cost universal service reform today I will make three main points:

- a telephone number-based contribution mechanism should be adopted;
- broadband services should not be assessed for universal service purposes;
- all universal service distributions should be competitively and technologically neutral and encourage efficiency.

A Number-Based Assessment Mechanism Should Be Adopted

The current USF contribution mechanism, which relies on the assessment of interstate telecommunications revenues only, virtually guarantees that the fund will continue to shrink. There are several reasons for this. An increasing number of companies offer consumers voice telephone service for a fixed monthly rate that does not differentiate between local or long distance calls. Companies also offer bundled packages of digital services that include voice telephony. Most consumer VoIP services are offered without regard to intrastate or interstate distinctions. The fact is that interstate telecommunications revenues have been declining and are predicted to continue declining for the foreseeable future. As the line between what is a local and long distance call continues to blur, the existing USF contribution mechanism will become increasingly obsolete which threatens the viability of the program itself.

To address this problem, the cable industry has long advocated the adoption of a telephone numbers-based contribution mechanism, a simple yet effective reform that will sustain the long-term health of this fund while adapting to the evolving technology and economics of voice telephony. Using telephone numbers would be a relatively simple means of determining who should contribute as well as when contributions were owed and in what amount. There would be no need to apportion provider revenues into interstate versus intrastate or to determine which portion of a bundled offering represents interstate telecommunications. It would also make no difference whether a service was defined as a telecommunications service or as an information service. Under a telephone number-based system, all that matters is whether or not the service uses a phone number. Adoption of this approach would promote competitive neutrality among all voice telephone providers – those who offer their services as a replacement for plain old telephone service (POTS) – and would avoid assessments on services that only include a voice component but are not a substitute for POTS. Few would argue, for example, that applications, or devices, where voice functionality is ancillary to the actual purpose of the service or device—such as voice enabled gaming—should be assessed for USF purposes.

Some have expressed concern that a numbers-based system would collapse as proposals to map telephone numbers to Internet addresses, such as ENUM, become a reality. However, ENUM requires that a subscriber have an active telephone line. If someday in the distant future a non-number based system were developed and widely

implemented, the telephone number- based contribution mechanism could easily be adapted, as some form of unique identifier or address will always be necessary to route various types of voice communications.

Mr. Chairman, the reality is that interstate telecommunications revenues are declining and will continue to decline. Conversely, an FCC staff analysis shows that the number of active telephone numbers is expected to grow for the foreseeable future, from 554 million numbers in use in 2004 to nearly 600 million numbers in use in 2007. Moving to a numbers-based USF contribution mechanism embraces this reality and will ensure the universal service fund remains solvent well into the future. Furthermore, it would create a more predictable and equitable split between assessments collected by providers of local and long distance telephone services, and between residential and business subscribers. Residential telephone subscribers would generally pay less under a numbers-based plan. Assuming an appropriate assessment amount, even most one-line households with low long distance usage would pay the same or less under a numbers-based system than they do under the existing interstate revenue model.

This is a particularly important point. Some who oppose a numbers-based assessment mechanism, because it's in their business interest to do so, claim that low-income and low volume long distance users will be unfairly burdened by a numbers-based system. They fail to note that proponents of such a system have proposed that low-income users be exempt from USF assessment. And, perhaps more misleadingly, they fail to note that even local telephone subscribers that make no long distance calls pay at least \$.54 per month into USF based on assessments on the interstate federal subscriber line charge. Given that the various proposals before the FCC call for at most an assessment of \$1.01 per number per month, and other proposals call for something less than \$1.00, arguments that low volume users will be unduly burdened ring hollow.

New Government Fees Should Not Be Imposed on Broadband Service

The imposition of new fees on broadband service at the same time policymakers seek to encourage more widespread deployment and service penetration would be counter-productive and would raise the price of high-speed Internet services for current and potential broadband customers. An appropriately crafted numbers-based assessment plan that avoids assessing broadband service will raise the revenue necessary to put the universal service fund on solid and stable ground. According to the FCC there are now 565 million telephone numbers in use. If each telephone number were assessed a universal service contribution of \$1.00 per month then \$6.8 billion per year would be raised – an amount that exceeds the 2005 expenditure of \$6.5 billion. But the various number-based proposals before the FCC also call for retaining an appropriate contribution from non-number based services, most particularly special access and private line services used by businesses. Whether such services are assessed on a capacity-based connections basis, or a revenue basis, the revenue raised would reduce the required number-based assessment well below \$1.00 per month. Thus, the assessment of broadband service is unnecessary to the goal of a stable, sufficient and predictable fund.

USF Distributions Should Be Competitively and Technologically Neutral and Encourage Efficiency

It is essential that any high cost universal service reform address disbursements as well as contributions. The goals of reform should be to ensure that contributions are assessed fairly, eligibility and distributions are determined equitably, efficiently, and support is targeted to the appropriate services.

Eligibility to Receive Funds. Existing statutory requirements impede the eligibility of new entrants to receive universal service funds, even if they are the most efficient provider of basic services. For instance, current law requires that a recipient must be an “eligible telecommunications *carrier*” (ETC), potentially excluding VOIP service

providers if VOIP is classified as information service. The FCC imposes additional restrictions on ETC eligibility, including the requirement to offer local usage plans comparable to those offered by incumbent local exchange carrier (ILEC) in the area and to provide equal access to long distance carriers if all other ETCs in area relinquish their designations.

Competitors should not have to mimic ILEC service offerings or network architecture or geographic coverage to qualify for universal service support. Cable telephony providers should be eligible if they offer supported services throughout their cable franchise areas, without regard to the historical ILEC study area or technology.

Promoting Efficiency. High cost universal service reform should attempt to introduce more efficiency into the rural and high-cost support mechanisms. As competitive options become available to rural consumers, it may be possible to cap the existing funds or even reduce them. Congress should also consider the possibility of promoting more efficient use of universal service funds by establishing a cost benchmark for awarding support and limiting support to one line per household.

Finally, while we agree that it is critically important to ensure that providers of supported services to consumers in rural and high-cost areas have adequate funding, as universal service contributors we also believe that funding must be subject to reasonable and regular oversight including assurances that universal service funds are being spent for their intended purpose.

Mr. Chairman, thank you for inviting me to testify today. I would be happy to answer any questions you or the members of the committee may have.

MR. UPTON. Thank you.

Mr. Crothers.

MR. CROTHERS. Good afternoon, Mr. Chairman.

My name is David Crothers. I am here today to testify on behalf of the National Telecommunications Cooperative Association. We thank you for the opportunity to appear before you today.

Universal service has remained the cornerstone of our Nation's telecommunications policy for more than 6 decades. It ensures that we enjoy the benefits of a nationwide integrated communications network. It is arguably one of the most successful programs in American history and has played a key role in our Nation attaining a near ubiquitous telephone subscribership level of 94 percent.

Mr. Chairman, the subject of this hearing is USF, what we are subsidizing and why. Let me begin my testimony by saying what USF is not. It is not a subsidy, and it is not a tax. USF is an industry-funded, cost-recovery mechanism that offsets the higher cost to build and maintain a vital communications network in rural, sparsely populated areas. No Federal monies are appropriated to this fund. Carriers that made the commitment to invest and deploy networks in high-cost areas receive support, which in turn allows them to offer service to rural consumers at a rate comparable to that offered to customers in lower cost urban areas.

As to the question why, Mr. Chairman, we believe the answer is evident. It is in the national and public interest for all Americans to have

affordable access to communication services. Some question the continued need for universal service. To those that doubt, I would invite you to visit my State of North Dakota and see the incredible accomplishments of this program for yourself. I can assure this committee that universal service is still needed and is even more essential now as the Nation transitions to a digital and broadband world. Likewise, this does not alter the fact that the cost to serve rural areas is, always has been, and always will be more expensive than in urban and suburban areas.

For ILECs, the High-Cost Universal Program is a highly accountable, cost-based program. Rural carriers with costs exceeding 115 percent of this national average cost per line receive support from the fund to offset these elevated costs. Incumbents file immense amounts of data that is reviewed and vetted at many levels, including the fund administrator, the Universal Service Administrative Company, and the FCC.

H.R. 5072, the Universal Service Reform Act introduced by Representatives Terry and Boucher contains provisions that meet the policy goals of NTCA. It has two goals: spur deployment of broadband services, and control growth in the Universal Service Fund. Broadband is an integral part of the commercial, economic, and social viability of any community. A community that lacks access to broadband and advanced services will not have pride and may not even survive.

While there are concerns that adding broadband to the Universal Service Program will cause the size of the fund to increase, this bill takes several steps to limit potential growth. We believe several of the cost-saving provisions in the bill will be extremely effective and may offset much of the additional cost of deploying broadband. In particular, NTCA supports the expansion of the pool of providers and services that pay into the fund. The bill would require all providers that use telephone number, IP addresses, or offer a network connection for a fee to the public to contribute to the fund. This is long overdue. Changes in technology have created loopholes that have allowed many new providers to abate contributing even though they benefit from the resulting network upgrades and investment.

We fully understand and appreciate the political realities of compromise in this legislative process, Mr. Chairman, and the need to control expenditures and growth of USF. If a cap is necessary to secure House passage, we stand willing to work with you to ensure that rural carriers are not negatively affected. NTCA is very pleased that Congressmen Lee Terry and Rick Boucher have taken a leadership role through their legislation to ensure the vital policy of universal service remains solvent and forward-looking. The Universal Service Fund is

critical in reaching the near ubiquitous telephone subscriber rate currently in the United States. This bill will put the Universal Service Fund on course to bring the same level of broadband subscribership to all Americans. We urge the committee to continue with the process and push for the passage of H.R. 5072 by the full House this year. NTCA stands ready and committed to working with Representatives Terry, Boucher, and the Energy and Commerce Committee to see that America takes this crucial step forward towards a broadband America.

Thank you.

[The prepared statement of David Crothers follows:]

PREPARED STATEMENT OF DAVID CROTHERS, EXECUTIVE VICE PRESIDENT, NORTH
DAKOTA ASSOCIATION OF TELEPHONE COOPERATIVES, ON BEHALF OF NATIONAL
TELECOMMUNICATIONS COOPERATIVE ASSOCIATION

Good afternoon. I am David Crothers, Executive Vice President of the North Dakota Association of Telephone Cooperatives. I am here today to testify on behalf of the National Telecommunications Cooperative Association. We thank you for the opportunity to testify before you today. My comments today will focus primarily on the high-cost program within the universal service fund.

Universal Service has remained the cornerstone of our nation's telecommunications policy for more than six decades, ensuring that we enjoy the benefits of a nationwide integrated communications network. It is arguably one of the most successful programs in American history playing a key role in our nation attaining a near ubiquitous telephone subscribership level of 94%.

Mr. Chairman, the subject of this hearing is "USF, what are we subsidizing and why?". Let me begin my testimony by telling you what USF is not. It is NOT a subsidy and it is NOT a tax. USF is an industry funded cost recovery mechanism that offsets the higher cost to build and maintain vital communications networks in rural, sparsely populated and insular portions of our Nation. No federal monies are appropriated to this fund what so ever. Carriers that made the commitment to invest and deploy networks in high-cost areas receive support which in turn allows them to offer service to rural consumers at a rate comparable to that offered to consumers in lower cost urban areas.

As to the question "why", Mr. Chairman my answer is simple: it is in the national and public interest for all Americans to have affordable access to communications services. Some question the continued need for universal service. To these doubters I invite you to visit my state of North Dakota and see the incredible accomplishments of this program for yourself. I can assure this committee that the universal service fund is still needed and I believe that it is even more essential now as the nation transitions to a digital and broadband world. While it is true that advances in technology may in some cases bring down the cost of providing communications services this is an over generalization. Likewise, this does not alter the fact that the cost to serve rural areas is, and always will be, more expensive than in urban and suburban areas. That, Mr. Chairman, is a fact that no one will dispute.

For ILECs, the high-cost universal service program is a highly accountable cost-based program. Support out of the fund is based on a national average cost per line calculated by the FCC. Rural carriers with costs exceeding 115% of this national average may receive support from the fund to offset these elevated costs. Incumbents file immense amounts of data outlining their costs and network investments to receive cost recovery support from the fund. This data is reviewed and vetted at many levels,

including by the fund administrator, the Universal Service Administrative Company (USAC), and the FCC.

However, new competitive carriers are treated differently. Under the guise of competitive neutrality the FCC unwittingly undermined the accountability of the fund by allowing new competitive carriers to receive support from the universal service fund without the same stringent reporting and accounting requirements mandated of the incumbents. Instead of filing their own cost and investment data, these new competitive entrants receive support based on incumbents costs. The vast majority of growth in universal service is due to competitive eligible telecommunications carriers (ETCs). Universal service support to competitive ETCs grew by over 115% in 2004¹. During this same period ILEC support grew by only 0.6%. Requiring all universal service fund recipients to receive support based on their own costs will increase program accountability, reduce demand for funds and ensure that funds are being used for their intended purpose.

NTCA's Communications Act Re-write Policy Course is attached to my testimony. In the interest of time I will not go over it but I would like to briefly go over its key universal service policy positions. NTCA strongly believes:

- The universal service fund must continue to be an industry-funded mechanism, and neither supported through general tax revenues nor subjected to the federal Anti-Deficiency Act.
- The base of contributors must be expanded to include all providers utilizing the underlying infrastructure, including but not limited to all providers of 2-way communications regardless of technology used.
- Support shall be made available for the cost recovery needs of carriers deploying broadband capable infrastructure.
- The contribution methodology must be assessed on all revenues or a revenues hybrid that ensures equitable and nondiscriminatory participation.
- Support must be based upon a provider's actual cost of service and must not be used to artificially incite competition.

If enacted, these policies will ensure the long term sustainability of the universal service fund, bring it in line with technological and market realities of today and position the fund to meet the communications needs of the future. The Universal Service Reform Act of 2006 (H.R. 5072) introduced by Representatives Terry and Boucher, contains provisions that meet the policy goals of NTCA. H.R. 5072 has two goals: spur deployment of broadband services and control growth in the universal service fund.

In regard to expanding the universal service program to cover deployment of broadband networks, I don't think anyone would dispute the growing importance of broadband. Broadband is an integral part of the commercial, economic and social viability of any community. A community that lacks access to broadband and advanced services will not thrive and may not even survive. It is simply that important.

While there are concerns that adding broadband to the universal service program will cause the size of the fund to increase, this bill takes several steps to limit potential growth. We believe several of the cost saving provisions in the bill will be extremely effective and may offset much of the additional cost of covering broadband. In particular, NTCA supports expansion of the pool of providers and services that pay into the fund. The bill would require all providers that use telephone numbers, IP addresses or offer a network connection for a fee to the public to contribute to the fund. This is long overdue. Changes in technology have created loopholes that have allowed many

¹ Wireless Communications and Universal Service by Bob Rowe, Senior Partner, Balhoff & Rowe, LLC @ Columbia Institute for Tele-Information. Slide 12.

new providers to evade contributing into the fund even though they benefit from the resulting network upgrades and investment.

NTCA however, does not support provisions contained in the bill that would institute a statutory cap on the universal service fund. A cap by its very nature means a carrier will not receive the support it is due and thus is antithetical to the very goal of universal service. A cap is a disincentive to network investment. The FCC has maintained a regulatory cap on the fund for a number of years, and while we are not supportive of it, it is evidence to this committee that the Commission takes its role as steward of universal service monies seriously. In addition, a regulatory cap allows for flexibility to adjust in the future should circumstances change. We believe the many other positive provisions in H.R. 5072 discussed here go a long way towards achieving the goal of limiting growth in the universal service fund and thus make the proposed statutory cap unnecessary.

NTCA is very pleased that Congressmen Lee Terry and Rick Boucher have taken such a leadership role through their legislation in working to ensure the vital policy of universal service remains solvent and forward looking. H.R. 5072 contains many provisions recommended by NTCA that would continue and expand upon the highly successful universal service program.

The universal service fund was integral to reaching the near ubiquitous telephone subscriber ship rate that currently exists in the United States. This bill will put the universal service fund on course to bring the same level of broadband subscriber ship to all Americans.

America stands at a crossroads between a narrowband and broadband world. The choice is clear. We must move forward aggressively with a national plan to bring broadband to all Americans, as envisioned by President Bush in his goal of ubiquitous broadband by 2007. To NOT move forward would imperil the global economic competitiveness of the United States. We urge the committee to adopt H.R. 5072 and push for its passage by the full House of Representatives this year.

NTCA stands ready and committed to working with the Energy and Commerce Committee, and the entire congress, to see that America takes this crucial leap forward towards a broadband America. Thank you.

MR. UPTON. Thank you.

Mr. Garnett.

MR. GARNETT. Good afternoon, Chairman Upton and members of the subcommittee. I want to thank you for focusing your attention on the important and timely issue of High-Cost Universal Service reform. CTIA is grateful for the opportunity to present its views in this important area on behalf of more than 200 million wireless subscribers.

Over the last decade, wireless industry contributions to universal service have been steadily rising while Universal Service distributions remain primarily directed to wireline carriers. Wireless carriers and their customers are responsible for about one-third of contributions to Universal Service. The wireless industry's payment into the Universal Service Program will likely exceed \$2.5 billion this year.

Meanwhile, the vast majority of universal service subsidies are directed to wireline carriers. Wireless carriers continue to receive only about 13 percent of universal service funding overall and less than 20 percent of the High-Cost Universal Service support. And to add a little

clarity to some comments made earlier about growth in the size of the fund, from 2000 through 2005, incumbent carriers accounted for roughly two-thirds the growth in the size of the High-Cost Universal Service mechanisms. Since 1997, of \$22 billion spent on High-Cost Universal Service subsidies, \$20.9 billion has gone to incumbent wireline carriers and only \$1.1 billion has gone to wireless carriers and other competitors. This inequity exists even as consumers are demanding more and more wireless services. In fact, there are now more mobile wireless service subscribers than wireline switched access lines in the United States.

As Congress considers the important question of how to reform the Universal Service system, we believe there are important lessons that can be learned from the incredible growth of the wireless industry over the last decade. In December of 1995, there were approximately 34 million mobile wireless subscribers in the United States. By December of 2005, there were over 200 million mobile wireless subscribers, and that number continues to grow. That growth has occurred even as consumers have received lower monthly bills, cheaper minutes, and new and innovative services. This result is due, in large part, to an environment of regulatory constraint that rewards efficiency and innovation.

Although most of the wireless industry's growth has occurred with the benefit of universal service subsidies, universal service can and does play a critical role in improving wireless services in high-cost, rural areas. For example, on the Pine Ridge Indian Reservation in South Dakota, Alltel has used universal service to increase telephone penetration rates from only 27 percent to 92 percent in 5 years. Centennial Wireless has used support to bring mobile wireless services to communities like Shaw and Blackhawk, Louisiana that previously had no telephone service at all, wireless or wireline. The public safety benefits of wireless deployment to these and other areas became obvious in the wake of Hurricanes Katrina and Rita last year when wireless services often were up and running long before wireline services were. We are proud of that track record, but we really do believe the best is yet to come.

As I mentioned to you before, efficiency and innovation have been the hallmarks of the wireless industry's success. We believe universal service distribution policy should replicate those values as much as possible. Unfortunately, the current High-Cost Universal Service mechanisms are frozen in a time of guaranteed profits for monopoly providers of wireline services. And I lament the very examples that Congressman Barton gave us earlier are not limited to Texas and are probably not even limited to three pockets in Texas. So unlike the competitive market in which wireless carriers operate, the High-Cost

Universal Service mechanisms and intercarrier compensation actually reward incumbent carrier inefficiency.

In practice, the FCC's High-Cost mechanisms compound incentives for inefficiency, inherent in any kind of actual cost support mechanism. For example, the High-Cost mechanisms discourage carriers from taking advantage of economies of scale normally associated with combining operations. The High-Cost mechanisms also are designed to guarantee a prescribed level of profit for incumbent wireline carriers. Taken together, these problems have resulted in the bloated fund that disserves consumers.

At the FCC, CTIA has put forth detailed market-oriented proposals to address these problems. CTIA has supported efforts to reduce demand for universal service while ensuring that support continues to be available to both incumbent and competitive ETCs, or eligible telecommunications carriers, on a non-discriminatory basis. Specifically, CTIA has proposed transitioning over a number of years from the current five High-Cost Universal Service mechanisms to one that calculates support based on the most efficient technology for a particular geographic area. CTIA is open to other market-driven proposals such as reverse auctions that would reward those carriers that bid down the price of universal service.

We also think that there are changes that can occur within the existing system as well. For example, CTIA supports eliminating profits in high-cost mechanisms. We think carriers should get their profits from their own customers, not from other carriers through universal service payments and certainly not from other carriers' customers. Increased accountability also has to be central to any reform. CTIA supports a "carrier of last resort" obligation for both incumbents and competitors. ETCs also need to show that the money that they spend is money well spent, and we support stringent reporting requirements for ETCs to show that that has happened.

We are open to other proposals, and we look forward to a continuing dialogue with the committee and Congress on these important issues.

Again, thank you for the opportunity to share our views on the universal service reform, and I welcome your questions.

[The prepared statement of Paul W. Garnett follows:]

PREPARED STATEMENT OF PAUL W. GARNETT, DIRECTOR, REGULATORY AFFAIRS, CTIA –
THE WIRELESS ASSOCIATION

- CTIA is grateful for the opportunity to present its views on high-cost universal service reform on behalf of the more than 200 million wireless consumers. Efficiency and innovation have been hallmarks of the wireless industry's incredible growth. Universal service distribution policies should replicate those values as much as possible.

- The wireless industry is a significant net payer into the universal service system. Wireless carriers contribute one-third to the overall fund, while receiving only about 13% of payments. Since 1997, of the \$22 billion spent on high-cost universal service subsidies, \$20.9 billion has gone to incumbent wireline carriers and only \$1.1 billion has gone to wireless carriers and other competitors. Wireless carriers continue to receive less than 20% of high-cost payments.
- Universal service plays a critical role in improving access to wireless services in high-cost, rural areas. In a few short years, wireless carriers have developed an incredible track record of using support to improve service quality and coverage in rural areas. In some cases, wireless carriers have brought services to communities that previously had no telephone service at all. We are proud of that track record. But, we believe the best is yet to come.
- The wireless industry shares Congress's commitment to the goals of universal service and its concerns about growth in the size of the universal service fund. Wireless carriers have strong incentives to ensure that the universal service fund is no larger than necessary, while ensuring that support is available to committed eligible telecommunications carriers (ETCs) on a non-discriminatory basis.
- There are numerous problems with the high-cost universal services mechanisms: (1) incentives for incumbent carrier inefficiency; (2) enrichment of incumbent carrier profits; and (3) a lack of accountability. Any reforms must address these issues. For the sake of consumers, who are the intended beneficiaries of and ultimately fund universal service, the high cost universal service mechanisms must demand more efficiency and accountability from fund recipients. In many instances, that would mean less "per-line" support for both incumbents and competitors.
- CTIA has proposed combining the current five high-cost universal service mechanisms into one mechanism that calculates support based on the most efficient technology – whether wireline or wireless – in a small geographic area. CTIA is open to other market-driven proposals (such as reverse auctions) that would reward more efficient carriers that compete away the cost of universal service. CTIA also has proposed shorter term reforms within the context of the current mechanisms that would reduce support for carriers that do not need it and potentially increase support to those carriers with legitimate needs.
- Incumbent and competitive ETCs also must be held accountable for the universal service funds they receive. CTIA has supported technology neutral "carrier of last resort" obligations for both incumbent and competitive ETCs. CTIA also has supported requirements that both incumbent and competitive ETCs achieve measurable results – for example, showing how universal service dollars have been used to improve service quality and coverage.

Chairman Upton, Ranking Member Markey and Members of the Subcommittee, on behalf of CTIA-The Wireless Association®, I want to thank the House Subcommittee on Telecommunications and the Internet for focusing its attention on the important and timely issue of high-cost universal service reform. CTIA is grateful for the opportunity to present its views in this important area on behalf of the more than 200 million wireless consumers. As a significant net payer into the universal service system, the wireless industry is uniquely positioned to comment on proposals to reform the universal service system.

Over the last decade, wireless industry contributions to universal service have been steadily rising, while universal service distributions remain primarily directed to wireline carriers. Wireless carriers and their customers are responsible for about one-third of contributions to universal service. The wireless industry's payment into the federal universal service programs may exceed \$2.5 billion this year.

Meanwhile, the vast majority of universal service subsidies are directed to our competitors – wireline carriers. Wireless carriers receive only about 13% of universal service support overall and less than 20% of high-cost universal service support. Since 1997, of the \$22 billion spent on high-cost universal service subsidies, \$20.9 billion has gone to incumbent wireline carriers and only \$1.1 billion has gone to wireless carriers and other competitors. So, to answer the Committee’s threshold question, the universal service mechanisms are primarily subsidizing wireline carriers. This inequity exists even as consumers – the only intended beneficiaries of universal service – are demanding more and higher quality wireless services in high-cost areas.

The wireless industry shares Congress’s commitment to the goals of universal service and its concerns about growth in the size of the universal service fund. Wireless carriers have strong incentives to ensure that the universal service fund is no larger than necessary, while ensuring that support is available to committed eligible telecommunications carriers (ETCs) on a non-discriminatory basis. Non-discrimination is a critical element of our universal service proposals. Consumers never benefit from regulations that distort the competitive market. Both incumbents and competitors should have the same opportunities to obtain universal service support.

Although we believe that a greater share high-cost universal service support clearly should be directed to deployment of more efficient wireless networks, the universal service reform debate must be more than about whether wireless or wireline carriers get the support. Policy-makers must address the more difficult question of how that support should be calculated. Otherwise, consumers will be faced with ever-increasing universal service costs. CTIA supports reforms that will ensure both incumbents and competitors receive no more support than is necessary to achieve the goals of universal service. As I will discuss, any reforms to the high cost universal service mechanisms must demand more efficiency and accountability from fund recipients. In practice, that would mean less “per-line” support for both incumbents and competitors.

Lessons Learned from the Wireless Industry Experience.

As Congress considers the important question of how to reform the universal service system, there are important lessons that can be learned from the incredible growth of the mobile wireless industry over the last decade. In December 1995, there were 34 million mobile wireless subscribers in the United States. As of December 2005, there were over 200 million mobile wireless subscribers. There are now more mobile wireless subscribers than wireline switched access lines.

Mobile wireless customers are in both rural and non-rural areas. According to the Bureau of Labor Statistics, the household wireless penetration rate in urban areas is 53.9%. The wireless household penetration rate in rural areas is not far behind – at 50.5%. The FCC has found that 97% of wireless customers live in counties with a choice of three or more wireless carriers and 87% of wireless customers live in counties with a choice of five or more wireless carriers.

Wireless carriers have been so successful, in part, because they have operated in an environment of regulatory constraint that rewards efficiency and innovation. The result has been lower monthly bills, cheaper minutes, and new and innovative service offerings. The average cost of wireless services has declined over time – even as wireless service offerings have expanded. In June 2002, before the Omnibus Budget Reconciliation Act of 1993, the average wireless bill was \$68.51 per month. As of June 2005, the average wireless bill was less than \$50 per month. In fact, in 1992 dollars, the average wireless bill in 2005 was equal to \$35.57 – slightly more than half the earlier bill. For many customers, nationwide bucket of minute plans have made wireless the service of choice for making local and long-distance calls. In 1995, the average wireless customer had about 115 minutes of use per month. In 2005, the average wireless customer had almost 700 minutes of use per month. In 1995, there were 37 billion minutes of use on wireless

networks. In 2005, there were approximately 1.5 trillion minutes of use on wireless networks.

Now, wireless carriers are in the midst of rolling out mobile broadband services. An alphabet soup of wireless broadband technologies is being deployed: Wi-Fi, Wi-Max, EV-DO, WCDMA, UMTS, to name just a few. Verizon Wireless has launched a broadband network based on evolution data only (“EV-DO”) technology available in 171 metropolitan markets covering more than 140 million people. Sprint Nextel began to roll out its EV-DO technology in mid-2005 and now offers wireless broadband services in 208 markets. In December, Cingular Wireless announced that subscribers could access its BroadbandConnect service through Cingular’s new 3G network. Alltel offers its Access Broadband service, which provides data rates comparable to wireline broadband, in nine metropolitan areas. In addition to its extensive network of wireless hotspots, T-Mobile offers mobile Internet access through its GPRS service. Deployment is not limited to the nationwide wireless providers. U.S. Cellular, Alaska Communications Systems, Cellular South, Cellular One of Amarillo, Dobson Cellular, First Cellular of Southern Illinois, Midwest Wireless, and many others are rolling out mobile wireless broadband services.

Although most of the wireless industry’s growth has occurred without the benefit of universal service subsidies, universal service can and does play a critical role in improving access to wireless services in high-cost, rural areas. Deployment of wireless services in rural markets is more costly on a per-customer basis than serving a more densely populated area. As with wireline networks, factors such as lower population densities, topography, and geographic isolation make the average cost of providing mobile wireless services in rural areas significantly higher than in urban areas.

Wireless deployment in some rural areas has occurred because of wireless carrier access to universal service support. In a few short years, wireless ETCs have achieved a great deal. In many cases, wireless ETCs have used universal service dollars to bring service to rural and insular areas. For example, on the Pine Ridge Indian Reservation in South Dakota, Alltel has used universal service to increase telephone penetration rates from 27% to 92% in only five years. Cellular South serves 380,000 square miles of rural territory in Mississippi and is using high-cost support to significantly expand its network capacity. Centennial Wireless has brought mobile wireless services to communities, such as Shaw and Blackhawk, Louisiana, that previously had no telephone service at all, wireline or wireless. These are areas where the incumbent carrier – the “carrier of last resort” – was unwilling or unable to serve all customers. The public safety benefits of wireless deployment to these and other customers became obvious in the wake of Hurricanes Katrina and Rita when wireless services were often available long before wireline services. We are proud of this track record. But, we believe the best is yet to come.

Market-Based Universal Service Reform.

As I mentioned before, efficiency and innovation have been hallmarks of the wireless industry. Universal service distribution policies should replicate those values as much as possible. Policy-makers should not repeat the mistakes of the past by supporting universal service policies that distort the competitive market or create incentives for both incumbents and competitors to develop business models premised on receipt of greater and greater subsidies. If the experience of the wireless industry can be any guide, simplified regulations that encourage and reward efficiency will best benefit consumers by ensuring that universal service is targeted only to where it is most needed and is no more than is necessary. To turn the tables on a popular wireline carrier analogy, instead of guaranteeing a “three-legged stool” of universal service, access charges, and end-user revenues in perpetuity, universal service laws and regulations should be designed to

enable carriers serving high-cost areas to eventually stand on their own two feet and compete in the marketplace.

Unfortunately, the current high-cost universal service mechanisms are frozen in a time of guaranteed profits for monopoly providers of wireline services. Unlike the competitive market in which wireless carriers operate, the high-cost universal service mechanisms (and intercarrier compensation) actually reward incumbent carrier inefficiency. They also allow incumbent carriers to keep support even as they lose customers. Absurdly, the high-cost mechanisms subsidize incumbent carriers based on what they spend (*i.e.*, their “actual” or “embedded” costs), not necessarily based on whether they actually serve customers located in a rural, high-cost area.

In practice, the FCC’s high-cost support mechanisms compound incentives for inefficiency inherent in actual cost support mechanisms. For example, the high-cost support mechanisms discourage carriers from taking advantage of economies of scale normally associated with combining operations. The high-cost universal service mechanisms also are designed to guarantee a prescribed level of profit for incumbent wireline carriers. Based on an estimated average cost of debt of only 5.46%, the average rural incumbent carrier earns a 15.06% return on equity from the universal service mechanisms. To make matters worse, many incumbent wireline carriers have reported to the FCC that they had profits far in excess of the prescribed rate-of-return. These elevated universal service profits do not translate to improved telecommunications services in high-cost areas. Instead, they simply enrich carriers, while increasing the overall size of the fund to the detriment of other carriers and consumers who end up paying higher universal service pass through charges.

Taken together, these problems result in a bloated fund that does not effectively target the appropriate levels of support to different high-cost areas. As a result, the high-cost support mechanisms do a poor job of ensuring that all Americans have access to high-quality, affordable telecommunications and information services. Moreover, the high-cost support mechanisms undermine the efficient development of competition as envisioned by the Congress in the Telecommunications Act.

At the FCC, CTIA has put forth market-oriented proposals to address these problems. CTIA has supported efforts to reduce demand for universal service, while ensuring that support is available to both incumbent and competitive ETCs on a non-discriminatory basis. Specifically, CTIA has proposed combining the current five high-cost universal service mechanisms into one mechanism that calculates support based on the most efficient technology – whether wireline or wireless – in a small geographic area. Under this proposal, incumbent and competitive ETCs would receive the same level of “per-line” support based on the most efficient wireline or wireless technology for a given area. As in the competitive market, ETCs would only receive support to the extent that they win customers. More customers would equate to more support. At the same time, incumbents and competitors that lose customers would lose support (a novel concept under the current mechanisms).

Although CTIA has suggested that a cost model could be used to calculate support, CTIA is open to other market-driven proposals (such as reverse auctions) that would reward more efficient carriers that compete away the cost of universal service. CTIA also has proposed shorter term reforms within the context of the current mechanisms that would reduce support for carriers that do not need it and potentially increase support to those carriers with legitimate needs. For example, CTIA has supported:

- (1) Eliminating profit guarantees in high-cost mechanisms (We think carriers should get their profits from their own customers, not through the universal service mechanisms);
- (2) Requiring carriers to combine study areas in a given state (The current rules allow large, low-cost incumbents to appear small and high-cost by balkanizing their operations within a state); and

(3) Transitioning larger rural incumbent carriers to the non-rural high-cost mechanisms.

Increased accountability must be central to any universal service reforms. That's why CTIA has supported technology neutral "carrier of last resort" obligations for both incumbent and competitive ETCs. CTIA also has supported requirements that both incumbent and competitive ETCs achieve measurable results – for example, showing how universal service dollars have been used to improve service quality and coverage. We are open to other proposals and look forward to a continuing dialogue with this Committee and Congress on these important issues. Again, thank you for the opportunity to share the wireless industry's views on universal service reform. I welcome your questions.

MR. UPTON. Thank you.

Ms. Pies.

MS. PIES. Thank you, Chairman Upton, Ranking Member Markey, and members of the subcommittee.

My name is Staci Pies. I am Vice President of PointOne, a VoIP provider, and President of Voice on the Net, or VON, Coalition, the voice of the VoIP industry.

On behalf of the VON Coalition, I thank the subcommittee for the opportunity to testify about this important issue.

We are pleased to be here today to encourage you to ensure that every American can benefit from broadband communications choices. With the right policy framework, VoIP has the potential to revolutionize the way all Americans communicate. Consumers throughout the country will be able to use VoIP to do things never thought possible. Businesses may increase efficiency and productivity and transform the way they operate. Importantly, VoIP can ensure that rural and low-income Americans have access to a vast array of exciting communications choices at prices that are more economical than plain old telephone services.

America's universal service system has been a cornerstone of our telecommunications policy, we say 70 years, I have now heard 60 and 80, we will go with 70, enhancing the value of the network and increasing our quality of life in immeasurable ways.

Yet for all its past success, USF today is at a crossroads. I wish to make three points today about reform of our universal service system. First, the VON Coalition supports modernizing USF and encourages you to establish a contribution approach that is based on a measurement of network connections that is equitable and non-discriminatory. Such a system would explicitly assess interconnected VoIP providers. Second, Congress should adopt distribution policies that create incentives rather than disincentives for efficient network deployment. And third, Congress should adopt forward-looking approaches that empower consumers and extend VoIP-driven benefits to rural Americans. This

means reforming both USF and the policies that determine the cost and availability of exchanging traffic between Internet networks and the legacy phone network.

First, to accelerate the benefits of broadband-enabled voice services to all Americans, we have long supported adoption of a USF contribution methodology that broadens the base to ensure the sustainability of the funds and reduces price distortions caused by the current system. As articulated in H.R. 5072, new technologies and all-distance pricing have rendered regulatory distinctions based on geography irrelevant and unsustainable. Therefore, we recommend that Congress require the FCC to adopt expeditiously a contribution methodology that is based on a measurement of end-user connections rather than the arbitrary and irrelevant approach of attempting to assess interstate revenues. Assessment of VoIP provider revenues leaves open the possibility that USF could be assessed on all applications, including instant messaging, e-mail, and other IP addresses. It could lead to double payments for the same service, enable broadband blocking, and it would be difficult, if not impossible, to ascertain the appropriate contribution amount with any certainty. We believe a numbers- and/or connections-based approach would best meet the objectives of effectively sustaining the Universal Service Fund while ensuring that assessments are equitable and non-discriminatory.

Second, in addition to lowering the cost of communication services through direct subsidies, Congress should focus on accelerating VoIP-driven benefits to consumers and businesses by establishing incentives for carriers to make cost-effective investment decisions while increasing the availability of broadband services. We agree that all Americans benefit from the fact that residents of rural areas have access to high quality communication services. However, the incentives for providers to improve economic efficiency by deploying IP-based networks are adversely impacted by the manner in which the Fund is currently administered. With the advent of more efficient, lower-cost technologies, such as VoIP, the cost of providing service in rural and high-cost areas can decrease significantly. Not only does VoIP enable robust, innovative communications experiences for all Americans, it significantly lowers the cost of network deployment and the provision of services to enterprises and residential consumers for a cost savings of 40 to 60 percent.

And third, as this subcommittee has recognized, reforming USF is only part of the solution for ensuring that consumers have access to innovative and affordable communication services. Universal service reform must go hand-in-hand with comprehensive intercarrier compensation reform. Piecemeal fixes that address only a small subset

of compensation issues actually undermine the potential for comprehensive reform. For example, the “phantom traffic” solution in H.R. 5072 perpetuates implicit subsidies rather than directly resolving USF funding issues. We do not support onerous “phantom traffic” legislation at this time, especially legislation that would apply retroactive compensation on providers as well as have the unintended consequence of giving network operators explicit authority to block an Internet user’s ability to use the Internet communications application of their choice. Legislation must help accelerate the transition to IP networks by eliminating implicit subsidies, removing interconnection barriers, and modernizing old policies for the new world.

In summary, reform of universal services should focus on bringing all consumers affordable and innovative communication services. The VON Coalition respectfully recommends that Congress reform the USF contribution mechanism towards an equitable, technologically-neutral, and easy-to-administer system that will ensure the sustainability of the Fund. The distribution process must also be reformed to make support explicit, funding fair, and provide the proper economic incentives for efficient network deployment. And finally, Congress should be conscious about harming innovation and address only those VoIP services that are substitutes for existing telephone services.

The VON Coalition would again like to thank the subcommittee for its leadership on VoIP, and with your continued leadership, we believe VoIP is positioned to make innovative communicating more affordable for all Americans.

Thank you, and I am happy to answer any questions.

[The prepared statement of Staci L. Pies follows:]

PREPARED STATEMENT OF STACI L. PIES, VICE PRESIDENT, POINTONE COMMUNICATIONS,
ON BEHALF OF VOICE ON THE NET (VON) COALITION

Thank you, Chairman Upton, Ranking Member Markey, and members of the Subcommittee. My name is Staci Pies. I am Vice President, Governmental and Regulatory Affairs, of Point One, a VoIP provider, and President of the Voice on The Net or VON Coalition - the leading U.S. organization representing the VoIP industry on critical legal and regulatory issues. On behalf of the VON Coalition, I thank the Subcommittee for the opportunity to testify about the important issue of the Federal Universal Service Fund and subsidizing high cost areas.

This Subcommittee has led in facilitating the deployment of VoIP in recent years. Your actions to tread lightly when it comes to Internet regulation have helped enable the timely delivery of innovative, competitively priced, voice services to Americans all over the country.

We are pleased to be here today to encourage this Subcommittee to ensure that every American can benefit from broadband communications choices. With the right policy framework, VoIP has the potential to transform the way all Americans communicate. Consumers throughout the country will be able to use VoIP to do things never thought possible, businesses may increase efficiency and productivity and transform the way they

operate. Importantly, VoIP can ensure that rural and low income Americans have access to a vast array of exciting communications choices at prices that are more economical than plain old telephone services.

Congress has an unparalleled opportunity to help launch a new era of broadband-enabled benefits. You can facilitate transformative improvements in the way we communicate that harness the power of the Internet. VoIP is not just another flavor of telephone service. In contrast to traditional plain old telephone service (“POTS”), VoIP voice is an application, just like e-mail, streaming audio, streaming video, and web browsing and can occur over any packet data network, including the Internet. Accelerating VoIP adoption can mean cost savings for consumers and businesses, reduced operational costs for providers, advanced features unavailable with traditional phones, increased competition among network and service providers, increased infrastructure investment, accelerated broadband deployment, improvements in emergency services, lower cost communications for rural and government users, increased access for persons with disabilities, and increased worker productivity.

To, to ensure that every American can benefit from broadband communications choices, I wish to make four points today about reform of our Universal Service system.

- First, the VON Coalition supports modernizing our Universal Service system and encourages the Subcommittee to establish a contribution approach that will be equitable, technologically neutral, understandable, easy to administer and will ensure the sustainability of the fund.
- Second, to help accelerate the transition to a nationwide broadband network, Congress should adopt policies that create incentives rather than disincentives for efficient network deployment and exchanging traffic between Internet networks and the legacy phone network -- thus geometrically increasing the value of both of America’s communications networks.
- Third, rather than automatically applying yesterday’s rules to tomorrow’s technologies, the Subcommittee should adopt forward looking approaches to Universal Service and intercarrier compensation that empower consumers, extend VoIP driven benefits to rural Americans, and boost productivity in the economy. This means strengthening and reforming both the Federal Universal Service system and policies that determine the cost and availability of interconnection, regardless of the underlying technology.
- And fourth, to the extent that the Subcommittee acts, it should take a light regulatory approach to VoIP and address only those services that are substitutes for existing telephone service.

America’s Universal Service system has been a cornerstone of our telecommunications policy for over 70 years – enhancing the value of the network and increasing our quality of life in immeasurable ways. Yet for all its past success, Universal Service support today is at a crossroads. The VON Coalition shares the concerns of this Subcommittee, industry stakeholders, and rural consumers that the current contribution mechanism is inadequate, the funding mechanisms may not provide network operators with proper economic incentives, and the system does not ensure a sustainable USF.

First, the VON Coalition believes that every American should have the opportunity to benefit from broadband enabled voice services. We have long supported modernization of the Universal Service fund contribution methodology to move away from yesterday’s revenue based system, to a broader connections or working telephone number based contribution mechanism that is competitively and technologically neutral. As articulated in The Universal Service Reform Act of 2006, H.R. 5072, new technologies and all-distance pricing have rendered regulatory distinctions based on geography irrelevant and unsustainable. There is a growing consensus that a revenue-based contribution methodology will not be sufficiently durable to withstand the broad transition to VoIP and other technological change. Moreover, a revenue-based

contribution methodology is inconsistent with the goals of ensuring that universal service support be sufficient and predictable.

This Subcommittee should focus on legislation that ensures the contribution mechanism is simple enough for the average consumer to understand, and to minimize transaction costs for consumers. Therefore, we recommend that Congress require the FCC to adopt immediately a Universal Service contribution methodology that is based on a measurement of end user connections such as working phone numbers rather than the arbitrary approach of attempting to assess revenues or identifier protocols other than working phone numbers. Assessment of VoIP provider revenues leaves open the possibility that USF could be assessed on all applications including every Instant Message, E-mail, or other IP address. It could lead to double payments for the same service, enable broadband blocking, and would be difficult if not impossible to ascertain the appropriate contribution amount with any certainty. We believe a numbers and/or connections-based approach would best meet the objectives of effectively sustaining the Universal Service Fund while ensuring that assessments are equitable and non-discriminatory.

Second, in addition to lowering the cost of communications services through direct USF subsidies, Congress should focus on accelerating VoIP driven benefits to consumers, businesses, and the economy by establishing incentives for carriers to make cost-effective investment decisions while improving service to consumers in their areas by increasing the availability of broadband services. The VON Coalition agrees that all Americans benefit from the fact that residents of rural areas have access to high quality telephone service. However, the incentives for providers to improve economic efficiency by deploying IP-based networks and services are adversely impacted by the manner in which the fund is currently administered given that high cost carriers generally receive subsidies based on their costs.

High-cost support provides subsidies to make carriers whole, regardless of their investment decisions or business models by guaranteeing 'reasonable' rates of return. Utilizing traditional, circuit switched technology, it is generally agreed that in those areas, basing end-user retail prices strictly on the cost of service would likely create a barrier to subscription and frustrate the achievement of Universal Service goals. However, with the advent of more efficient, lower cost technologies such as VoIP, the cost of providing service in rural and high cost areas can decrease significantly. Not only does VoIP enable robust, innovative communications experiences for all Americans, it significantly lowers the cost of network deployment and the provision of services to enterprises and residential consumers. Consumers and businesses are flocking to VoIP because it can do what plain old telephone service can – and much, much more – at a competitive price. Indeed, VoIP is cutting phone bills by as much as 40 percent and enabling the kind of voice competition that this Committee envisioned when it passed the 1996 Telecom Act. In some cases VoIP can replace a home or business phone system, in many other cases it is integrated into existing software applications, and voice recognition systems. In the workplace, businesses, small and large, are tapping into VoIP for cost savings of 40 to 60 percent, and at the same time boosting productivity by as much as 15 percent through smarter communications systems. VoIP provides breakthrough new features that enable businesses to function more efficiently and respond more effectively to the needs of consumers.

Third, reforming the federal Universal Service system is only part of the solution for ensuring that consumers have access to innovative and affordable communications services. Despite minor steps towards access charge reform, a significant portion of non-traffic sensitive costs of the local network are still assigned to interstate calls. This cross subsidy exists today despite the fact that the 1996 Act called for elimination of implicit subsidies in part because these costs do not vary with minutes of calling in any jurisdiction. Legislation enacted by Congress must help accelerate the transition to IP-

enabled networks by reforming intercarrier compensation to eliminate implicit subsidies, removing interconnection barriers and modernizing old polices for the new world. We commend this Subcommittee for ensuring that VoIP providers can interconnect with the public switched telephone network (“PSTN”) to provide consumers with new voice alternatives.

As this Subcommittee has recognized, Universal Service reform must go hand-in-hand with *comprehensive* intercarrier compensation reform. To ensure that consumers and businesses can take advantage of this global medium that spans geographic boundaries, intercarrier compensation reform must speed the transition to broadband-enabled communications. IP networks and the gateways that enable the transition between broadband communications and the PSTN are critical links for empowering consumers and driving economic benefits. By focusing on overall, complete reform, in a timely fashion, you will ensure continued investment in IP-enabled networks, and avoid piecemeal decisions that can stifle innovation, technology investment, and slow the transition to broadband communications.

Piecemeal fixes and stand-alone decisions that only address a small subset of intercarrier compensation issues actually undermine the potential for comprehensive reform. For example, the “phantom traffic” solutions in H.R. 5072 perpetuate implicit subsidies rather than directly resolving USF funding issues. The VON Coalition would support the need to ensure that, where technically feasible, all providers that interconnect with the PSTN pass the call identifying information they receive without alteration, if Congress finds it necessary to impose such a requirement; however, we do not support onerous phantom traffic legislation at this time, especially where such legislation would apply retroactive intercarrier compensation on providers as well as have the unintended consequence of giving network operators explicit authority to “block” an Internet users’ ability to use the Internet communication applications of their choice.

A broad range of parties have recognized that there is a difference between identifying traffic and reforming Universal Service and intercarrier compensation. Addressing traffic identification by itself is only a half-measure. The only real solution is comprehensive Universal Service and intercarrier compensation reform that eliminates today’s artificial distinctions between different types of traffic, and puts Universal Service on a more stable footing than does implicit subsidies through access charges. Accordingly, we recommend that rather than attempt to resolve USF through the continuation of implicit subsidies inherent in the phantom traffic solutions of H.R. 5072, you provide the FCC a 180-day deadline by which to complete their long-pending Universal Service and intercarrier compensation proceedings, consistent with Section 254 of the Communications Act.

And fourth, the VON Coalition urges the Subcommittee to recognize the distinction between innovative IP-based services that do not connect to the public network and those services that are substitutes for existing telephone service. For example, VoIP services that offer consumers the ability to make and receive calls from the traditional phone network could be subject to traditional social regulation such as Universal Service contributions. These are the types of voice services that may rely on the public phone network and which consumers may consider substitutes for traditional phone service. One example of a web-based service that does not constitute telephone replacement services is the innovative help line available on the Gerber baby food web site (<https://www.gerber.com/contactus>). If a new mother has an urgent question at 3am, she can today click on the web site using a click-to-dial, one-way VoIP service that immediately connects the parent to an infant care specialist 24/7. However, if legislation imposing Universal Service obligations would apply to innovative, one-way VoIP services, this potentially life-saving service for new moms would presumably have to be shut down because it would not be able to sustain the economic cost of contributing.

In summary, reform of Universal Service should focus on bringing consumers affordable communications services. The VON Coalition respectfully recommends that Congress reform the Universal Service contribution mechanism towards an equitable, technologically neutral, understandable, easy to administer system that will ensure the sustainability of the fund. The distribution processes must also be reformed to make support explicit, funding fair and provide the proper incentives for efficient network deployment. To do this, Universal Service support should be distributed in ways that reward providers for economic efficiencies. Moreover, Universal Service and interconnection costs and policies must be reformed to ensure that implicit subsidies are eliminated and support is distributed in a competitively and technologically neutral manner so that consumers are able to make purchasing decisions based on economically rational pricing signals and their communications needs rather than having government pick technological winners and losers. Finally, Congress should be cautious about harming innovation and continue to maintain a hands-off approach to the delivery of IP-enabled services, especially those that are not substitutes for traditional voice services.

The VON Coalition would again like to thank this Subcommittee for its leadership on VoIP. With continued leadership, we believe VoIP is positioned to help make innovative communicating more affordable for all Americans, businesses more productive, jobs more plentiful, the Internet more valuable, and Americans more safe and secure.

Thank you very much. I am happy to answer questions.

MR. UPTON. Thank you.

Mr. Feiss.

MR. FEISS. Mr. Chairman and members of the committee, it is an honor to be here. I remember fondly my years as a resident of Michigan, and I only moved to Montana--

MR. UPTON. Just remember, it is the great State of Michigan.

MR. FEISS. The great State. And I only moved to Montana because it started with an "M" as well.

It is an honor for me to be here to discuss what universal service is and the benefits it provides to all Americans, no matter where they live.

First, to answer the title of this hearing, what are we subsidizing? Simply put, all Americans should have access to quality, affordable, advanced telecommunications services. Much in the same way that the National Highway System has enabled transportation of goods from one coast to another and all points in between, so has our Nation's telecommunications infrastructure enabled the transportation of information to all corners of the Nation and, indeed, to the world. Without universal service, investment in this infrastructure in high-cost parts of the Nation, in particular, may not be possible. And rates in Montana, for example, would increase by \$330 to \$600 a year. That is real money in a State like Montana whose per capita income ranks near the bottom of the Nation.

Montana provides an excellent illustration of why we have universal service. Our State is the fourth largest, in terms of geography, in the

country, yet our population is less than one million people. In telecom terms, we average only three access lines per mile.

Congress and the President have called for broadband deployment throughout the United States as an important means by which to advance our country's worldwide economic competitiveness. Here is a sampling of what we have done in Montana. Over 250 rural Montana communities have access to broadband. When the largest city is 100,000 people, we are talking about scores of towns with populations of less than 1,000. Montana's rural telcos have deployed broadband access to between 80 percent and nearly 100 percent of their service areas. That is better than what is repeated often to be the number one connected country in the world, South Korea. We have deployed videoconference, telemedicine, and distance learning access sites to over 130 rural Montana communities, including sites on all of the Native American reservations in the State.

As a result of the investment that Montana's rural telcos have made in advanced telecommunications infrastructure, a nationally-certified software engineer can live in Canyon Creek, Montana and serve her clients anywhere in the world. A programmer from Los Angeles who designs video graphics for national professional exams directs plays in the summer from Virginia City, Montana. He continues to operate his graphic design business from Virginia City, thanks to a DSL connection that he has in that town. I should point out that I had a board meeting in Virginia City recently, and there was a 4-H Club there, and a bunch of fourth and fifth grade children were there from the metropolis of Twin Bridges, Montana, and they didn't know who their phone company was, but they did know who their Internet provider was. At the Great Divide Ranch near Philipsburg, Montana, the suburbs of Philipsburg, the non-profit Project Vote Smart provides online access to information on about 40,000 political candidates in every State. Project Vote Smart's access to advanced broadband services makes the non-profit's databases available to 45,000 members and voters nationwide. And the list goes on.

Investment in the national information infrastructure enables a panoply of telecommunications-related applications, services, and businesses that rely on advanced underlying telecommunications infrastructure. For example, we have heard today from wireless providers. Wireless capabilities depend on a reliable, wireline infrastructure. Indeed, wireless communication are wireless only from the consumers handsets to the nearest point of presence on the wireline network. Similarly VoIP, Voice over Internet Protocol, relies on a broadband connection. The VoIP service itself is a software program.

That broadband connection is dependent on a broadband connection to the underlying telecommunications infrastructure.

Additionally, we have heard about efficiencies. A continual investment in the national telecommunications network creates efficiencies that save universal service outlays in the long run. For example, modern fiber optic backbone technology and soft switches have resulted in carriers receiving less universal service support today than they have in the past. For example, Blackfoot Telephone Cooperative in Missoula, Montana is deploying an Ethernet backbone, and it receives \$500,000 less in universal service from the efficiencies it has created. Similarly, Three Rivers Telephone Cooperative in Fairfield, Montana is receiving \$1.5 million less in universal service support than it did in 2004 versus 2005. And meanwhile, these technologies are deploying more robust services, faster speeds, out to the edges of these telecommunications networks and creating efficiencies and saving the Universal Service Fund.

However, reasons for universal service are as valid today, if not more, than they were 70 years ago. The number is about 70, by the way. The Universal Service Funding mechanism is facing a financial squeeze, as you have heard. Designation of wireless and newly-eligible telecommunications carriers, or ETCs, has grown the distribution side of the fund exponentially. The growth of the fund, as you have heard from CBO, is mostly from transfers of revenues or revenue streams that existed in one place, and they have been shifted over. But the new growth of the fund is in wireless ETCs, which have gone from zero to nearly \$1 billion in 5 years. Some question whether universal service is supposed to subsidize competition by awarding financial windfalls to new ETCs.

Finally, H.R. 5072 introduced by Congressmen Terry and Boucher addresses these financial pressures on the Universal Service Fund by broadening the base of contributions to include all voice communications and by more rationally governing the designation of newly eligible telecommunications carriers. We support H.R. 5072 and encourage this committee to pass it and use that as a benchmark with which to guide its deliberations with the Senate should they pass a bill, too.

I appreciate very much this committee's attention to universal service and look forward to any questions you may have.

[The prepared statement of Geoff Feiss follows:]

PREPARED STATEMENT OF GEOFF FEISS, GENERAL MANAGER, MONTANA
TELECOMMUNICATIONS ASSOCIATION

Rural telcos have met the goals of universal service: to preserve and promote access by all Americans to affordable, quality, advanced telecommunications capabilities on which our economy increasingly depends.

Congress and the President have called for broadband deployment throughout the United States as an important means by which to promote and preserve our country's worldwide economic competitiveness. Despite significant distance and density challenges (Montana's rural carriers average less than 3 access lines per mile) Montana's rural independent telcos are meeting the broadband challenge:

- Over 250 rural Montana communities have access to broadband
- Montana's rural telcos have deployed broadband access to between 80% and nearly 100% of their service areas (better than S. Korea!)
- Videoconference, telemedicine and distance learning access in 130 rural Montana communities

Continual investment in upgrading underlying telephone networks enables advanced capabilities to be deployed on a modern telecommunications platform. Like the federal highway system, universal service provides for ubiquitous transfer of information from coast to coast and all points between. Modern automobiles and trucks would be of little use today if the underlying highway system built in the 1950s weren't able to support modern vehicular traffic.

Investment in a national information network infrastructure enables a panoply of telecommunications-related applications, services, and businesses:

- Wireless capabilities depend on a reliable, redundant, quality underlying wireline (or fiber) infrastructure;
- Similarly, VOIP relies on a broadband connection;
- Examples abound regarding economic development opportunities enabled by advanced telecommunications infrastructure.

Continual investment in national telecommunications infrastructure creates efficiencies that save universal service outlays in the long run; e.g., modern fiber optic backbone technology and softswitches, have resulted in carriers receiving less universal service support today than they have in the past.

Telcos rely on rates, intercarrier compensation (access) charges and universal service support (the "3-legged stool") to recover their significant network investment costs. Universal service and access comprise as much as 50% or more of rural telcos' revenues. Rates in Montana (with one of the lowest per capita incomes in the U.S.) would be between \$330 and \$600 more without universal service support.

The federal Universal Service Fund is being squeezed by the dual problem of insufficient, and diminishing revenues and increasing distributions. Designation of newly eligible carriers (mostly wireless) has grown the distribution side of the fund exponentially. Some question whether universal service is supposed to subsidize competition with windfall to new ETCs.

HR 5072 (Terry-Boucher) addresses the financial pressures on the Fund by broadening the base of contributions to the Fund to include all voice communications and by more rationally governing the designation of newly eligible carriers (ETCs) to receive support from the Fund.

Mr. Chairman and distinguished members of the Committee, my name is Geoff Feiss, General Manager of the Montana Telecommunications Association. It is an honor

to be invited to share with you my perspectives on the reasons why we have universal service and the benefits it provides to all Americans, no matter where they may live.

I will address what universal service means to residential and business consumers particularly from a Montana perspective, and how universal service is integral to deploying a national infrastructure on which all Americans derive direct economic benefits. I'll close by addressing some of the deficiencies that have evolved in the universal service program today and discussing some more common criticisms of universal service, and—hopefully—I'll mitigate those concerns.

In brief, universal service is vital for ubiquitous access to affordable, quality, telecommunications capabilities on which our economy increasingly is dependent. That is not to say that problems don't exist. They do. And it's encouraging to see this Committee address the problems—and the substantial, tangible benefits—of universal service at this hearing.

Universal Service in Montana

Montana is the nation's fourth largest state. If you were to superimpose Montana over the eastern part of the United States, the northwest corner of the state would overlie the suburbs of Chicago, and the southeastern corner would touch the suburbs of Washington D.C. Yet, we have fewer than one million residents. Our largest city is Billings, with a population of about 100,000. We also rank somewhere between 45th and 49th in per capita income, depending on whose statistics you use.

From a telecommunications network point of view, Montana's independent rural telecommunications providers serve about one-third of the telecom consumers of Montana, but our networks cover roughly 80% of the state's geography: about 120,000 square miles. On average we serve three access lines per mile. Western Montana is relatively more populated than Eastern Montana, where the average access line per mile is less than one.

Despite the significant barriers to development posed by tremendous distances between very few customers, commonly referred to as the "distance and density" dilemma,¹ Montana's independent rural telcos are key drivers for economic development throughout the state. With an annual payroll of over \$50 million, these companies employ over 1,000 Montanans with well paying jobs and competitive benefits. They often are the largest taxpayer in counties where they operate.

As important, Montana's rural telcos have deployed modern, efficient, affordable, advanced telecommunications capabilities throughout the state for the direct benefit of Montana's residential and business consumers. They are doing exactly what Congress intended universal service to do, as outlined in the principles of universal service under Sec. 254(b).² (See below.) The quality of these networks is unquestioned. Consumers simply assume calls will go through, 911 will work, etc.

Montana's rural telcos have deployed well over 5,000 miles of fiber optic backbone facilities throughout the state. They have pushed high-quality, secure broadband capabilities out to the edges of their networks so that between 80% and nearly 100% of Montana's rural telco consumers have access to broadband service. That's better than South Korea, the world's most connected country by some accounts. Broadband service is available to over 250 Montana communities, and that's saying something when the largest city in our state has a population of 100,000. The vast majority of Montana's

¹ For a thorough discussion of the challenges associated with deploying rural telecommunications networks, see White Paper #2 of the Rural Task force, an independent advisory panel appointed by the Federal-State Joint Board on Universal Service to provide guidance on universal service issues affecting the telecom industry. The panel comprised experts from all facets of the industry, including local, long distance, wireline, wireless, etc. http://www.wutc.wa.gov/rtf/old/RTFPub_Backup20051020.nsf?OpenDatabase. January, 2000.

² 47 U.S.C. 254(b).

broadband-capable towns has fewer than 1,000 residents. (It's interesting to note that broadband's popular support continues to grow: many Montana rural telcos report that over 50% of their Internet customers subscribe to broadband service.)

Montana's rural telcos also have formed consortia, to leverage resources and better serve their markets. One such consortium is VisionNet, which provides advanced videoconference and Internet access services. Over 130 video conference sites are deployed throughout the state. There is at least one, and often more than one, VisionNet site on each of Montana's Native American reservations. On an average school day, 60 to 80 hours of K-12 classes are taught using VisionNet's videoconferencing network. VisionNet also facilitates Telemedicine applications connecting rural health clinics to urban medical centers on a real time basis. Vital health care services now are reaching rural consumers as a result of broadband applications made possible by rural telcos.

As a result of the investment that Montana's rural telcos have made in advanced telecommunications infrastructure, a Cisco software engineer can live in Canyon Creek, Montana, and serve clients anywhere in the world, thanks to investment made by her local telecom provider, Lincoln Telephone Company. A programmer from Los Angeles who designs video graphics for national professional exams, directs plays in the summer from Virginia City, Montana. He continues to operate his graphic design business from Virginia City, thanks to access to DSL technology provided by 3 Rivers Telephone Cooperative. At the remote Great Divide Ranch near Philipsburg, Montana, the non-profit Project Vote Smart provides online access to factual and unbiased information about 40,000 political candidates in every state. Project Vote Smart's access to advanced broadband telecommunications services from Blackfoot Telephone Cooperative makes the non-profit's databases available to its 45,000 members and voters nationwide. And Pixar Entertainment, the movie company responsible for *Toy Story* and other hits, is putting a studio in Kalispell, Montana, thanks to the combination of an unbeatable quality of life, and the quality of telecommunications facilities provided by CenturyTel.

National Telecommunications Infrastructure

Much as the national highway system makes it possible for goods to get from one place to another efficiently, the national telecommunications infrastructure enables information to get from one place to another. While the volume of traffic may be greater in Los Angeles or New York than in Forsyth, Montana, it is still essential that our nation's information highways reach from one coast to another, and all points between. Ubiquitous access to telecommunications is essential so that the rancher in Montana can sell beef on a real time basis on the Chicago Board of Trade so that diners in Boston can benefit from efficiencies realized in the distribution of the steak they purchase at their supermarket. Similarly, consumers and businesses benefit from products and services from other states. Amazon.com and E-bay are just to examples of how information technology has influenced our economic lives.

It is an economic policy given that ubiquitous deployment of advanced telecommunications capabilities is essential to national competitiveness. Policy-makers frequently have noted the less-than-enviable position of the United States in relation to its international trading partners regarding deployment of broadband capability.³ The President and members of Congress on both sides of the aisle have called for nationwide deployment of broadband capabilities; and as noted above, Montana's rural telcos are committed to such broadband deployment throughout their service areas.

The investment made by rural telecom providers into a national information network infrastructure enables a panoply of telecommunications-related applications, services, and

³ See Organisation for Economic Cooperation and Development (OECD). Broadband Statistics, December, 2005. http://www.oecd.org/document/39/0,2340,en_2649_34223_36459431_1_1_1_1,00.html.

businesses—the network isn't just for telephone calls anymore. For example, much attention is paid to wireless capabilities. The fact remains, however, that wireless capabilities are wireless only for the “last mile” connection from a network point of interconnection to the end-user. In other words, “wireless” traffic relies on an underlying wireline (or fiber) infrastructure.

Similarly, the newest kid on the block, voice over Internet protocol, or VOIP, is nothing more than a software application that is installed on a computer that acts as a telephone. VOIP relies on a broadband connection, which itself relies on an underlying advanced telecommunications infrastructure.

In short, telecommunications is the foundation of modern economies. Universal service supports the nation's investment in ubiquitously-accessible underlying telecommunications infrastructure. Does universal service pay for broadband assets, per se? No; not directly. But continual investment in upgrading underlying telephone networks enables advanced capabilities to be deployed on a modern telecommunications platform.

Returning to the highway analogy, modern automobiles and trucks would be of little use today if the underlying highway system built in the 1950s weren't able to support modern vehicular traffic.

Three-Legged Stool

How is investment in advanced telecommunications infrastructure possible? All local exchange carriers rely on three main sources of revenue from which to recover their substantial investments in telecommunications plant: revenues from ratepayers/customers; revenues from intercarrier compensation (what telecom networks charge one another for access to their networks by other carriers completing calls to or from one another); and universal service, designed to ensure that consumers have access to affordable, quality telecommunications service. All providers of interstate telecommunications are supposed to contribute to the universal service support mechanism, and companies whose costs exceed a benchmark cost are able to receive support from the Universal Service Fund in order to maintain access by consumers to affordable, quality service. Access (intercarrier compensation) revenues and universal service together comprise between 50% and as much as 80% of rural telcos' revenues. In contrast, urban carriers rely far less on either access or universal service since their networks in general are lower cost and serve more densely populated areas. Moreover, the larger carriers rely less on access payments since they effectively pay themselves access to originate and terminate long distance traffic on their own networks; so access revenue does not constitute as significant a revenue stream as it does for rural carriers, who rely on other carriers to complete long distance traffic.

Without universal service, Montanans would pay an additional \$330 per year on average. Nearly 100,000 Montanans (10% of our population) would face increases of between \$300 and \$600 annually.⁴ Given the fact that we are one of the nation's lowest per capita income states, this is real money. Moreover, it is entirely likely that even with tremendous rate increases, rural telcos' ability to maintain adequate investment in advanced telecommunications networks capable of supporting modern applications, services and features, would be severely threatened.

In other words, the “three-legged” stool must remain standing if Americans are to continue to benefit from a ubiquitously available, affordable, quality telecommunications infrastructure.

⁴ Universal Service Administrative Corporation (USAC): 3Q 2005; Appendices HC 01 and HC 05.

What's Wrong with Universal Service Today?

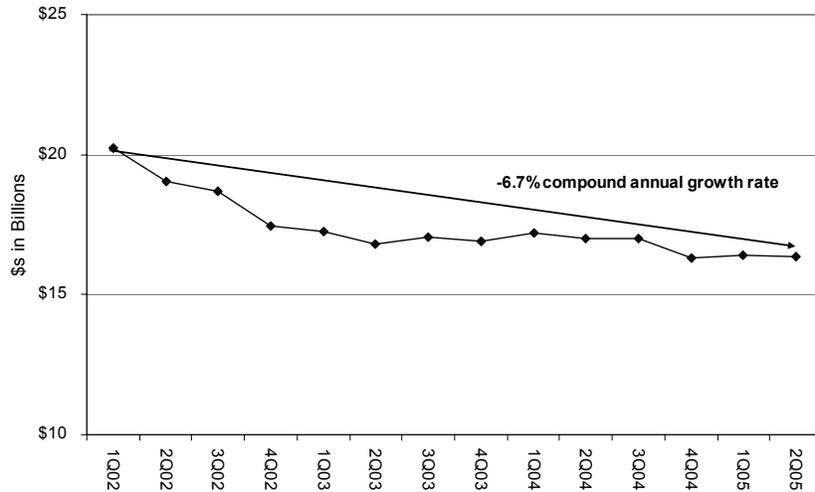
The reasons for, and benefits of, universal service are as valid today as they were when Congress passed the Telecommunications Act of 1934, and codified universal service policy in 1996. As provided in Section 254(b) of the Telecommunications Act of 1996, universal service is based on the following principles:

1. quality services available at just, reasonable and affordable rates;
2. access to advanced services;
3. access in rural and high cost areas;
4. equitable and non-discriminatory contributions;
5. specific and predictable support;
6. Such other principles that may be determined appropriate for the protection of the public interest.

So why is universal service attracting such negative attention lately? Briefly, it's getting squeezed from both ends. More and more voice communications traffic is circumventing universal service contributions mechanisms, while more and more companies (mostly wireless carriers) are being designated as eligible telecommunications carriers (ETCs), eligible to receive universal service support. And to make matters worse, it is apparent that current policy provides a windfall to most new ETCs by allowing the new ETCs to receive the same level of universal service support as incumbent ETCs, regardless of the new ETC's costs of providing service. This policy is referred to as the "identical support" rule.⁵ Part of the incumbent's universal service support which a new ETC "inherits" is "new money" to the new ETC resulting from previous regulatory policies that replaced a portion of access revenues for incumbent telcos. Thus, universal service support to wireless carriers is growing substantially and dramatically, while support to incumbent wireline companies has remained essentially constant.

The following chart illustrates the shrinking universal service contribution base.

⁵ See Reply Comments of the Montana Public Service Commission. *In the Matter of the Federal-State Joint Board on Universal Service, Request for Comments on Certain of the Commission's Rules Relating to High-cost Universal Service Support*. CC Docket No. 96-45. December 14, 2004. "To further illustrate the need to eliminate the identical support rule we offer the following information. Western Wireless' CEO, John Stanton, in his presentation to this fall's Qwest Regional Oversight Committee (ROC) meeting of September 12 and 13, [2004] Missoula, Montana, presented estimates of relative wireline and wireless investment costs. Those costs are as follows: (1) national wireline carriers' cost is \$2,492; (2) national wireless carriers' cost is \$920; (3) rural wireline carriers' cost is \$7,195; and (4) rural wireless carriers' cost is \$1,734. It is apparent from the presentation that to base support to wireless carriers upon the cost of the ILEC would bequeath an extraordinary subsidy to the wireless industry." [Emphasis added.]



Source: FCC

Meanwhile, universal service distributions are accelerating, mostly as a result of designation of additional wireless ETCs. In 2000, non-incumbent ETCs received \$1.5 million in universal service support. By 2006, funding to competitive wireless ETCs is expected to approach \$1 billion.

The following chart shows the relative growth of the universal service fund by competitive ETCs (CETCs), while incumbent local exchange carriers (ILECs) support has remained relatively stable, with the exception of access revenue replacement rulings which simply moved existing ILEC revenues from access to universal service.

	Funding in \$millions			% of USF		Growth in funding			Incremental ILEC funding (2)
	CETC	ILEC	Total	CETC	ILEC	CETC	ILEC	ILEC w/o (2)	
1998	.	1,696.6	1,696.6	0%	100%	-	-	-	
1999	.5	1,723.1	1,723.7	0%	100%	-	1.6%	1.6%	
2000	1.5	2,515.3	2,516.8	0%	100%	179.1%	46.0%	17.0%	\$500M from reg. chngs., including IAS
2001	20.2	2,583.2	2,603.4	1%	99%	1251.1%	2.7%	2.7%	
2002	47.5	2,934.5	2,982.	2%	98%	135.3%	13.6%	5.5%	\$210M from reg. chngs., including ICLS
2003	131.5	3,141.8	3,273.2	4%	96%	176.8%	7.1%	2.6%	\$130M from reg. chngs., including ICLS/IAS
2004	333.1	3,154.5	3,487.7	10%	90%	153.4%	0.4%	0.4%	
2005E	719.4	3,174.2	3,893.5	18%	82%	115.9%	0.6%	0.6%	

Source: USAC; projections by Balhoff & Rowe and are based on USAC's 2Q05 estimates for full year

In summary, ninety-seven percent of new ETCs are wireless carriers. They receive 100% of the incumbent carriers' universal service support, even though part of the incumbent's support is due to regulatory policies which shifted implicit support from access payments to universal service support. Wireless carriers never received access payments, but they receive access replacement through universal service. Further, to the extent that new ETCs' costs are lower than incumbents', receipt of incumbent universal service support constitutes a windfall, as noted above. The identical support rule, in other words, needs to be eliminated.

As FCC Chairman Kevin Martin noted last October at a meeting of USTelecom,

The current fund totals nearly \$7 billion dollars and a lot the fund's growth in recent years is attributable to new competitive eligible telecommunications carriers (or CETCs), particularly wireless CETCs, that have begun to receive funding.

The number of CETCs is increasing dramatically and is one of the primary drivers of fund growth. Since 2000, CETC high cost payments have grown from about \$1.5 million annually to about \$333 million annually.

Over the past few years, I have repeatedly expressed my concerns with the Commission's policies of using universal service support as a means of creating competition in high cost areas.

I do not believe it is viable in the long term to continue subsidizing multiple competitors to serve areas in which costs are prohibitively expensive for even one carrier...--Kevin Martin, Chairman, FCC. Speech to USTelecom. 10/26/05. [Emphasis added.]

Clearly, while the intent and benefits of universal service remain valid, universal service funding is threatened by the dual problems of: 1) diminishing contributions to the Universal Service Fund by voice communications providers who should be, but are not necessarily, contributing their share to the Fund; and, 2) distribution of support to an ever-growing number of new ETCs—as exacerbated by the identical support rule.

As FCC Chairman Martin and many others have noted, when designating additional ETCs, it is important to distinguish between promoting and advancing access to affordable, advanced telecommunications capabilities (i.e. universal service), on the one hand; and subsidizing competition, particularly in areas where even the existence of a single telecommunications provider requires support. Returning to the highway analogy, we do not need to build parallel, redundant highways, especially in areas where infrastructure is sufficient to carry all traffic.

How to Put the Universal Service Fund Back on Track

Universal service, like the highway system, works; and it works well. It should not be considered a rural subsidy, any more than the national highway system is a rural subsidy. In fact, most of the largest beneficiary states in terms of universal service dollars are not necessarily commonly identified as rural states.⁶ All Americans, no matter where they live, depend on an interconnected, robust interstate communications infrastructure.

That said, the squeeze on revenues and disbursements needs to be addressed. Broadening the base of contributions not only will enhance the Fund's revenues, but will address regulatory arbitrage issues in which some carriers seek to avoid contributing to the Universal Service Fund.

On the distribution side, requiring greater scrutiny of the ETC designation process, and eliminating the identical support rule will go along way toward returning the Fund to balance without burdening telecommunications consumers.

H.R. 5072, introduced by Energy and Commerce Committee members Lee Terry (R-NE) and Rick Boucher (D-VA) proposes a series of remedies for the contribution and distribution pressures faced by the Universal Service Fund. Briefly, the bill expands the base of contributors to the fund to include all providers of voice communications; and it rationalizes distribution of funds by providing for more scrutiny over the designation of ETCs. MTA endorses H.R.5072 and encourages this Committee to pass and report this important legislation expeditiously so that the House can use H.R.5072 as a benchmark going into conference with the Senate which planning to mark up S.2686 this week amending universal service statutes among other things.

⁶ For example, Texas, Mississippi, and Kansas are the largest recipients respectively of universal service high cost support. Universal Service Administrative Corporation (USAC). HC02, High Cost Support by State, 1st Qtr., 2006. <http://www.universalservice.org/about/governance/fcc-filings/2006/Q1/HC02%20-%20High%20Cost%20Support%20Projected%20by%20State%20-%201Q2006.xls>.

Universal Service Promotes Network Efficiencies

Some critics of universal service allege that telecom providers “gold plate” their networks, and lack incentives to invest efficiently in their networks. Such accusations are not borne out in reality. Rural telcos are exemplary in their commitment to service, investment, and support of their local communities. Rural communities, and likely all business managers, know the value of a dollar. Moreover, contrary to the allegations, their continual investment in modernization of their networks is creating efficiencies that reduce the distributions from the universal service Fund. For example, a digital switch, traditionally the principal brains of a telecommunications network cost somewhere in the \$1 million range. Modern Internet protocol (IP) based “softswitches” can deliver the same functionality—and more—for a fraction of the cost. Similarly, fiber optics provide far more capacity and are easier to maintain (once installed—at considerable expense), thereby creating long term efficiencies and cost savings over the life of the asset.

Consequently, Blackfoot Telephone Cooperative of Missoula, Montana, for example, is investing in an Ethernet broadband backbone which will enable it to push faster, more robust service options to the edges of its network. Simultaneously, the company is drawing \$500,000 less in universal service support. 3 Rivers Telephone Cooperative of Fairfield, Montana, received \$1.5 million less in universal service support in 2005 than the year-earlier period for similar reasons.

Conclusion

Universal service continues to contribute substantially to on-going investment in America’s affordable, quality telecommunications infrastructure which enables consumers and businesses to expand their economic and social horizons through access to world wide information. Congress has an opportunity this year to preserve and advance universal service while addressing stresses, strains and abuses that have developed since 1996. A healthy, balanced universal service program will ensure that Americans will benefit from access to a quality, affordable, advanced telecommunications network that supports America’s worldwide competitiveness for years to come.

MTA looks forward to working with the Energy and Commerce Committee and other interested parties in developing policies that can preserve universal service’s laudable goals while mitigating deficiencies in the program.

Suggested Reading

“Universal Service: Rural Infrastructure at Risk.” Release 2.0. McLean & Brown. April, 2006. http://www.mcleanbrown.com/usf_406.pdf

“The Rural Difference.” White Paper #2. Rural Task Force. January, 2000. http://www.wutc.wa.gov/rtf/old/RTFPub_Backup20051020.nsf/?OpenDatabase.

Findings include:

- RLECs serve 8% of nation’s access lines; 38% of U.S. geography
 - [In Montana, RLECs serve 32% of lines; 80% of land.]
- Ave. urban density = 134 customers/sq. mi.
 - National rural average is 10.5/square mile
 - [Montana average is less than 3 per mile.]
- Ave. urban customers per switch: 13,314
 - National rural average: 2,201
- Ave. cost to serve urban customer: \$240/yr.
 - National rural average cost/customer: \$337/yr.
- Rural carriers lack economies of scale and density
 - Fewer customers, and fewer high-volume customers
- Rates recover less investment cost for rural providers than urban providers
 - 50% to 75%+ of all rural providers’ revenues come from “access” fees and universal service (i.e., NOT rates)

About the Montana Telecommunications Association

The Montana Telecommunications Association (MTA) represents independent telecommunications service providers throughout Montana, offering local and long distance residential and business phone services, as well as a full spectrum of other services including broadband and dial-up Internet; satellite TV, and competitive local exchange services.

MR. UPTON. Thank you.

Dr. Cooper.

DR. COOPER. Thank you, Mr. Chairman and members of the committee. I greatly appreciate the opportunity to testify on universal service.

Although the questions posed in the title of this hearing are what are we subsidizing and why, in an era of technology change, the real questions facing the Congress are what should we be subsidizing and how. The answers are clearly the Communications Act and its history.

The cornerstones of communication policy in America for the past three-quarters of a century is stated clearly in the first sentence of the Act: "to make available, so far as possible, to all people of the United States, without discrimination on the basis of race, color, religion, national origin, or sex, a rapid, efficient, nationwide, and worldwide wire and radio communication service with adequate facilities at reasonable charges."

In 1934, when this goal was adopted, two-thirds of the households in America did not have telephone service. It was a progressive, forward-looking policy.

In 1996, when over 90 percent of households in America had telephone service, the Congress wisely sought to give specificity to this goal for the information age and reaffirm our national commitment to progressive universal service policy by articulating universal service principles, two of which are of paramount importance: quality services should be available at just, reasonable, and affordable rates; and consumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high-cost areas, should have access to telecommunication and information services, including interexchange and advanced telecommunication and information services that are reasonably comparable to those services in urban areas that are available at rates that are reasonably comparable to rates charged for similar services in urban areas.

Reasonably comparable services available at reasonable comparable rates for all Americans is the right goal. It remains the right goal. Broadband facilities, wire or wireless, are the facilities that must be defined as adequate in the 21st Century. By that standard, today, the 1996 Act has failed miserably. Rural, high-cost areas and low-income

consumers do not have broadband services available at affordable rates, and as a Nation, we are falling behind other advanced economies in the adoption of broadband.

Now is the time to reaffirm our commitment to universal service and declare broadband to be the dial tone of the 21st Century. The competitive telecommunications market will not lead us to that goal. It needs help. Congress should begin a transition plan leading to a phase-in where universal service eligible carriers must be offering a full broadband-compatible platform to convert Internet protocol platform that carries voice and data is more efficient, more robust, and not substantially more expensive than a dial-up world. We have to transition to that world. The FCC's definition of broadband at 200k is unacceptable and backward-looking. It must be revised to ensure appropriate levels of service, and that level must continuously be expanded, as the 1996 Act said, an evolving level of service over time.

Universal Service Fund should be available to the most efficient technologies to meet the needs of the uniquely underserved groups in our society. Thereby, we will be investing in technology that promotes the least cost-efficient system. We must broaden the base of universal service support, as we advocated in the very first proceeding. We said include all of the revenues in the system. And the court said, "No, Congress needs to fix that." We should tighten the reins of oversight to be sure. We should increase data collection to be sure. We should discipline the size of the growth with rigorous oversight. But let us not let the foibles of the current USF system be used to undermine and abandon our commitment to what is a fundamental and correct commitment in our society, very traditional value embodied in the Communications Act that has served our society well: available service for all Americans at affordable rates. Now is the time to reaffirm that commitment and look forward to our 21st Century communications network.

Thank you.

[The prepared statement of Dr. Mark Cooper follows:]

PREPARED STATEMENT OF DR. MARK COOPER, DIRECTOR OF RESEARCH, CONSUMER
FEDERATION OF AMERICA

Mr. Chairman and Members of the Committee

My name is Mark Cooper. I am Director of Research of the Consumer Federation of America. I appear to on behalf of the Consumer Federation of America, Consumers Union and Free Press.

The Consumer Federation of America,¹ Consumers Union,² and Free Press³ appreciate the opportunity to testify on the issue of universal service. As consumer advocates, we strongly support the Universal Service programs that have delivered essential communications services to low-income households, rural areas, schools, libraries, and rural health clinics. We recognize the fiscal crisis of falling receipts and expanding expenses in the program demands reform. Yet we view the current predicament as both a threat and an opportunity. We believe that as communications technologies evolve, universal service must evolve with it. We support the expansion of the Universal Service Fund (USF) support to broadband as the organizing principle to overhaul its contribution and distribution systems.

As Congress looks to resolve the thorny problems of reforming the Universal Service system, we urge Members to start with the principles that lie at the base of the Communications Act. The purpose of the Act was to regulate communications networks “so as to make available, so far as possible, to all the people of the United States, without discrimination on the basis of race, color, religion, national origin, or sex, a rapid, efficient, Nationwide, and world-wide wire and radio communications service with adequate facilities at reasonable charges.”⁴

The goal of the Communications Act of 1934, as amended by the Telecommunications Act 1996 is “to make available, so far as possible, to all the people of the United States, without discrimination on the basis of race, color, religion, national origin, or sex, a rapid efficient, nationwide and world-wide wire and radio communications service with adequate facilities at reasonable charges.

The Act goes on in Section 254 to specify this Universal Service Principles as follows:

- Quality services should be available at just, reasonable and affordable rates.
- Access to advanced telecommunications and information services should be provided in all regions of the country.
- Consumers in all regions of the nation, including low income consumers and those in rural, insular and high cost areas, should have access to telecommunications and information services, including interexchange and advanced telecommunications and information services that are reasonably comparable to those services in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas.

Reasonably comparable services available at reasonably comparable rates for all Americans are the right goals. Broadband facilities are the facilities that must be the goal of universal service in the 21st century. By that standard, the 1996 Act has failed

¹ The Consumer Federation of America is the nation’s largest consumer advocacy group, composed of over 280 state and local affiliates representing consumer, senior, citizen, low-income, labor, farm, public power and cooperative organizations, with more than 50 million individual members.

² Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education and counsel about good, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with more than 5 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

³ Free Press is a national, nonpartisan organization with over 225,000 members working to increase informed public participation in crucial media and communications policy debates.

⁴ *Communications Act of 1934*, 47 USC 151.

miserably. Moreover, if enacted into law, the COPE Act, which was recently passed by the House of Representative would make matters worse.

Instead of reaffirming that commitment to universal service, the COPE Act turned its back on low-income consumers, and consumers in rural and high cost areas by excusing network operators from their obligation to provide universal service and allowing them to redline high cost areas. By allowing network operators to discriminate against applications, service and content providers, it opens the door to anti-competitive bundling that raises the threshold of prices far beyond the affordable level for low income Americans. Earlier this week AT&T announced a brutally anti-competitive, anti-consumer price for stand alone DSL, which it agreed to offer as a merger condition. AT&T charges \$29.85 for DSL and required customers to have local service for about \$16 per month. The mandatory bundled cost is \$46 per month. Forced to break the bundle, AT&T announced that it will charge \$44.95 for stand alone DSL service. Giving network operators the freedom to exercise their market power will increase the threshold costs for gaining access to the broadband network.

This principle—strongly reaffirmed in 1996—is the simple, powerful, and fundamentally progressive commitment to universal, affordable access to communications services for all Americans. It is this policy that has brought telecommunications to schools, libraries, rural health facilities, low-income households, and rural areas at reasonable rates and adequate quality of service. The vital importance of this program is clear to anyone who has ever lived rural America or struggled to make ends meet. The economic case for affordable access is clear, and research produced by consumer groups has been documenting it for many years.⁵

The public policy commitment to ubiquitous communications has never been more important than now. Standing at the threshold of an information technology revolution, we cannot and should not abandon or weaken our guarantee of universal, affordable access. Granted, the communications marketplace has changed substantially since 1996—the last time USF was comprehensively addressed. The needs of our society and economy have evolved, and USF must evolve with them. The labyrinthine complexity of USF distribution—with both its successes and shortcomings—must not be allowed to blind us from the bottom line: Broadband is now, undeniably, the essential communications medium of the 21st Century. Broadband networks are the “adequate facilities” that we must provide to all Americans at “reasonable charges.”

Yet, as in past technological paradigms shifts, rural communities and low-income groups have been left behind. The economic costs of this digital divide are severe—curtailing the educational, economic, and social opportunities for a significant sector of our society. It is no secret to this Committee that the United States lags badly behind other nations in broadband penetration. The longer we wait for universal deployment of broadband to every region of the country, the further behind our global competitors we will fall. Not only should we apply USF to broadband, we can't afford not to. This is the only way to get back on track toward the President's stated goal of universal affordable broadband by 2007.

The current financial crisis in the USF programs and the difficulty in ensuring USF support delivers a strong return on investment have been readily identified as threats to a successful policy. But needed reform is equally an opportunity. We should look to reform USF both to address its long term stability and to use it to bridge the broadband digital divide. The cornerstone of this policy historically, and now, must be a commitment to

⁵ See for example the work of Mark Cooper: “Disconnected, Disadvantaged, Disenfranchised: Explorations in the Digital Divide,” Consumer Federation of America and Consumers Union, October 2000, <http://www.consumersunion.org/pdf/disconnect.pdf>; “Expanding the Digital Divide and Falling Behind on Broadband,” Consumer Federation of America and Consumers Union, October 2004, <http://www.consumersunion.org/pub/ddnewbook.pdf>.

bringing affordable service to average citizens. At the time of the Communications Act of 1934, telephone penetration rates were around 40%—very similar to where we currently stand with broadband.⁶ The vision that inspired a policy that brought that telephone penetration rate above 90% must now be applied to high-speed Internet access.

The USF system does have a checkered track record and some serious problems. There is virtual consensus that we need reform. The program faces a financial crisis at present because of declining receipts and expanding outlays. If broadband becomes an explicit part of USF, these issues must be immediately addressed. To do this, there will be a significant number of tough questions this committee will face in an effort to overhaul the system of contributions and distributions. But this is no time to turn from the principles that have proven so successful. Nor is it time to lose sight of the real problems that USF is meant to solve—our communications inequalities.

Diagnosing the US Broadband Problem

The crisis in USF is severe, but the crisis it is intended to address is arguably much worse, and certainly portends more dire consequences to the health of the US economy. As this Committee has heard ad nauseum in hearing after hearing this year, the US has fallen out of the top 15 nations in broadband penetration. It bears repeating here because this testimony will bring new data to the question. This new research directly ties our global broadband rank to the issue of Universal Service.

Defenders of current broadband policy have argued that America's low global ranking is misleading because our population density is so low compared to smaller nations such as Japan, South Korea, and Sweden.⁷ Noting that Canada outperforms us in broadband penetration despite its size and population density, we investigated this question. We analyzed the data from the OECD study of broadband in 30 nations and specifically controlled for population density. The results are striking. [See Appendix.] Population density turns out to have very little impact on our relative broadband performance compared to other nations. Far more important are median household income, the poverty rate, and exposure to Internet technologies inside and outside the home.

Rural areas are indeed underserved—broadband penetration rates in urban areas are nearly double those of rural areas. Yet, our research indicates that geography is a factor in depressed broadband penetration because of two higher order causes that are characteristic of rural areas—the price of service and the low income levels of potential subscribers. It costs more (per customer served) to build rural infrastructure, which limits competition and raises prices, and the disposable income of the average rural family is lower than average. Additionally, rural areas tend to have a disproportionate number of retired Americans on fixed incomes. These factors result in depressed broadband penetration. These conclusions comport with the findings of a study by the Pew Internet and American Life Project.⁸ Our research also confirms a recent survey showing that over 45% of broadband *non-subscribers* in the US do not subscribe because of high prices. A further 10% report that service is unavailable.⁹ The combination of high prices and poor people results in lower technology exposure and adoption in rural America.

On the question of exposure to the Internet, another key factor in promoting broadband penetration, Pew found that 32% of the adult population does not use the

⁶ Mark Cooper, "Universal Service: A Historical Perspective and Policies for the Twenty-First Century," Consumer Federation of America and the Benton Foundation, 1996.

⁷ See for example, FCC Chairman Kevin Martin, "United States of Broadband," *Wall Street Journal*, July 7, 2005.

⁸ See Peter Bell, Pavani Reddy, and Lee Rainie, "Rural Areas and the Internet," Pew Internet and American Life Project, February 17, 2004, http://www.pewinternet.org/PPF/t/112/report_display.asp

⁹ Yankee Group Research, Inc. February 2006, cited at <http://www.emarketer.com/article.aspx?1003833>

Internet—a figure that held steady for the first half of 2005.¹⁰ But our problem is not only with adults, it is also children. Of the 30 nations in the OECD study, the US ranked 26th (ahead of only Mexico, Turkey, and Slovakia) in the percentage of 15-year olds that have used a computer. Other nations are winning the broadband race because they are bringing technology and services to low-income areas.

The USF program is specifically designed to address these problems and is uniquely suited to do so if we apply its support to broadband. There are plenty of rural communications providers. The issue is finding the right balance of subsidies to incent investment and to make their products affordable to low-income Americans. Expanding USF support to broadband is a logical step to correcting the negative trends in our broadband markets. First, USF brings service to rural and low-income areas at affordable rates. Perhaps no other single policy is more important to our long term broadband prospects. Second, USF supports discounted Internet access in schools and libraries, which frees resources to buy PCs for the computer labs that connect to these lines. These public institutions serve to expose our young people to technology and catalyze the residential market for home computers and broadband services.

Other nations have used strategic direct investment in broadband infrastructure in low-income and rural areas to outperform us across the board. We should take note and plan accordingly. Policies that stimulate low-income consumer demand will improve the U.S.'s broadband situation. Universal Service policy applied to the broadband market will play a positive role in bridging the economic and rural digital divides. This in turn will significantly improve U.S. broadband performance relative to other leading nations.

General Principles of Implementation for USF Reform

As consumer representatives, we look to USF reform as an opportunity to extend the burden of contributions more equitably *and* to broaden the scope of distributions more effectively. The principles for implementing USF reform in 2006 must carry the same spirit as the principles for implementing USF in 1996. The functions, however, must be more forward looking. USF reform should:

- Explicitly expand USF to broadband and set a level of service and a target price comparable to dominant technology in urban areas. The FCC's broadband definition of 200 kbps is unacceptable and backward-looking. It must be revised to ensure appropriate levels of service.
- Broaden the base of USF contributions, equitably assessed and technology neutral, to stabilize the financial future of the Fund.
- Tighten the reigns of oversight and control that ensure disclosure of how the Fund's distributions are spent, who qualifies to spend them, and what the results of that spending yield. Increased data collection to make these assessments, including determining the capacity of lines in service areas, will be a key component to understanding how and where to make strategic investments in infrastructure.
- Find the right balance for USF subsidy. If the subsidy is too big, investment does not flow to the most efficient provider and rate paying consumers are overly burdened without a commensurate benefit. The inter-industry wrestling over revenue must be exposed to scrutiny and untangled fairly. Consumer contributions to the Fund must produce a tangible social and economic benefit in the form of a more robust network and catalyzed economic growth. We have real success stories with broadband provision by carriers of all kinds—we should identify those blueprints and duplicate them.

¹⁰ See John Horrigan, "Broadband in the United States: Growing but Slowing," Pew Internet and American Life Project, September 21, 2005, http://www.pewinternet.org/PPF/r/164/report_display.asp

- Invest in a technology neutral manner that promotes the least costly, most efficient systems that meet robust quality of service standards.
- Begin a transitional phase leading to a point when all USF eligible carriers offer broadband compatible networks. The converged IP platform that carries both voice and data is more efficient, more robust, and not substantially more expensive than PSTN upgrades. As the PSTN equipment depreciates and requires replacement, it should be replaced with an IP platform.
- Discipline the size of the fund through rigorous oversight, realistic maximum allocations, forward-looking cost assessments where appropriate, and sliding scales of eligibility and reimbursement. The FCC and state utility commissions should work in tandem to develop new protocols that make sense for a USF that supports 21st Century communications services.
- Reform USF in conjunction with a comprehensive set of broadband policies. These should include:
 - Opening more of the spectrum for unlicensed wireless broadband,
 - Focusing on competition inducing policies that counterbalance mergers,
 - Strategic direct investment in rural broadband infrastructure,
 - Reinstatement of the Technology Opportunities Program at NTIA,
 - Encourage community development programs as broadband partners in order to expand access to low-cost equipment and technology training.

Conclusion

There are no easy solutions to correcting to the problems of the Universal Service. But they must be addressed based on the same principles that have always guided progressive communications policy—a commitment to ubiquitous, affordable access to the most important technologies of the era. Broadband unquestionably qualifies as the dominant communications service of the 21st century. The benefits of applying USF to broadband outweigh the costs by a wide margin. Without a strong, comprehensive policy commitment to developing our broadband markets, we cannot hope to correct the problems that have plunged us down the ranks of global competitiveness. We need policies that give the “green light” to investment in communications infrastructure in rural and low-income America with a strong commitment to accountability, efficiency, and oversight. We strongly encourage this Committee to uphold the remarkable and progressive commitment to Universal Service that is the foundation of our communications policy.

MR. UPTON. Well, thank you all very much. I appreciate your testimony, that is for sure. And I have to say that as I listened and read your testimony and have been thinking about this issue for a long time, particularly as we begin to engage with the Senate on the COPE Act, which we passed by a broad margin 2 weeks ago in the House and look forward to the Senate’s action in full committee this week. I am one that, at least as it relates to USF, believes that the status quo is simply not acceptable because of the continued increasing cost, even though it is neutral as it relates to the government budget. Doubling the cost every couple of years is not a trend that I, certainly as a fiscal conservative, want to continue to see. So I am looking for ways that we can reform the system, not one for eliminating USF. I realize the importance, particularly in rural areas, and my State is one of those that has a pretty

good balance of urban and rural. I know the importance of connections, certainly in our district and the good work that they do. But simply times two every 3 or 4 years is not the course that I want to be on.

And I guess my first question is for Dr. Marron, and I noted that in your testimony, you noted that the growth in the High-Cost Fund has come largely because of the dramatic increase in the wireless carriers, which have become eligible, of course, to receive the High-Cost support. And I would note concerns that stress that the wireless carriers receive such support based on the wireline carriers' costs, which are often higher, I believe, than the wireless. If we are to change the program to limit wireless carriers' support to their own costs rather than wireline costs, what do you think the savings would be within a few years?

DR. MARRON. I am sorry, Mr. Chairman; that is not an analysis that we have had an opportunity to attempt. As you know--

MR. UPTON. Well, I mean you do everything else.

DR. MARRON. Well, yes, we analyze many, many, many questions, as you know. On that one, one of the key issues is that, as you know, in the current structure of the program, the program is structured to generate very good data about the cost of the incumbents and so that that can be tracked for purposes of implementing the program, but similar data are not collected for the entrants since, as you said, they are paid based on the incumbents' costs. And so the first data that you would want to go to to answer that question isn't immediately available. We want--

MR. UPTON. And yet--go ahead.

DR. MARRON. I was just going to say that we would be happy to go back and take a look and see what we could find, but I am not entirely sure what we would find there.

MR. UPTON. That might be available for us to look at. And I want others to comment on that as we go.

The other question that I have relates to something that Ms. Pies indicated and that would be that to limit it to one connection and one telephone line. Have you done an analysis in that regard?

DR. MARRON. Sir, we haven't yet done that specific analysis, but we do, as I mentioned earlier, have one number, which is a good starting point for thinking about that, which you mentioned for fiscal year 2005, the entrants, the competitive providers, their compensation in the system was about \$640 million. And that is going to be an upper bound, but if you adjust that down so whatever customer base has two lines, it would seem that that would be kind of the right order of magnitude for what the effect would be of going to one line.

MR. UPTON. And the comment that it would limit it to about \$1 a month per line, do those numbers equate with you in terms of where we

are today that was indicated in the testimony? I think it was Mr. Cimerman.

DR. MARRON. Yes. Yes.

MR. UPTON. Does anybody else on the panel want to comment on either of those questions that I posed?

Okay. Mr. Clark.

MR. CLARK. Yes. Mr. Chairman, I would just add that something to understand also about the identical support rule, it actually has even a little bit more harmful effect than has been presented today, because remember that it is based on the incumbents' costs, but it is based on their average per-line cost, so to the extent that you have two ETCs in an area and the wireline company may be losing customers to the wireless company, their average per-line costs go up at the same time, so both carriers end up receiving more money because they are both eligible for that money. So when we talk about sometimes the "death spiral" of universal service, because of the way that identical support rule operates, that is what people are referring to.

MR. UPTON. Well, are you not concerned about the level of the Fund as we have seen these costs double over the last 4 or 5 years?

MR. CLARK. I certainly am. Speaking for myself and not necessarily the Association, I mean, to me, the identical support rule is probably the largest single problem that we have. I am not as enamored with the primary line restriction for a number of reasons that we can get into later, but I think that the identical support rule would certainly be something worth looking at.

MR. UPTON. Okay. My time has expired.

MR. GARNETT. Can I just quickly dovetail off of what Commissioner Clark was saying?

I think the problem is not the identical support rule. The problem is that we are subsidizing carriers based on their actual costs plus profit. We don't think either the incumbent or the competitor should get support based on actual costs plus profit. We need to get to a system where both incumbents and competitors are rewarded for being efficient just as wireless carriers and other competitors are rewarded in the competitive marketplace.

MR. UPTON. But we would do that if we went to one money, would we not?

MR. GARNETT. We may.

MR. UPTON. Dr. Cooper.

DR. COOPER. Chairman Upton, I want to offer an observation. All of this talk about numbers and lines is very backward-looking. We are in a world where some people won't have numbers; they will go to ISPs. And we have heard a lot about the growth of the size of the Fund, but

think about the volume of traffic that has been flowing over those lines. It has been exploding. Even if you did revenue in the sector, it is growing, not as fast as the Universal Service Fund, but pretty darn fast over that 10-year period. So I would encourage that we think about this as a connection and the capacity that is being used, because if we understand, as I have suggested, that broadband is the adequate facility for the 21st Century, it gives us a different perspective on the one-line issue. It is a one-connection issue. And that connection will be doing lots of things. It will be supporting voice, video, and data, and I think that that is the way we need to think about it rather than comparing it to this line and numbers context, which is last century's framework.

MR. UPTON. Mr. Stupak. Oh, excuse me. I didn't see Mr. Boucher come back.

Mr. Boucher.

MR. BOUCHER. Go ahead, Bart.

MR. UPTON. Mr. Stupak.

MR. STUPAK. Well, thank you. And thanks for holding this hearing, Mr. Chairman.

You know, we are investing in a first rate telecommunications network that is affordable for all Americans and without universal service, my constituents would pay anywhere between \$100 and \$700 more per year for basic phone service. So as we look for ways to reform the Fund, we have to make sure that the end goals of affordable universal service are not compromised. I look forward to working with you, Mr. Dingell, Mr. Boucher, Mr. Terry, and others on the committee for this endeavor. And Chairman Barton said today that if we can't get rid of it, and I assure you we do not want to get rid of it, we need to reform it, and so I stand ready with you guys ready to work with you to try to reform and modernize it, because as I said, I assure you, we cannot get rid of it.

Mr. Cimerman, I appreciate the investment that cable companies that serve rural areas are making in VoIP technology. In fact, I am a VoIP customer myself through a cable company. Are you aware of any cable company that does not pay in the USF today?

MR. CIMERMAN. No, my understanding is that all cable companies that are offering VoIP service, as well as those that offer traditional circuit-switched service, do pay into Universal Service.

MR. STUPAK. Well, we note today the FCC just came out with their ruling saying that VoIP providers or cable companies should pay in, that VoIP providers must pay in. Why were they paying in before required to do so?

MR. CIMERMAN. Well, back in February of 2004, we issued a white paper with a rights and responsibilities framework. That is the same framework that we have advocated on the video side, that, as providers

providing whatever service, on the one hand, they seek certain rights, for example the right to interconnect. On the other hand, there are certain social obligations, e-911, working with law enforcement, paying into Universal Service that, from the beginning, we felt was an important part of offering our service to pay into Universal Service.

MR. STUPAK. We are getting to Mr. Cooper's statement there at the end that we should be looking at each connection and capacity as a different way of looking at paying into USF.

MR. CIMERMAN. Well, I appreciate the opportunity to respond, because we actually have several concerns. The first, the connections, is how you measure a connection. There are still a number of people that don't have, for example, a broadband service today. They choose not to subscribe. It is available to them. But if you do have broadband service and you have a phone line and you have, let us say, a wireless phone, how are we measuring connections? Are people double paying, triple paying? It is unclear exactly how a connections-based plan would work. And on a capacity-based plan, we have an even bigger concern, because generally we give the most capacity bang for the buck, but Verizon and others are rolling out new services. As we are increasing speeds, increasing capacity, the idea that you would pay more into Universal Service just because you are getting increased capacity doesn't necessarily seem to make sense. We think the number-based plan, as Dr. Marron, I think, agreed in the question from Chairman Upton, would provide a sufficient revenue basis for universal service because there are so many numbers in use. And we don't think that people are moving away from numbers. We have advocated that if people were to get into some regime to numbers, that the FCC ought to have the authority to use that addressing system. But we are always going to need some kind of a unique addressing system to figure out who is who, and so we think a number-based plan would be quite robust.

MR. STUPAK. Okay. Mr. Crothers, thanks for your testimony today. As a representative of the North Dakota Telecommunications Association, can you tell me how much more North Dakotans would pay without Universal Service Fund and why?

MR. CROTHERS. Mr. Chairman, Mr. Stupak, I do not have the specific number. We have an average rate in North Dakota of \$18 for local service. It is generally acknowledged that it will be \$25, \$35, \$45, \$50, \$150 a month in some instances to provide service. So it is extremely costly to serve rural North Dakota. It is one of the least dense areas of our country. The State is 350 miles from east to west. One-third of our population lives in the six counties adjacent to the Minnesota border, so we have a density of less than two subscribers per square mile

in North Dakota. It is phenomenally expensive to serve. Sir, I can get the specific number for you for an average family, if you wish.

MR. STUPAK. How about quality of service? Would you be able to afford wireless service in North Dakota, especially in that western part without universal service?

MR. CROTHERS. Mr. Chairman, Mr. Stupak, there is wireless service in western North Dakota. That low density in the southwestern portion of the State of North Dakota is about 0.6 of an individual per square mile. But the wireless service is very, very spotty. You can literally go the majority of counties and not have any service. You can drive 10 miles south of Bismarck, North Dakota, the capital of North Dakota, and not have service. It is a very difficult area to serve with wireless.

MR. STUPAK. One more, if I may, and the Chairman has been generous with his time, but there seems to be this myth that rural customers do not pay as much as their urban customers for phone service. Isn't it true that on an average, rural consumers pay on average more for their phone service than urban customers? Let us see. From 1994 to 2002, it was increased, in the urban rates, about 145 percent to \$22.65 while the rural areas had only gone up 36 percent, but that is still \$28.08, so we still paid more in rural areas than we do in urban, is that true?

MR. CROTHERS. Mr. Chairman, if I may, Mr. Upton, that makes exact sense to me, tremendous sense to me. In rural areas, especially these very low density areas, you find that individuals make an increasing number of long-distance calls, of toll calls. They need additional connections. They do their business, whether it be education, their business, their entertainment, it is frequently a toll call. We believe the costs are much higher. Yes, sir.

MR. STUPAK. Thank you.

MR. UPTON. Mr. Barton.

CHAIRMAN BARTON. Thank you, Mr. Chairman.

So many questions, so little time.

Let us see. Mr. Frantz, do you think a subdivision in suburban Katy, Texas, where the medium home price is over \$400,000 and there are four or five homes per block on half-acre to acre lots with lakefront property qualifies as a high-cost, low-density area for Universal Service Fund applications?

MR. FRANTZ. That is difficult to answer that question, because I don't know really much about that area. I think I understand.

CHAIRMAN BARTON. Well, I am not exaggerating.

MR. FRANTZ. I think I understand your point, and I guess I would respond this way. Any complex compensation system is susceptible to

gaming in some manner to some degree, and I think that is the challenge, really, that we are discussing today.

CHAIRMAN BARTON. But in any reauthorization of the Universal Service Fund, would your association support a reform that excluded those types of communities from the Universal Service Fund program?

MR. FRANTZ. Again, it is difficult for me to conceptualize how that would be designed or structured, Congressman.

CHAIRMAN BARTON. Well, it is a true example. I mean, I am not making these things up.

Let me go to my friend from CBO, who I always have an interesting dialogue with.

If we were to pass a bill that reduced the outlays for the Universal Service Fund, how would that be scored, if at all, in a budget reconciliation package?

DR. MARRON. Sir, the budgetary treatment of the USF program, as you know, is that both the revenues to it and the spending of it are both considered being part of the budget. The revenues show up on the revenue side and the spending shows up on the spending side, so if you do reduce the spending, it would show up as a spending reduction.

CHAIRMAN BARTON. So it would score?

DR. MARRON. Yes.

CHAIRMAN BARTON. All right. And can I quote you on that to the Speaker?

DR. MARRON. Oh, well, let me check to make sure I haven't--

CHAIRMAN BARTON. That is the answer I wanted, but I just want to make sure.

DR. MARRON. I just want to make clear, as you know, I have been Acting Director only for 6 months and occasionally there are nuances of scoring that confuses even me.

CHAIRMAN BARTON. Okay.

DR. MARRON. I mean, I should emphasize that the way USF is structured is that the spending and the revenues are such that they tend to track one another, and so whatever spending change there would be would automatically, in essence, be offset possibly by some--

CHAIRMAN BARTON. At least for today's hearing, if we were to reform the program and have less outlays, that would score as a positive, a revenue savings for reconciliation purposes?

DR. MARRON. I am sorry. It would be a savings on the spending side, and it would, under the current construction result in a revenue reduction.

CHAIRMAN BARTON. Yes, sir. Okay. Well, I am going to quit while I am ahead with that one.

The gentlelady from Texas, Ms. Pies, the FCC today, I think, did something that taxes at 64 percent of revenues. What is your group's position on that particular decision by the FCC? I am not sure they have the authority to do it, but besides that, do you think your group is going to be happy to hear they are going to get their revenues taxed at 64 percent?

MS. PIES. Well, we haven't seen the details of the order yet. I am sure that the Commissioner and the General Counsel's Office have done a good job supporting the jurisdictional authority. The one--

CHAIRMAN BARTON. I am not so sure as you are of that, but--

MS. PIES. Well, I have a friend who worked there, so I think there are some quality employees there.

CHAIRMAN BARTON. Well, I will admit there used to be at least one.

MS. PIES. Thank you.

CHAIRMAN BARTON. No, I believe there are quality employees at the FCC. They are good people.

MS. PIES. We actually support, very strongly, the goals of the Universal Service Fund and have long supported changing the contribution methodology so that VoIP providers do contribute on an equitable, non-discriminatory basis. Our concerns about the FCC's action today are probably three-fold.

First, there is going to be a tremendous funding gap when DSL stops contributing at the end of July. We have not taken a position on whether or not broadband should continue to contribute, but that was the basis of the FCC's actions today. Estimates have been close to \$350 million.

CHAIRMAN BARTON. But should you set a percentage based on expected revenue gap from another medium?

MS. PIES. I don't believe that would be consistent with the goals of Section 254. We are also concerned that a tremendous number of VoIP providers and users are small businesses and are anxious to see the FCC's analysis of the impact on the small businesses of this tremendously high percentage. It is almost twice of what wireless carriers are required to contribute. And we are also concerned because a large number of VoIP users are low-income users and dramatically increasing their phone bills, even for the interim, hurts the very consumers that the FCC is supposed to be protecting.

CHAIRMAN BARTON. Okay. Mr. Chairman, if I could, I have got two more questions. I know my time has expired.

I want to ask Mr. Cooper, who is one of our more frequent visitors here to testify, does your group support a reform in Universal Service Fund that whatever it is and however it is distributed, it should be based on the least cost alternative as opposed to the existing cost model regardless of what the costs are?

DR. COOPER. Absolutely, we have since the Act was passed.

CHAIRMAN BARTON. Okay. Thank you.

DR. COOPER. It should be the broad base. We were the first people to argue that. The People's Council in Texas was one of the vigorous supporters of that and unfortunately lost that.

CHAIRMAN BARTON. I tried to look hard to find an answer that you and I would agree on, and I am glad that I got that.

My last question is, again, to Mr. Frantz.

In my opening statement, I eluded to several rural telephone cooperatives that paid more out in dividends than their subscribers paid in charges. Again, as part of any Universal Service Fund reform, should one of the reforms be that we subtract dividends paid out from the costs reported in?

MR. FRANTZ. Conceptually, the USF subsidizes networks. The companies that receive the subsidies can have varying financial effects or results from the receipt of those subsidies, depending on many factors, including their cap structure, et cetera. So again, it would be difficult for me to really be able to venture a thought on that without really further analysis.

CHAIRMAN BARTON. Well, does it seem fair that apparently, and I have to say apparently because I have evidence of specific companies, but I don't know to what depth it is. I don't know if that is 10 percent or 5 percent or 100 percent, but there are a number of these smaller telephone companies. There is one in particular that prides itself for so many consecutive years paying out more in dividends every year than the subscribers have paid in line charges. And conceptually, should the general telephone interstate users that are paying an average of 11 percent tax subsidize a telephone company that is routinely paying more out in dividends than it charges its subscribers in service charges, line charges?

MR. FRANTZ. I understand the thrust of your question, I believe, but your question implies that the source of the dividends distributed is either predominantly or totally attributable to the subsidies--

CHAIRMAN BARTON. Well, in the specific instance that I mentioned on the record in Alpine, Texas, that record shows that they get 5 percent of their revenues from subscriber charges and yet last year they got \$28 million in subsidies from the Federal system and the State system. And I don't know their dividend stream every year, but in 2003, they paid out \$12 million and in 2004 they paid out, I think, \$3 million. So in that case, 95 percent of their revenue is coming from subsidies, and yet they are paying these huge dividends. I am out for dividends. I don't think dividends are bad. I think they are good, but when 95 percent of your dividend structure is coming from a Federal or State subsidy, it would

seem to me to be a fair reform to limit. If you are paying that much out in dividends, you should subtract that from the costs that are used to calculate the rate of return it is guaranteeing under the Universal Service Fund. That is all.

MR. FRANTZ. Well, clearly it doesn't seem right nor is it consistent with the purposes of the program for that type of excessive situation to occur. And I think I can safely venture the view that the trade association would not support any situation where the system could be gamed to that extent.

CHAIRMAN BARTON. I appreciate that answer. I yield back, Mr. Chairman.

MR. UPTON. Mr. Boucher.

MR. BOUCHER. Thank you very much, Mr. Chairman.

And I want to thank our witnesses today for spending time with us here and for their patience. This has been a long hearing. Your information has been very enlightening to us.

Mr. Frantz, Mr. Crothers, and Mr. Feiss, let me give you an opportunity to talk a little bit about why universal service is so important. And let me just kind of paint a picture, and tell me what would happen were this picture real.

Let us suppose that the worst occurs and that Congress perhaps is not capable or not able or doesn't have the will to stabilize the Universal Service Fund and that it meets its demise, so we really no longer have the Universal Service Fund available for the rural companies that are using that funding today. What would happen to that rural service? Could those companies continue to survive? And as an adjunct to that question, how would you rank the importance of universal service today as compared to its importance historically? Is it more important today, less important? Is it of diminishing importance over time or of growing importance over time?

Who would like to begin? Mr. Frantz?

MR. FRANTZ. Although it is difficult to generalize because there are enormous variations among the various companies comprising the USTelecom membership, I think it is fair to say that the companies that predominantly serve the low density areas are very significantly dependent upon subsidies. Would they go out of business? I think, in some cases, they clearly would; in other cases, they would hold on. But I think the consequence, the effect, in the case of many of the companies that serve low density areas, Congressman, would be very adverse.

In terms of the relative importance, in my comments, I ventured the point of view that this program is more important today than ever, mainly because we, in this country, as I think we all know, are competing not just against various of the other segments or parts of the country, but

in a very real sense, we are competing against the world. And without a very robust telecommunications infrastructure, we are going to be very hard pressed to compete.

MR. BOUCHER. So stated another way, if we lose universal service, we lose connectivity in a lot of rural America, and if that happens, that injures the national economy, which depends upon the entire country being connected to drive economic progress. Is that a fair statement?

MR. FRANTZ. Yes, sir; it is.

MR. BOUCHER. Okay. Would you like to comment, Mr. Feiss or Mr. Crothers? Mr. Crothers, I see you reaching for the microphone.

MR. CROTHERS. Mr. Boucher, thank you. In response to your question, what if the worst occurs, it would be devastating for North Dakota, the overwhelming majority of which is rural. In North Dakota, we have approximately 290 communities. The 12 largest of those communities may be 5,000 people. The rest are far below that. The exchanges are tremendously large. We serve a tremendous amount of communities where there are literally 200 and 300 people, but the exchange that that encompasses goes 25, 35, 40, 50 miles in some instances. So the rates would be phenomenal for those that are served by those rural companies. And because of those high rates, in the affordability, it would be very helpful, to the very last point that was made, that an individual could participate in what we refer to as today's economy or a 21st Century economy. There are educational opportunities. We use that tremendously in North Dakota: long-distance learning opportunities to our universities. Our hospitals and technicians are frequently trained through long-distance technologies. That robust infrastructure is absolutely critical, and not for just some or some in the highest density areas, but also our elderly in our rural areas, which the elderly are disproportionately large residents of, have the opportunity to be in their homes. So if that infrastructure is so critical, that is what the universal service dollars have done in rural North Dakota. It is also critically needed for VoIP services and cellular services. If they are to exist in these rural areas, the capacity they need to deliver their services, it is absolutely essential that this USF program be as healthy and robust as possible.

MR. BOUCHER. And let us hit those, Mr. Crothers and Mr. Feiss. And I think Mr. Feiss actually may have had a number answering this question in his testimony. But let us suppose the Fund goes away and the rural subscriber has to pay the entire cost of delivering the service to him. What would that mean in dollar terms, do you think, perhaps on a monthly bill or an annual bill, in terms of the addition to that bill for the typical rural subscriber having to carry the entire cost of delivery of the service to him?

Mr. Feiss, I think you had a number.

MR. FEISS. Yes, Mr. Boucher, I do. I did have in my testimony a \$330 additional annual cost if just the universal service were to be eliminated for the average Montana consumer and as much as, for 10 percent of the consumers, \$600 additional cost. In combination with the low per capita income in Montana, it could be devastating for numbers of residents. And as Mr. Crothers pointed out, it is the infrastructure which, as Dr. Cooper points out, is migrating toward a totally IP Internet-based platform. And it is that platform that enables the people I have cited in my testimony, and there are hundreds and thousands more who are living and working in rural America who have access to the world now because of an advanced infrastructure. And if that infrastructure were to become dramatically more costly, there are people who would drop off the network and network investment would be more difficult and even questionable in large parts of the country.

MR. BOUCHER. I am going to say thank you to these witnesses. My time has expired. I appreciate your answers.

MR. UPTON. Mr. Terry.

MR. TERRY. Thank you, Mr. Chairman.

And I do want to say that I respect and appreciate Chairman Barton's position. I don't think anyone, no matter whether you have a rural telecom business or you are a State regulator, wants to support anyone who is gaming the system. And certainly the intent of universal service is not to provide free but simply, as Dr. Cooper stated, that it is reasonable. I forget the term right off hand, but that they are paying, essentially, the same rate, and not 300 percent or up to 600 percent more. But on the cost aspect of the overall Fund, what we are talking about, at least with the Terry-Boucher bill, is the high-cost rural aspect, not E-Rate or some of the other categories. So I guess this will be to our CBO friend, but a couple of questions here. Under our bill, we have capped the Fund at its current rate. Then the FCC has a specific telephone inflationary formula, what we then adapt. But we also then regulate, and a good portion of the new costs for this Fund have been on the ETC, or the new entrant, side. And we control that more. Have you, in your testimony here today, looked at how this formula would work or, i.e., score when it is capped and you now controlling new entries?

DR. MARRON. Yeah. No, we haven't looked at that.

MR. TERRY. All right. Thank you.

In regard to whether or not it reduces spending or not, my view is that how the FCC works it is they determine what they have to send out by way of the dollars to the entities receiving USF and then they send out a bill to the payers. Isn't that generally the way it works, Mr. Feiss?

MR. FEISS. Pardon me.

MR. TERRY. Well, we are trying to go through the scoring of this, and I am helping our people from CBO. Understand that the FCC bills out to the payers the amount that is needed by the FCC. Is that generally accurate?

MR. FEISS. The way I understand how it works is that the revenue requirements by high-cost companies are submitted, actually, to, I think, NECA, the National Exchange Carriers Association. And they have a figure of how much Universal Service Fund is needed. And then the FCC quarterly adjusts.

MR. TERRY. Yes. Then they adjust and the FCC then notifies the companies that pay.

MR. FEISS. Right. And there is actually a 2-year lag in this process, so the revenues that a company in 2006 receives is, at least in the wireline business, different in the wireless business, 2004 cost reimbursement.

MR. TERRY. No, I appreciate that because it is a really unique way in which they derive both the revenue and then the disbursements which is why the antideficiency aspects are so important.

I have a thought or a question, Ms. Pies. And I really appreciate your statement. I think it shows why we need a bill like the Terry-Boucher bill so that these rural telephone companies can upgrade their systems as we move toward VoIP or an Internet-based exchange. Which I think then once we get all of rural Montana and Iowa and Nebraska and Wyoming with access to broadband and they can then use VoIP. So I think that enhances your position.

MS. PIES. Yes.

MR. TERRY. Then the issue of paying in, you mentioned something about the "phantom traffic," and that is actually part of our bill because we only want to make sure that those that are using voice are the ones that are paying in and not ones that are doing data transfers or gaming or something like that, which is why we think it is necessary to identify the traffic, so if a VoIP user, when they are providing a voice service that they are paying in. Do you think then identifying that traffic is injurious? Because it sounded like you say that if we try to identify the traffic, then that is going to cause all of the problems. But I think it eliminates the problem.

MS. PIES. With respect, Mr. Terry, the VON Coalition views the "phantom traffic" issue not as a universal service issue but as an intercarrier compensation issue. We recognize that the two go hand-in-hand; when one goes up, the other tends to go down and vice-versa.

MR. TERRY. So on the universal service side, you would support "phantom traffic" in our bill, the language?

MS. PIES. We do support requirements that providers pass the call identifying information that they receive. We would support any requirements that would prohibit the alteration of call identifying information. What we don't support are provisions that require an originating carrier to generate some type of artificial designation. By doing so, what you are doing is adding costs solely for the purpose of beating some sort of arbitrary regulatory goal. In addition, the way that the "phantom traffic" solution is addressed in your bill, it also allows the terminating carrier, at their discretion, to block the traffic because they have the ability to determine whether or not that type of labeling is accurate. I believe that is the word. And it is their choice whether or not it is accurate. If a call originates IP, it is not naturally going to originate with a traditional phone number, and the terminating carrier may decide that that is not accurate and block the call. And certainly we would be opposed to anything that would enable terminating carriers to block traffic, whether it is a VoIP call that is 911 or a VoIP call to a friend or loved one.

MR. TERRY. Constructive. I appreciate that.

MR. UPTON. Mrs. Blackburn.

MRS. BLACKBURN. Thank you, Mr. Chairman, and thank you all for your patience today.

I have got a few simple questions, and I am going to tell you what they are, and then I am going to let you vote by raising your hands so that we can finish this up and get you all on your way. You have been mighty patient.

And we do have concerns, and we want to look at this. We are very concerned. One of you mentioned a couple of times concerns about individuals or companies that game the system. When you are looking at a pool of money this large, as I said in my opening remarks, that is something that is of incredible concern to us. And while we have been sitting in this hearing, I got a Blackberry where some folks in one part of the country, my part of the country, don't want to be subsidizing Amtrak. And then, just as I said in my opening remarks, there are folks maybe on this side of the country or in urban areas that say, you know, "Why should I be subsidizing broadband? Why should I be subsidizing more than one connection to a household?" This is a tax that has outlived its usefulness. And Ronald Reagan said it well when he said, "There is nothing so close to eternal life on earth as a Federal government program." And our constituents believe that. I do, too. And once you get attacks against something, maybe it has outlived its usefulness, you can't get rid of it.

So I am going to give you all the questions and then we will come back and vote. These are the things I am going to want to know. Do you

support subsidizing more than one connection per household? Question number two: how many of you are for expanding or increasing the USF? How many of you are for reducing the USF is number three? And number four, how many of you would like to completely eliminate the USF? How many favor disbursement caps would be number five? And number six, and your last question, short test, how many think broadband deployment should be left to the private sector?

Okay. Real short test, and there are no grades except my answers are all right and whoever agrees with me makes 100, so here we go.

Okay. How many of you are for subsidizing more than one connection per household? Let me see your hands.

DR. MARRON. Well, for the record, I have to, given my job, abstain from all of the votes.

MRS. BLACKBURN. Spoken like a true bureaucrat.

MR. FEISS. Are we allowed to put footnotes on our hands?

MRS. BLACKBURN. Only if you want to submit them in writing. And I will take any footnotes submitted in writing. How about that?

MR. FEISS. I appreciate that. Yes.

MRS. BLACKBURN. I know Dr. Cooper is going to give me a lot of footnotes in writing. Dr. Cooper is good at that.

Okay. Let me see those hands again for subsidizing more than one connection per household. One, two, three, four.

MR. FEISS. My left hand is a footnote.

MRS. BLACKBURN. So submit it in writing. We are moving for speed.

How many would like to expand the USF? Two.

Okay. How many would like to see the USF reduced? One.

How many would like to eliminate the USF? Zero.

How many favor disbursement caps? Two.

Ms. Pies, you have no opinions?

MS. PIES. Not really. My opinions on--

MRS. BLACKBURN. You have to submit it in writing.

Okay. How many think broadband deployment should be left to the private sector? Three.

None of you made 100, I can tell you that, because not any of you are in complete agreement with me. Is that a hand up for being in agreement? Okay. Four. Or a comment? In agreement? Leaving it to the private sector? All right. So we got a four on that one.

Thank you all very much for your time, for your patience, for your interest in the issue, and I yield back, Mr. Chairman. Thank you.

[Response for the record follows:]

July 12, 2006

The Honorable Marsha Blackburn
509 Cannon House Office Building
Washington, D.C. 20515

Dear Congresswoman Blackburn,

I want to thank you for taking such an active interest in the hearing on universal service in the Telecom and the Internet Subcommittee on June 21. I was honored to testify and pleased to respond to Members' questions and comments.

In this regard, as promised, I'd like to provide you with greater detail on the "footnotes" I attached to the six questions you asked the panel at the end of the hearing. (I also apologize for the delay in responding to you. I had a long-scheduled vacation planned immediately after the hearing and wasn't able to attend to this letter until my return.)

1. Should universal service support more than one connection?

My answer was "yes—with a footnote." There is widespread opposition to a "primary line restriction" for universal service support. In fact, Congress twice has enacted one-year moratoria on imposition of any primary line restriction, and rural companies support a permanent moratorium/prohibition on the primary line restriction. One problem with a primary line restriction lies in its practical (or should I say "impractical") implementation. First, it would be very difficult to determine which line is "primary," and which one(s) is (are) not. There would be tremendous opportunity to game the system; to slam, cram, or otherwise attempt to characterize line(s) as primary. If one of the intentions for universal service reform is to reduce arbitrage and "gaming," this potential reform may go in the opposite direction. For example, wireless companies offer each member of a household a separate phone and number—each of which receives universal service support if the wireless carrier is an ETC. (This is one reason why the primary line concept is attractive.) Wireline households may have multiple phones but only one universal service-supported line, but wireless carriers provide separate lines per individual in a household. If there were a primary line restriction, would each member of the family choose a "primary" line, or would one "household" choose a primary line? And then how would you determine what a household is, and who in the household gets to choose the primary line? And so on.

A second problem with the primary line restriction is if only the primary line receives universal service support, then all other lines would be priced according to their actual costs. (Remember, wireless carriers do not even account for their actual costs today.) Presumably, non-primary lines would then be more expensive. In Montana, they could be hundreds of dollars more expensive. This would be a significant deterrent to small business (i.e., multi-line commercial enterprises) development in rural areas, and I do not believe Congress intends to thwart rural economic development.

2. Should we expand universal service?

I think my answer was "yes—with a footnote." I believe that the approach taken by H.R.5072 is a reasonable, conservative approach to "expanding" universal service to include investment in broadband technology. On the one hand, it is widely acknowledged that access to affordable, ubiquitous broadband capabilities will expand

economic opportunity for Americans throughout the nation, and enhance America's worldwide competitiveness. This is why the President and Members of Congress on both sides of the aisle have endorsed nationwide broadband deployment. On the other hand, Members of Congress appear concerned about the cost of such a policy. Indeed, it's obvious that to accelerate deployment faster than the market allows requires "incentives," e.g. money. Depending on how fast you want to accelerate beyond normal market forces, and how fast you want "broadband" to be defined, the cost can vary. If we want gigabit speeds to be delivered by the end of 2006, it likely would cost billions. If we seek megabit speeds in 5 years, it'll cost less. In fact, at the current rate of network investment and technology advancement, most networks may be able to deliver megabit bandwidth to most of their customers in 5 years without significant "new" support from universal service. H.R.5072 allows broadband investment costs to be supported by universal service, but authorizes the FCC to determine the level of broadband that can be supported, thereby providing a reasoned, incremental approach to broadband support.

Second, while allowing broadband to be supported by universal service "expands" universal service, it does not *necessarily* increase the cost to the Universal Service Fund if other reforms, such as a broadened contribution base and more disciplined distribution (e.g., elimination if identical support), are implemented.

Finally, as noted above, universal service already is providing support for network investments which facilitate deployment of advanced services without directly supporting specific broadband facilities. That is, universal service supports underlying investment in network upgrades like replacing copper with fiber backbones. Once fiber is deployed, bringing broadband service to residential and business consumers is more cost effective.

So it's a matter of timing: if you support bringing ubiquitous broadband capacity to America's consumers sooner, you may want to consider including the provisions contained in H.R.5072 as a rational, incremental approach to such a policy. If you want to wait for the market and normal investment in modernization of our nation's telecommunications markets to bring broadband to America's consumers, then you may not support "expanding" universal service specifically to include broadband investment.

3. *Should we reduce universal service?*

My answer was "no—with a footnote." Currently the size of the high-cost Universal Service Fund is determined by the level of investment in supported services by high cost carriers. As I noted in my testimony, incumbent wireline carriers are actually reducing their universal service support by investing in more efficient, modern network technologies. (Also, as noted above, investment in fiber technologies facilitates more efficient broadband deployment, enabling greater efficiencies for the Fund.) Two Montana companies alone received \$2 million less in 2005 than in 2004. In this regard, the Universal Service Fund is self regulating, and demand on the Fund from certain carriers is diminishing.

However, consumers' line items on their phone bills now are in the 10% range, which is historically high. (That's 10% of the interstate-revenues portion of a phone bill, not of the entire telecom bill.) I should note, too, that this quarter's contribution assessment went down from 10.9% to 10.5%, further indicating the "self-governing" aspect of the Fund and its contribution mechanism. But as noted during the hearing, new ETCs—mostly wireless carriers—are receiving universal service windfalls as they receive universal service support based on incumbent ETCs' support, and not on their own costs, which generally are considered less because they don't have the level of infrastructure

investment, quality, ubiquity, etc. that the incumbent has. (Wireless facilities need only reach from the end user to the nearest point of presence on the wireline network, thus saving them considerable expense; yet, wireless carriers receive the wireline carriers' same level of universal service support.)

So to return to your question, should we reduce universal service? It's possible that as carriers invest in more efficient technologies and with the right reforms (e.g., elimination of identical support), we can "reduce" universal service distribution costs, while not reducing the effectiveness of universal service or the legitimate services and investments which universal service is intended to support.

4. *Should we eliminate universal service?*

No. Ubiquitous access to affordable, quality advanced telecommunications capabilities is as valid today, as it has ever been. Indeed, it is more valid in today's worldwide economy, with the importance of Internet connectivity to our economic competitiveness. Again, I return to the highway analogy in my testimony. We continue to invest in our nation's transportation system as a vital national economic infrastructure. Continual investment in our nation's ubiquitous information "transportation" system is equally, if not more important.

5. *Should we cap universal service?*

No—with a footnote. Obviously a cap, by definition, will mean that certain legitimate investment is not recovered. The current regulatory cap already negatively affects investment decisions as well as prices. Remember, as CBO points out, most of the so-called growth in the Universal Service Fund has resulted from regulatory cost shifting, as directed by Congress, from "implicit" support mechanisms (i.e., intercarrier compensation or access revenues) to "explicit" support (i.e., universal service). Economically speaking, consumers are paying no more to support investment in ubiquitous, affordable, advanced telecommunications infrastructure. (This is not so, however, with regard to "new" support created by designation of new, mostly wireless, ETCs.) While the Fund (explicit support) has grown, intercarrier compensation (implicit support) has shrunk, and the next intercarrier compensation reform proposal in the pipeline will bring more of the same shift from implicit support to explicit support. Capping universal service without taking into account the regulatory cost shift from implicit to explicit support would significantly harm investment in our national telecommunications infrastructure.

Moreover, the Telecommunications Act requires affordable rates, quality and advanced capabilities, and predictable and sufficient support. A cap violates these statutory principles.

6. *Should broadband deployment be left to the private sector?*

Yes. The only reason I hesitated to raise my hand was that I was not certain I understood the intent of the question. I inferred, perhaps mistakenly, that the question may have implied whether universal service should support (private) investment in broadband deployment. I've discussed the merits of H.R.5072's treatment of universal services support for broadband above in question #2.

If the question meant whether we support municipal or other government broadband network deployment, our answer is almost unequivocally no. The private sector under nearly all circumstances is a superior investor of scarce resources.

I hope this addresses adequately your questions and I hope I have not burdened you with my lengthy "footnotes." Please do not hesitate to contact me if you have any questions or if you'd like further elaboration.

Again, it was an honor to testify before the Telecom and the Internet Subcommittee, and I look forward to working with you in the future.

Best regards,

/s/

Geoffrey A. Feiss, General Manager
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406.442.4316

MR. UPTON. Mr. Bass.

MR. BASS. Thank you, Mr. Chairman. And I want to thank you for holding this hearing. I think it is a very important issue in the overall debate as to how we update and modernize telecommunications in this country.

To some extent, the debate that we are having today is reminiscent of the kinds of debates that we have had on other issues in the recent past on larger issues throughout the modern history of this country. The reality of it is that we are a United States, and the taxpayers of this country have subsidized, to a great extent, economic development in all sections of the country, be it the power marketing associations, the Tennessee Valley Authority or out in the far West to develop electricity at very, very low cost for people, be it the subsidized mass transit systems for urban areas in the northeast corridor with Amtrak in order to provide for a more diverse and strong economy there, be it the excise taxes, the Federal excise tax that everybody pays on gasoline that was a State contribution, but there are some States that donate more money and there are some States that don't. In the case of telecommunications, it is really no different.

Now we passed a telecommunications bill a few weeks ago that had, in my opinion, two of the three principal components of a good, balanced telecommunications reform act. It has a national franchise that would create a lot more competition and availability for telecommunications in rural areas, and everywhere, for that matter. It also contained a municipal broadband provision, which would allow the municipalities to get together and provide services in areas where the traditional carriers weren't willing to do so. And thirdly, I think we have to retain and maintain a fund that could be used to meet the needs of rural areas where

competition simply can't exist. I opposed amendments that were opposed to the telecom bill that would have required a build-out requirement because I see that it would have the exact opposite effect of what its original intent was. But without universal service and without build-out, in my opinion, you will never have good, high-quality, broadband service in rural parts of America, and America will not be as strong as it could be if people living in small towns and in rural areas can not get the same access to market as have people who live in suburban and urban areas in this country. This is a debate that has been going on in America ever since it was created.

And I guess my only question to the panel here is if there were a critical change that we could make to the Universal Service Fund that is outside of either expansion or limitation but to make it work better and to make it work fairer, what would that be? And I am not requiring everybody to answer that question. A single change to the Fund, what would we do?

Yes, go ahead. There is no order here.

MR. GARNETT. The single change that I would propose would be to go from the current system that calculates support based on the costs of the most efficient technology for a particular geographic area.

MR. BASS. Fair enough.

Anybody else? Dr. Cooper.

DR. COOPER. I would second that with one additional observation, that we really do need to make broadband the dial tone of the 21st Century. So we have to look at least-cost, forward-looking technology and stop looking backward at numbers and lines and so forth. But clearly, the least-cost, most-efficient broadband technology is what this Congress ought to be shooting at.

MR. FEISS. Again, since I seem to be liking footnotes today, I think that one of the issues that is both on the distribution side and the contribution side of universal service is the disparate treatment of similar voice services. So if I could, in one sweep sort of comprehensively say what we need to do is ensure that voice communications are treated similarly, whether they are wireless or wireline. That would mean that I am actually not too far away from the wireless group in that the costs of any voice provider should be taken into account in what they receive. And then similar voice communication services should all contribute. So that is kind of a regulatory arbitrage, the elimination of different treatment of similar services.

MR. CROTHERS. Sir, the NTCA would recommend a provision that is actually found in the Boucher-Terry bill and that is that all connections, all telephone numbers, all IP addresses be included as contributors to the fund. There is too much arbitrage today, and that is

the system of universal service, who can game the system the most in either the contribution or the distribution side. And so that contribution side, which is actually found in the bill, is tremendously helpful and will go a long way towards making it equitable.

MR. BASS. Anybody else? I know we are running out of time, but one more.

MR. CIMERMAN. Just, I think, reasonable and regular oversight, including assurances that Universal Service Funds are being spent for their intended purpose, because I am not sure that on the High-Cost side of the Fund that that oversight has really taken place.

MR. BASS. Thank you. And I note we don't have any time for any more response, so I just want to just thank the Chairman for this hearing and hope that we can move forward with legislation. This isn't the end of it.

Thank you. I yield back.

MR. UPTON. Mr. Gillmor.

MR. GILLMOR. Thank you, Mr. Chairman.

I had a question for Mr. Garnett. One of the major points of contention with the USF is its method for administrating funding. In your opinion, is the current system fair to all eligible telecommunication providers who receive funding, and if not, why not?

MR. GARNETT. As Commissioner Clark mentioned earlier, the FCC adopted very specific guidelines two years ago for ETCs' designations, requirements for both incumbent and competitive carriers. And a requirement that those carriers, whether they are incumbent or competitive, prove that the dollars that are being given to them are being spent wisely. We think that that is the fairest way to do it. We think that is happening, and we would hope that that continues.

MR. GILLMOR. Thank you. I yield back.

MR. UPTON. Mrs. Cubin.

MRS. CUBIN. Thank you, Mr. Chairman. I am glad I am the last questioner, and I know you are, too.

I just have two quick questions. Mr. Navin, could you explain to me why the FCC has not chosen to base support from USF on a carrier's own costs rather than on the incumbent costs? I am most interested in seeing that Wyoming citizens have access to a full array of telecommunication services at a reasonable price, as everyone is, but we are here today to analyze where the growth in USF is coming from. And it seems clear to me, from Mr. Marron's testimony, that the growth is primarily coming from the entrants of wireless companies that don't share the same obligations and they don't share the same expenses of the incumbents. So can you explain the rationale for me?

MR. NAVIN. What I can tell you is that you are correct that the growth in the Fund, at least the High-Cost Fund, has been, in large part, as result of wireless ETC access to funding based upon the incumbents' costs. In 2000, I believe that the Fund distributed approximately \$1.5 million to competitive ETCs, and in 2005, that number had grown to approximately \$500 million. I also know that that issue has been teed up for the Federal-State Joint Board. They are looking into this issue today, and the Commission recently extended that referral past the end of June, so those deliberations continue, and we look forward to getting the recommendations from the Federal-State Joint Board on this issue. I know that the Chairman, in the past, has questioned whether it was Congress's intent to use the Universal Service Program to subsidize multiple competitors in an area that may not economically support a single provider. I believe in the Virginia Cellular case, when he was a commissioner, he laid out his thinking, and he was of the belief then, and I believe it to be true today, that the primary purpose of the Universal Service Program, was to make sure that all consumers in rural areas of the country were able to obtain services, communication services, at affordable rates.

MRS. CUBIN. Okay. That was going to be my next question. Should we be subsidizing competitors as well? Well, would you agree that the cost for the incumbents is higher than it is for the new entrants?

MR. NAVIN. They use different technology.

MRS. CUBIN. Well, of course they do.

MR. NAVIN. The wireless carriers coming in to the market today have completely different network architecture. The incumbents are oftentimes required to provide a wireline service to areas that are very sparsely populated so they have extremely long loops.

MRS. CUBIN. And they are required to provide one to everyone.

MR. NAVIN. Yes, they have the "carrier of last resort" obligation. So that is something else that the Joint Board is currently considering right now as it relates to support for wireless ETCs is whether the support should be based upon the incumbents' costs or the wireless carriers' own costs and whether or not there should be some sort of cap on the amount of support available once there is competitive entry into the particular service area.

MRS. CUBIN. Well, it seems to me if the wireless cost isn't as much as the incumbents' cost and yet they either receive money based on the incumbents' costs, that that is a real advantage for them. But you think those will be decided soon?

MR. NAVIN. We are hopeful. I know they just met down in Red Boiling Springs to talk about these very issues, so I am looking forward

to getting a report with regard to the progress they made down in Tennessee, and we are hopeful.

MRS. CUBIN. Thank you.

MR. TERRY. Would the gentlelady yield?

MRS. CUBIN. Sure.

MR. TERRY. In our bill, we don't leave it up to the FCC. It will be on actual costs, not incumbent costs, and that is another way that we control cost.

MRS. CUBIN. I see that my time has expired.

Thank you, Mr. Chairman, and thank all of you for being here.

MR. UPTON. I want to thank the panel for being here as well. Based on the questions, you can see that I don't think anybody is happy with the status quo. We need some changes here that are going to be made. I look forward to working on a bipartisan basis toward constructive, positive changes. And we appreciate your extensive testimony today.

Thank you very much.

[Whereupon, at 4:58 p.m., the Subcommittee was adjourned.]

RESPONSE FOR THE RECORD OF DR. DONALD B. MARRON, ACTING DIRECTOR,
CONGRESSIONAL BUDGET OFFICE

Question 1. In his testimony, Director Marron states that “[s]pending for [the high-cost] program could be curbed by limiting high-cost support to one connection per household, by basing support on each carrier’s own costs rather than on a cost standard set by the incumbent carrier, or both.” Please comment on whether you agree or disagree with these two reform proposals and explain your answer.

Answer. The Congressional Budget Office’s (CBO’s) recent analysis indicates that limiting high-cost support to one connection per household could have reduced spending from the high-cost program by over \$600 million in 2006 and, if other elements of current policy remained in place, would reduce spending by between \$1.2 billion and \$1.8 billion annually by 2011. Those estimates assume that all support for competing eligible telecommunications carriers is for second connections. That assumption is supported by the observation that about 95 percent of high cost support for new entrants is paid to wireless providers and that a very large percentage of consumers who purchase wireless service continue to purchase wireline service. Regarding basing each carrier’s support on its own costs, many analysts have pointed out that new entrants have lower costs than incumbent carriers. But current regulations do not require those entrants to file cost data, so that claim cannot be verified with currently available data. Nevertheless, either reform proposal by itself or both in combination would probably reduce future spending from the Universal Service Fund (and revenues collected by the fund) below the level it would otherwise be.

Question 2a. In February 2004, the Federal-State Joint Board on Universal Service recommended supporting a single connection per household, as a means of reducing excessive growth in the fund: “We believe that limiting the scope of high-cost support to a single connection to the public telephone network would be more consistent with the goals of section 254 than the present system.” Please comment on whether you agree or disagree with this statement and explain your answer.

Answer. Section 254 establishes the Joint Board and specifies its role in determining the services covered by the Universal Service Fund. The board has explored in detail the question of whether support for a single connection or for multiple connections is consistent with the legislation. CBO is unable to comment on this legal/policy issue.

Question 2b. The Joint Board also determined “Section 254(b)(3) encourages access to connectivity, however, not unlimited connections at supported rates. Advanced services increasingly are being provided along with voice services over a single connection. Nothing in the Act supports the argument that multiple connections should be supported for access to dial-up Internet access or fax services, neither of which is a supported service.” Please comment on whether you agree or disagree with this statement and explain your answer.

Answer. The board has explored in detail the issue of the advanced services that can be provided over a single connection and the question of whether support for a single connection or for multiple connections is consistent with the legislation. CBO is unable to comment on this legal/policy issue.

Question 2c. The Joint Board also concluded “We believe that further growth due to supporting multiple connections presents a significant threat to fund sustainability.” Please comment on whether you agree or disagree with this statement and explain your answer.

Answer. CBO projects that funding for multiple connections is likely to increase spending from the Universal Service Fund by between \$600 million and \$1.2 billion annually by 2011. The fund has sustained such increases in the past by increasing collections from telecommunications providers. In 2004, the most recent year for which the Federal Communications Commission (FCC) has published data, the fund’s revenue base was \$77.8 billion. To finance \$600 million in additional spending with the 2004 revenue base would have required an increase in the contribution rate of 0.8 percentage points from its 2004 annual average level of 8.8 percent. A \$1.2 billion increase in spending would have required a rise of 1.6 percentage points in the contribution rate. (In recent quarters, the contribution rate has been as high as 10.9 percent.)

CBO’s report *Factors That May Increase Future Spending from the Universal Service Fund* stated that “Further increases in spending by the USF would drive up the fee percentage even higher, unless either a different revenue mechanism was devised or the base of telecommunications services subject to the fees was broadened. Higher fee levels might cause consumers to shift more of their spending to telecommunications services that are not subject to USF fees—such as e-mail and instant messaging—thus reducing receipts for the fund.”

The FCC has recently taken actions to expand the revenue base by raising the payments required by cellular telephone providers and including revenues based on Internet telephony. Those actions would decrease the payments made by traditional wireline carriers necessary to finance the fund. However, funding multiple connections would further increase budgetary pressure on the fund and divert resources from other economic activity to support the purposes of the fund.

Question 3a. Should only one provider receive universal service support in any given area? Please explain your answer.

Question 3b. Should only the provider that can serve the area at the lowest possible cost receive the universal service support? Please explain your answer.

Answer. The answers to those questions are policy judgments. CBO’s mandate to provide impartial analysis precludes making such policy recommendations.

Question 4a. In his testimony, Mr Garnett asserts that “the high-cost mechanisms subsidize incumbent carriers based on what they spend...not necessarily based on whether they actually serve customers located in a rural, high-cost area.” Do you agree with the accuracy of this statement? Please explain your answer.

Answer. For a carrier that serves both rural and nonrural areas, support of the high-cost fund is based on an economic-engineering model that estimates what an efficient entrant would need to spend to provide service in the areas served by the carrier, rather than the carrier’s reported costs. Included in that model is a count of the number of lines the carrier actually serves.

A rural carrier receives high-cost loop support according to a formula that relates its allowable cost to the number of lines that it serves. Under that calculation, if the number of lines served by an incumbent rural carrier declines, its per-line support will rise,

because many of the carrier's costs are fixed and therefore do not vary with the number of lines served.

An incumbent carrier also often has an obligation as the "carrier of last resort" that requires it to provide service to virtually any customer in its service region. State regulators usually place some limits on the obligation, for example, exempting extremely remote sites. The regulations also allow an incumbent to shift much of the cost of serving such sites to the customers who desire service.

Question 4b. Do you believe that subsidizing incumbent carriers (or any carriers) based on what they spend rather than who they actually serve is the right policy outcome? Please explain your answer.

Answer. CBO cannot comment on whether one policy or another produces a desired policy result. However, approaches to providing universal service that provide the targeted population with the means to purchase services, rather than subsidizing the providers of those services on the basis of their costs, will probably provide a specified level of service at a lower total cost to the economy.

Question 5. As Mr Garnett points out in his testimony, "CTIA has proposed combining the current five high-cost universal service mechanisms into one mechanism that calculates support based on the most efficient technology—whether wireline or wireless—in a small geographic area." Please comment on whether you support or oppose such a proposal and why?

Answer. CBO has not studied that issue.

RESPONSE FOR THE RECORD OF THOMAS J. NAVIN, CHIEF, WIRELINE COMPETITION
BUREAU, FEDERAL COMMUNICATIONS COMMISSION

1. In February 2004, the Federal-State Joint Board on Universal Service (Joint Board) recommended that the Commission limit the scope of high-cost support to a single connection that provides access to the public switched telephone network (February 2004 Recommended Decision (FCC 04J-1)). The Joint Board expressed its belief that such an approach would curb growth of the fund. Indeed, in comments filed in June 2003 in the record in that proceeding, the National Association of State Utility Consumer Advocates had estimated that making non-primary lines ineligible for support would reduce the size of the high-cost fund by \$336 million annually. Congress subsequently passed the *FY2005 Consolidated Appropriations Act*, which included a provision prohibiting the Commission from using appropriated funds to modify, amend, or change its rules or regulations to implement the Joint Board's recommendation regarding single connection or primary line restrictions on universal service support payments. On November 22, 2005, Congress extended this ban through this fiscal year. Thus, the Commission is prohibited from limiting high-cost support to one connection per household.

The Commission is now focused on other possible ways to limit universal service fund growth. One way to limit growth would be to consider whether high-cost universal service support should be based on a particular provider's actual costs. Specifically, in the ongoing *Rural Review Proceeding* (FCC 04-125), the Joint Board is considering alternatives that may better reflect a wireless competitive eligible telecommunications carrier's (ETC's) cost of serving high-cost areas that receive universal service support. Once the Joint Board makes a recommendation in that proceeding, the Commission will carefully consider the record and weigh any alternatives to the current approach.

2a. In its *February 2004 Recommended Decision*, the Joint Board found that limiting high-cost support to a single connection would be consistent with the goals of section 254 before Congress prohibited the Commission from using appropriated funds to implement such a policy. Although this primary line policy restriction remains in place (see answer to question 1), in the *Rural Review Proceeding*, the Joint Board is considering other means of reducing excessive growth in the fund and whether they are consistent with the goals of section 254. Once the Joint Board makes a recommendation in that proceeding, the Commission will carefully consider the record and weigh any alternatives to the current approach.

2b. & 2c. As the Joint Board notes, dial-up Internet access and fax services are not supported services under the Commission's rules. Moreover, the Joint Board found that nothing in the Act requires supporting multiple connections. As stated in the response to question 1, however, Congress prohibited the Commission from using appropriated funds to modify, amend, or change its rules or regulations to implement the Joint Board's recommendation regarding single connection or primary line restrictions on universal service support payments.

3a. Chairman Martin has expressed his concerns over policies that use universal service support as a means of creating "competition" in high cost areas in which costs are prohibitively high for even one carrier. Subsidizing duplicative networks in high-cost areas has increased the demand on the universal service fund.

In the *Rural Review Proceeding*, commenters proposed requiring more stringent criteria for designating ETCs or otherwise limiting the number of supported carriers in rural areas. Once the Joint Board makes a recommendation in that proceeding, the Commission will carefully consider the record and weigh any alternatives to the current approach.

3b. Chairman Martin has expressed interest in a reverse auction approach to high-cost fund disbursement in which carriers compete for the least amount of universal service funds needed to operate a network. Such an approach has the potential to promote efficient investment by encouraging the deployment of the most cost-effective technology.

4a. & 4b. The high-cost support mechanisms for incumbent rural and rate-of-return carriers are based on those carriers' embedded, or actual, costs for the areas they serve. In the *Rural Review Proceeding*, the Joint Board sought comment on what carrier characteristics, in addition to company size, the Commission should consider for purposes of determining how high-cost loop support should be calculated. The Joint Board specifically asked: "[s]hould the Commission try to target support more effectively to the highest cost rural areas by considering whether the area served is rural, as defined in some fashion?" The Joint Board is considering the comments it received. Once the Joint Board makes a recommendation in that proceeding, the Commission will carefully consider the record and weigh any alternatives to the current approach.

5. In the *Rural Review Proceeding*, the Joint Board is considering several proposals, including CTIA's proposal, that would combine the high-cost universal service mechanisms into one mechanism. Once the Joint Board makes a recommendation in that proceeding, the Commission will carefully consider the record and weigh any alternatives to the current approach.

RESPONSE FOR THE RECORD OF TONY CLARK, PRESIDENT, NORTH DAKOTA PUBLIC SERVICE
COMMISSION, ON BEHALF OF NATIONAL ASSOCIATION OF REGULATORY UTILITY
COMMISSIONERS

July 21, 2006

The Honorable Fred Upton
Chairman, Subcommittee on
Telecommunications and the Internet
Committee on Energy and Commerce
2125 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Upton:

Thank you for the opportunity to respond to the committee's written questions. I should note that my responses are representative of my own views, and not necessarily those of the National Association of Regulatory Utility Commissioners, which has not adopted specific policy positions on the detailed questions you have asked.

As for your specific questions:

1. I do not support the idea of limiting support to one connection per household, though I do believe that eliminating the identical support rule carries merit. Connections-based limitations are almost always flawed from the onset because they ignore the reality of the telecommunications business, namely, that high cost areas are served by networks. Therefore, it is networks that must be the focus of support. A voucher-type system (which is encompassed in many of the connections-based proposals) would also be an administrative disaster in the making. I do, however, believe there is a need to revisit the notion that many multiple competitive carriers should be funded in areas that may be unable to support even one if not for the subsidy. Rather than a flawed and administratively prohibitive single connection limitation, I believe a reasonable compromise would be to:
 - a. better define truly high cost areas
 - b. target support to networks in those areas, regardless of who that carrier happens to be (i.e. "rural" or "non-rural")
 - c. limit support to one wireline and one wireless carrier in high cost areas, and reimburse those carriers based on their own cost models, rather than on the incumbent's per line average.

2a. I disagree with that statement for the reasons stated in my answer to question 1.

2b. While I generally agree with the statement, I would note that second lines for faxes and dial-up Internet access is not a large cost driver for the fund. To the extent there has been an increase in fund expenditures, it is primarily because of competitive ETC's, related to wireless.

2c. I believe that the policy of supporting unlimited numbers of carriers is a significant threat to fund stability. As I mentioned earlier, I believe a reasonable step would be to instead support up to one wireline and one wireless provider in high cost areas.

3a. Please see my responses to questions 1 and 2c. I will expound a bit on them by explaining why I would support both one wireline and one wireless network. For most people the wireline and wireless phones are complements to each other. For voice quality and reliability, wireline service is the gold standard. But it lacks what wireless provides, mobility. For economic development, for public safety and for quality of life, I argue that availability to both networks is needed for communities. Yet I readily understand the concern that the fund is unsustainable if current growth patterns continue. One wireline and one wireless provider would achieve a balance between these competing interests.

3b. Because the telecommunications industry is very capital intensive, it is highly unlikely any provider would realistically be able to duplicate an incumbent's existing network and underbid it. Therefore, a low-cost provider regime (which would probably be based on bids or auctions) would likely not be of much benefit. However, for the sake of argument, if any such model ever was adopted, I would strongly urge the following:

- a. Wireline providers would only bid against other wireline providers and wireless providers would only bid against other wireless providers (this is in keeping with my belief that one network of each type should be supported) and;
- b. There must be very stringent and ongoing oversight of quality of service and requirements for deployment of advanced services. A low cost bid process might be a disaster for quality of service and the deployment of advanced services if this oversight is not included.

4a. I disagree in part, and agree in part. Carriers (whether incumbent or competitive) receive support based on the incumbent's average per line embedded costs. There is however, some truth to the fact that support itself is often not targeted to truly high cost rural areas. For example, in my home state of North Dakota, there are very rural, high-cost exchanges served by Qwest that receive no support simply because they are served by Qwest. If they happened to be served by a rural LEC, however, they would be eligible. Frankly, this is unfair to both the non-rural LEC and to the consumers living in those areas.

4b. While perhaps not perfect, I believe that an embedded cost model for incumbent LECs in rural areas is the best approach to use. Low-bid models have the problems I referred to in my answer to question 3b. Theoretical models (like TELRIC) might be a second-best option, but I do have some concerns that TELRIC may not be an appropriate reflection of costs in high-cost areas. Embedded cost models do have the advantage of being verifiable and accountable to regulatory bodies. As I said in my answer to 4a, I do not believe it is fair to exclude support for certain high-cost areas simply because of the characteristics of the provider that serves there.

5. I am not familiar enough with the CTIA proposal to indicate my thoughts on it. I would however, direct readers to my response to question 3a and b, which highlights some of the concerns I have with any pure "low-cost" model being able to take into account the varying quality, reliability and mobility characteristics of different technologies.

Sincerely,

Tony Clark, President
North Dakota Public Service Commission

RESPONSE FOR THE RECORD OF SKIP FRANTZ, CHAIRMAN, UNITED STATES TELECOM
ASSOCIATION

1. In his testimony, Director Marron states that “[s]pending for the [high-cost] program could be curbed by limiting high-cost support to one connection per household, by basing support on each carrier’s own costs rather than on a cost standard set by the incumbent carrier, or both.” Please comment on whether you agree or disagree with these two reform proposals and explain your answer.

The first reform proposal asserts that spending for the high cost program could be limited by limiting high-cost support to one connection per household. Proposals for restructuring universal service support must be measured on a variety of criteria. While cost is certainly important, effectiveness and ease of administration also must be taken into account. One connection per household ignores the high fixed cost nature of telecom infrastructure. When a wireline provider loses a customer to wireless the phone pole is not chopped down. The wireline provider is obligated to provide service to everyone who requests it. Under a primary line regime, a wireline provider could, for example, split residential households in a service area with a wireless provider. The high cost funding associated with those households would be cut in half to each company, providing an inadequate amount of assistance toward fulfilling the goal of providing quality service at affordable rates. Furthermore, the amount of support would be unpredictable, discouraging each from investing in facilities.

Moreover, such a system would be very difficult to administer. For example, if three students shared an apartment would each be a separate household, or would it be considered only one household? How about a house with an “in-law suite”? Furthermore there would be tremendous potential for abuse by listing phone lines in various names. Finally, the proposal ignores business users for whom universal service support of high cost rural telecom infrastructure is key to their success and thus rural economic development. Congress has rejected this “primary line” proposal numerous times and should continue to do so on solid public policy grounds.

The second reform proposal asserts that spending for the high cost program could be curbed by basing support on each carrier’s own costs rather than on a cost standard set by the incumbent carrier. This assumes that CETC costs are necessarily lower than the costs of the incumbent ETC. There is no objective evidence on the record supporting this assertion. Furthermore, such a system would require a regulatory costing approach for CETCs, many of whom are relatively lightly regulated today.

2a. In February 2004, the Federal-State Joint Board on Universal Service recommended supporting a single connection per household, as a means of reducing excessive growth in the fund: “We believe that limiting the scope of high-cost support to a single connection to the public telephone network would be more consistent with the goals of section 254 than the present system.” Please comment on whether you agree or disagree with this statement and explain your answer.

See first paragraph of response to question 1.

2b. The Joint Board also determined “Section 254(b)(3) encourages access to connectivity, however, not unlimited connections at supported rates. Advanced services increasingly are being provided along with voice services over a single connection. Nothing in the Act supports the argument that multiple connections should be supported for access to dial-up Internet access or fax services, neither of

which is a supported service.” Please comment on whether you agree or disagree with this statement and explain your answer.

First, the question supposes that multiple connections are being used for dial-up Internet services or fax services. As we know, dial-up Internet services are quickly being supplanted by broadband services, so the number of connections used for dial-up is rapidly diminishing. This is one of the factors accounting for the well-documented reduction in ILEC access lines. Second, many fax services do not use a dedicated line – often they are structured so that the caller can select the voice or fax option on a single line. Third, dial-up Internet services and fax services are far from being “advanced services.” High speed broadband is an advanced service – dial-up Internet and fax services are provided over an ordinary Public Switched Telecommunications Network (PSTN) voice connection which is a supported service. Finally, Section 254(b)(2) states that “Access to advanced telecommunications and information services should be provided in all regions of the Nation.”

2c. The Joint Board also concluded “We believe that further growth due to supporting multiple connections presents a significant threat to fund sustainability.” Please comment on whether you agree with this statement and explain your answer.

Further growth can and should be mitigated by ensuring that rigorous standards for designation of and performance by CETCs are developed and enforced. Currently states view CETC designation as a “reverse unfunded mandate” – that is, the more CETCs states designate, the more funds flow to a particular state. FCC “guidelines” for CETC designation should be made more robust, supplemented with further standards, and should be enacted into law.

3a. Should only one provider receive universal service support in any given area? Please explain your answer.

The Telecommunications Act of 1996 currently provides for states to take public policy considerations into account in the designation of multiple ETCs in areas served by rural telephone carriers. States should take that responsibility seriously and operate under strict standards for designation of multiple ETCs.

3b. Should only the provider that can serve the area at the lowest possible cost receive the universal service support? Please explain your answer.

This question assumes that such provider can be conclusively identified. First, such a system would require a strict regulatory costing approach. Second, it assumes that the technology mix and therefore the cost of each provider remains static. And third, it assumes that the relative cost of technology used by each provider would be unchanged. A provider initially determined to be the low cost provider could end up being the highest cost provider if technology allows competitive providers to serve high cost areas more efficiently.

4a. In his testimony, Mr. Garnett asserts that “the high-cost mechanisms subsidize incumbent carriers based on what they spend...not necessarily based on whether

they actually serve customers located in a rural, high-cost area.” Do you agree with the accuracy of this statement? Please explain your answer.

The high-cost mechanisms are designed to support infrastructure that assures the availability of service to all customers in a rural, high-cost area, as mandated by the carrier of last resort (COLR) responsibilities imposed by many state laws and regulatory bodies and the Rural Utilities Service telecommunications lending programs.

4b. Do you believe that subsidizing incumbent carriers (or any carriers) based on what they spend rather than who they actually serve is the right policy outcome? Please explain your answer.

Universal service funding must support the availability of network infrastructure in high cost rural areas, not particular services or customers. Telecommunications is a business which is characterized by high fixed costs and long term investments. Efficiently constructed telecommunications networks are designed to serve present customers and anticipate future growth. When a telecommunications provider loses customers it is generally not possible to reduce costs proportionately, as most of the costs are sunk. Although ideally the amount of telecommunications infrastructure would always exactly match the number and service requirements of customers in a rural area, this is an unrealistic expectation.

5. As Mr. Garnett points out in his testimony, “CTIA has proposed combining the current five high-cost universal service mechanisms into one mechanism that calculates support based on the most efficient technology – whether wireline or wireless – in a small geographic area.” Please comment on whether you support or oppose such a proposal and why?

We cannot properly evaluate this proposal based on the description. However, as noted in the response to question 3b above, it is difficult to define the lowest cost provider let alone the “most efficient technology.” That definition could change over time as technology changes and as the definition of universal service changes. For example, the “most efficient technology” could be very different for narrowband versus broadband services. Second, the definition of “a small geographic area” could bias the result as to which technology could serve it most efficiently. It would be easy to envision scenarios in which gerrymandering could change the result.

RESPONSE FOR THE RECORD OF RICHARD CIMERMAN, VICE PRESIDENT, STATE
GOVERNMENT AFFAIRS, NATIONAL CABLE AND TELECOMMUNICATIONS ASSOCIATION

1. In his testimony, Director Marron states that “[s]pending for [the high-cost] program could be curbed by limiting high-cost support to one connection per household, by basing support on each carrier’s own costs rather than on a cost standard set by the incumbent carrier, or both.” Please comment on whether you agree or disagree with these two reform proposals and explain your answer.

The cable industry agrees that high-cost support should be limited to one connection per household. While we have not examined data on the number of multiple connections that are currently supported, a limitation on the number of supported connections would necessarily limit spending.

We do not agree that support should be based on a carrier’s own costs rather than a cost standard set by the incumbent carrier. Support should be the same for all carriers, whether based on the incumbent’s costs or the costs of the lowest cost carrier. In this way the universal service support mechanism can drive higher cost carriers to become more efficient.

2a. In February 2004, the Federal-State Joint Board on Universal Service recommended supporting a single connection per household, as a means of reducing excessive growth in the fund: “We believe that limiting the scope of high-cost support to a single connection to the public telephone network would be more consistent with the goals of section 254 than the present system.” Please comment on whether you agree or disagree with this statement and explain your answer.

The cable industry agrees that limiting the scope of high-cost support to a single connection to the public telephone network would be more consistent with the goals of Section 254 than the present system. Section 254 specifically calls for “access” to telecommunications services. A single connection is sufficient to balance the twin goals of ensuring access while also ensuring that contributors to the fund (ultimately the end users of telecommunications services) are not unduly burdened by the size of their contributions.

2b. The Joint Board also determined “Section 254(b)(3) encourages access to connectivity, however, not unlimited connections at supported rates. Advanced services increasingly are being provided along with voice services over a single connection. Nothing in the Act supports the argument that multiple connections should be supported for access to dial-up Internet access or fax services, neither of which is a supported service.” Please comment on whether you agree or disagree with this statement and explain your answer.

The cable industry does believe that the statutory language of Section 254(b)(3) requires support for multiple connections.

2c. The Joint Board also concluded “We believe further growth due to supporting multiple connections presents a significant threat to fund sustainability.” Please comment on whether you agree or disagree with this statement and explain your answer.

The cable industry has not sufficiently examined data on the level to which multiple connections are supported to determine the extent to which they pose a “significant threat to fund sustainability.” Nonetheless, as explained above multiple connections should not be supported.

3a. Should only one provider receive universal service support in any given area? Please explain your answer.

Universal service support should be portable. Any eligible provider should receive universal service support for the customers they serve in a rural high cost area. A provider in a rural high-cost area that loses a customer should lose support for that customer. A provider that wins a customer in a rural high-cost area in which support is available should receive support for that customer.

3b. Should only the provider that can serve the area at the lowest possible cost receive the universal service support? Please explain your answer.

As long as the subsidy in a given area is based on the costs of the lowest cost provider then the subsidy should be available to any provider willing to serve the area. Limiting support to one carrier would limit the efficiencies and cost savings that competition can bring.

4a. In his testimony, Mr. Garnett asserts that “the high-cost mechanisms subsidize incumbent carriers based on what they spend ... not necessarily on whether they actually serve customers located in a rural, high-cost area.” Do you agree with the accuracy of this statement? Please explain your answer.

Generally, yes. Under the current system an area is largely determined to be a high-cost area if the incumbent carrier’s self-reported costs of serving customers are sufficiently greater than the national average cost of serving customers. Incumbent carriers operating under a rate-of-return based regulatory scheme have little incentive to be efficient. So the fact that a carrier may have spent more than the national average to serve customers, does not mean that it is actually more costly than the national average for those customers to be served, and an efficient carrier may be able to serve them at a lower cost.

4b. Do you believe that subsidizing incumbent carriers (or any carriers) based on what they spend rather than who they actually serve is the right policy outcome? Please explain your answer.

No. Subsidies should be targeted to carriers serving those rural areas that are determined to be high-cost areas based on what an efficient carrier would spend and as described above the subsidies should be portable.

5. As Mr. Garnett points out in his testimony, “CTIA has proposed combining the current five high-cost universal service mechanisms into one mechanism that calculates support based on the most efficient technology – whether wireline or wireless – in a small

geographic area.” Please comment on whether you support or oppose such a proposal and why?

While this proposal seemingly has merit we would need additional information on how the new mechanism would operate to determine whether we support or oppose it.

RESPONSE FOR THE RECORD OF DAVID CROTHERS, EXECUTIVE VICE PRESIDENT, NORTH
DAKOTA ASSOCIATION OF TELEPHONE COOPERATIVES, ON BEHALF OF NATIONAL
TELECOMMUNICATIONS COOPERATIVE ASSOCIATION

Question 1: In his testimony, Director Marron states that “[s]pending for [the high-cost] program could be curbed by limiting high-cost support to one connection per household, by basing support on each carrier’s own costs rather than on a cost standard set by the incumbent carrier, or both.” Please comment on whether you agree or disagree with these two reform proposals and explain your answer.

Answer 1: *Director Marron offered two recommendations for curbing growth in the universal service fund. First, limit high-cost support to one connection per household. Second, base support on each carrier’s own cost rather than on a cost standard set by the incumbent carrier. I agree with Director Marron’s conclusion that basing the support from the universal service fund on a carrier’s own cost would curb spending but would disagree with his recommendation of limiting support to one connection.*

Limiting support to one line while may have been a cost saver in years past, isn’t much of a cost saver now and will be even less so in the future due to increased broadband subscriptions. The driving force behind second lines in households was primarily for a dial-up Internet connection, with higher broadband adoption rates this is increasingly less of a factor. Multiple lines are much more a factor for our nation’s small businesses. Limiting support to one line would harm this sector of our economy greatly and will put rural businesses at an extreme disadvantage.

Regarding the recommendation that recipients of USF receive support based upon their own cost and not that of the incumbent, I and NTCA could not agree more. This is long overdue and a position that rural carriers have advocated since its inception. For ILECs, the high-cost universal service program is a highly accountable cost-based program. Support out of the fund is based on a national average cost per line calculated by the FCC. Rural carriers with costs exceeding 115% of this national average receive support from the fund to offset these elevated costs to keep local rates affordable. Wireline incumbents file immense amounts of data outlining their costs and network investments to receive cost recovery support from the fund. This data is reviewed, vetted and approved at many levels, including by the fund administrator, the Universal Service Administrative Company (USAC), and the FCC.

However, new competitive carriers are treated differently. Under the guise of competitive neutrality the FCC unwittingly undermined the accountability of the fund by allowing new competitive carriers to receive support from the USF without the same stringent reporting and accounting requirements mandated of the incumbents. Instead of filing their own cost and investment data, these new competitive entrants receive support based on the incumbents’ cost. All the competitive carriers’ are required to file is a count of the number of customers they serve. In many cases, especially if the competitive carrier is a wireless provider, their cost is well below that of the incumbent potentially giving wireless carriers a windfall of support. This situation has perpetuated and encouraged abuse of the USF by wireless carriers, which account for 97% for competitive ETCs.

Elimination of this identical support rule is a necessity if Congress is serious about controlling growth and increasing accountability of the USF. Experts from the CBO and FCC on the panel stated the irrefutable fact that the vast majority of growth in universal service is due to competitive eligible telecommunications carriers (ETCs). Universal

service support to competitive ETCs grew by over 115% in 2004¹. During this same period ILEC support grew by only 0.6%. The numbers speak for themselves. Requiring all universal service fund recipients to receive support based on their own costs will increase program accountability, reduce demand for funds and ensure that funds are being used for their intended purpose.

Question 2a: In February 2004, the Federal-State Joint Board on Universal Service recommended supporting a single connection per household, as a means of reducing excessive growth in the fund: “We believe that limiting the scope of high-cost support to a single connection to the public telephone network would be more consistent with the goals of section 254 than the present system.” Please comment on whether you agree or disagree with this statement and explain your answer.

Answer 2a: *I and NTCA disagree with the Federal-State Joint Board’s assessment of the goals of section 254. It is clear that the purpose and goal of section 254 is to ensure comparable services at comparable rates to all Americans, regardless of how many lines they have in their home or business. Limiting support to one connection per household is antithetical to the goal of universal service and would drastically raise the cost of additional lines for rural consumers. Limiting support to one connection is not in line with the comparability clause and therefore would be illegal under current law in my opinion. Why should rural families or small businesses be forced to pay two, three or even four times what urban consumers and businesses pay for additional lines? The answer is they should not. Such a limitation would greatly diminish the competitiveness of rural businesses due to their location and would likely rely more heavily upon telecommunications to sell and market their services.*

Question 2b: The Joint Board also determined “Section 254(b)(3) encourages access to connectivity, however, not unlimited connections at supported rates. Advanced services increasingly are being provided along with voice services over a single connection. Nothing in the Act supports the argument that multiple connections should be supported for access to dial-up Internet access or fax services, neither of which is a supported service.” Please comment on whether you agree or disagree with this statement and explain your answer.

Answer 2b: *Your statement that advanced services increasingly are being provided along with voice services over a single connection is true as noted above in Answer 1. Therefore, limiting support to a single or primary line is not a cost saver for the universal service fund. However, to your point that section 254 (b)(3) does not specifically allow support for multiple connections, it certainly does not preclude this, and further my interpretation is that multiple lines should be supported to be in compliance with the comparability clause.*

Question 2c: The Joint Board also concluded, “We believe that further growth due to supporting multiple connections presents a significant threat to fund sustainability.” Please comment on whether you agree or disagree with this statement and explain your answer.

¹ Wireless Communications and Universal Service by Bob Rowe, Senior Partner, Balhoff & Rowe, LLC @ Columbia Institute for Tele-Information. Slide 12.

Answer 2c: *I and NTCA would disagree with this statement and it would appear that you do as well based on your statement in question 2b where you state, "Advanced services increasingly are being provided along with voice services over a single connection." Again, due to the decrease in second lines in homes, limiting support to a primary or single connection would not be a significant cost saver for the universal service fund moving forward.*

Question 3a: Should only one provider receive universal service support in any given area? Please explain your answer.

Answer 3a: *In some high-cost, sparsely populated, economically depressed rural areas, yes. As FCC Chairman Kevin Martin previously stated "I am hesitant to subsidize multiple competitors to serve areas in which the costs are prohibitively expensive for even one carrier. This policy may make it difficult for any one carrier to achieve the economies of scale necessary to serve all of the customers in a rural area leading to inefficient and/or stranded investment and a ballooning universal service fund."² In a case like this with a high-cost, sparsely populated area the provider that should receive support is the wireline provider since without the wired infrastructure, the residents will not have comparable services [to urban areas] as the wired infrastructure is necessary for voice, video and data including wireless voice services.*

Question 3b: Should only the provider that can serve the area at the lowest possible cost receive the universal support? Please explain your answer.

Answer 3b: *The idea of providing universal service support to the lowest possible cost carrier is contradictory to the goal of universal service – to ensure that consumers living in rural and high-cost areas have access to comparable communications services at rates comparable to consumers residing in urban and suburban areas.*

Consumers in rural communities must not be relegated to a substandard level of service or technology in order to save a few dollars. Less expensive services are often not built to the same high standards as the ILEC wireline network. For instance, wireless and VoIP calls are less expensive than traditional wireline service and is reflected in the lower call quality. Anyone who has used these new technologies can attest to the lower call quality, often dropped calls or being disconnected from the network for periods of time. Rural consumers would be forced to rely solely on these services with lower quality by those in Washington, DC if USF support were limited to the lowest cost provider.

Additionally, it is important to remember that these "lower cost carriers" such as wireless and VoIP are dependant upon the wired infrastructure of the ILEC for their services to work. Contrary to public perception, a wireless network does not stand alone. The only portion of a wireless call that is actually wireless is from a consumer's handset to the nearest cell tower. It may be more appropriate to think of a wireless network as a large number of gateways to the interconnected network that makes up the national and global telecommunications infrastructure. Truly, much of what makes up the nation's wireless networks is provided by the wireline LEC and interexchange carriers (IXCs) that

² *In the Matter of the Multi-Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers CC Docket 00-256, Federal-State Joint Board on Universal service CC Docket 96-45, Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate of Return Regulation CC Docket No. 98-77, and Prescribing the Authorized Rate of Return for Interstate Services for Local Exchange Carriers CC 98-166, FCC 01-304, ¶142 (rel. November 8, 2001) (MAG Order), Separate Statement of Commissioner Kevin J. Martin. (MAG Order), Separate Statement of Commissioner Kevin J. Martin.*

make up the public switched telephone network (PSTN). It is essential to note that the viability of wireless networks is entirely dependent upon the ongoing availability of the wireline networks that actually serve as the backbone. Similarly, VoIP calls are entirely dependant upon the broadband network, a majority of which was built by our nations wireline providers.

In addition, how will “low cost” be determined and measured? Providing support to only the carrier with the lowest upfront deployment cost may seem efficient but in actuality may turn out to be short sighted and more expensive in the long run. Certain technologies, including wireless and even traditional cable modem, may be unable to increase capacity as consumer demand and requirements rise. Experts agree that running a fiber line may be the most costly upfront but due to its long life and potentially unlimited capacity may, in the long run, be the least expensive and efficient for all American’s communications needs. Short term cost is only one factor that must be considered.

Other factors that should be considered when determining ETC status are the ability to serve an entire service area, long term commitment to serve rural communities in question, bandwidth/capacity of the service at current time and in the future, quality of service to consumers, ability to remain functional during an emergency, financial viability of a communications company, and interoperability.

If law requires the FCC to continually abandon existing ETC recipients in favor of new lower cost providers the result will be devastating to rural communities. USF recipient churn and instability in the market would be a disincentive to invest in networks to improve and upgrade service by the existing ETC receiving support.

Furthermore, if a carrier’s ability to receive USF support is not secure they will be unable to obtain long term public (RUS) and private financing necessary to build networks. Communications is a capital intensive industry which requires long term network planning and continual upgrading. This would not be possible if support could be pulled from the ETC and given to a new lower cost provider at any time or even within a few years.

Question 4a: In his testimony, Mr. Garnett asserts that “high-cost mechanisms subsidize incumbent carriers based on what they spend...not necessarily based on whether they actually serve customers located in a rural, high-cost area.” Do you agree with the accuracy of this statement? Please explain your answer.

Answer 4a: No. In his statement Mr. Garnett refers to ILEC support being tied to investment and not on who an ILEC serves. The statement is incorrect and Mr. Garnett appears to be confusing two separate issues – basis of support and definition of rural.

To receive support from the high-cost fund for rural carriers, an ILEC must meet the definition of a rural carrier and the service territory must meet the definition of a rural service area. These definitions are established by the FCC. Therefore, an ILEC’s eligibility to receive support under the rural USF program is directly tied to its customers and service territory.

Once a carrier and its service area are deemed to have met these requirements then the question as to the level of support comes into play. The money rural carriers “spend” is the actual, embedded cost to provide regulated telecommunications service to consumers throughout their rural service areas, as defined by the FCC. This data is what the FCC and the fund administrator, USAC, use to calculate the level of support an ILEC is eligible to receive. The rural high-cost universal service support mechanisms are therefore based on the actual cost to provide affordable telephone service to consumers throughout their specific rural service areas. These costs are reviewed and approved by both state and federal regulatory agencies.

Since the early 20th century, AT&T, the Bell Operating Companies and GTE chose not to invest in facilities to provide basic telephone service to nearly 40 percent of the geographic area of the United States. This territory consisted primarily of the most rural, insular, and sparsely populated areas in the Nation. Thin populations and difficult landscapes made these vicinities too costly for large carriers to invest in and the risk of not recovering their investment was too high. Many Americans living in these areas therefore had to invest their own time, labor and money to form small subscriber-owned telephone cooperatives and community-based commercial telephone companies in order to bring service to their homes and communities.

Today, there are over 1,000 rural telephone companies serving rural America. These companies were the first and often the only companies willing to bring the latest telecommunications technology to Americans living in the remote areas of our country. This cooperative spirit that brought telephone service to rural America is the same spirit that Congress embraced when it enacted the Communications Act of 1934 so that all people of the United States, rural and urban, can have access to affordable and comparable telecommunications services.

Question 4b: Do you believe that subsidizing incumbent carriers (or any carriers) based on what they spend rather than who they actually serve is the right policy outcome? Please explain your answer.

Answer 4b: *Carriers are not reimbursed based on what they spend. As stated in answer 4a ILEC support is directly tied to the customers they serve and their actual cost of providing that service. And again, all relevant data is filed, reviewed, vetted and approved on the state and federal level. On the contrary, CETCs are not required to meet the FCC definition of a rural carrier as does an ILEC nor are they required to demonstrate their cost of providing service. This lack of accountability has detrimentally impacted the universal service fund and must not be allowed to continue.*

Question 5: As Mr. Garnett points out in his testimony, “CTIA has proposed combining the current five high-cost universal service mechanisms into one mechanism that calculates support based on the most efficient technology – whether wireline or wireless – in a small geographic area.” Please comment on whether you support or oppose such a proposal and why?

Answer 5: *The five funds within high cost are designed specifically to calculate more accurately appropriate distributions from the fund to recipients. For instance, the separate rural and non-rural distinctions are made to ensure accountability and are specifically needed to meet the goals of universal service taking into account the difference between the RBOCs and the smaller independent carriers. The FCC has considered combining the rural and non-rural funds on more than one occasion and each time the conclusion of FCC experts is that doing so would reduce accountability and lead to waste in the fund.*

USF support from the non-rural fund is based on a forward-looking cost model and support from the rural fund is based on the embedded cost of small independent carriers. While such cost models may enhance incentives for cost-reducing innovation relative to embedding cost mechanism, such models can't guarantee that support will be either predictable or sufficient as required by the Telecommunications Act of 1934. Independent carriers vary vastly in size, scope, geography and population distribution. No cost-model can accurately account for these vast differences.

In the several years the FCC worked on developing the forward-looking cost model that is currently used for non-rural carriers, many attempts were made to adapt this model to rural independent carriers. All attempts were deemed a failure. During the testing of the cost-model it was found that support levels for some rural carriers were too low and for some carriers way too high. Therefore support was unpredictable and did not provide the required sufficient level of support to some carriers while providing a windfall of support to other ILECS. Thus, it was unanimously determined that applying a cost model to the rural fund would not meet the policy goals of universal service and would reduce fund accountability.

In addition, the FCC sought and received input from many industry experts such as the Rural Task Force. The Rural Task Force studied this very question and found this idea to be un-workable. Please see Rural Task Force paper, "A Review of the FCC's Non-Rural Universal Service Fund Method and the Synthesis Model for Rural Telephone Companies" for further information [<http://www.wutc.wa.gov/rtf>].

RESPONSE FOR THE RECORD OF PAUL W. GARNETT, DIRECTOR, REGULATORY AFFAIRS,
CTIA – THE WIRELESS ASSOCIATION

1. In his testimony, Director Marron states that “[s]pending for [the high-cost] program could be curbed by limiting high-cost support to one connection per household, by basing support on each carrier’s own costs rather than on a cost standard set by the incumbent carrier, or both.” Please comment on whether you agree or disagree with these two reform proposals and explain your answer.

While CTIA supports proposals to curb growth in the size of the universal service fund, we oppose each of the proposals described by Director Marron, because they would disserve consumers. Consumers in both rural and non-rural areas benefit from high-quality, competitively priced, and innovative services that result when multiple competitors are in a marketplace. In adopting section 254(b)(3) of the Act, Congress recognized the importance of providing consumers in high-cost rural areas access to the same types of telecommunications service offerings that are available to consumers in urban areas. At the same time, Congress recognized the importance of competition. As noted by the United States Court of Appeals for the Fifth Circuit in *Alenco Communications, Inc. v. FCC*, 201 F.3d 608, 616 (5th Cir 2000), “[t]he FCC must see to it that *both* universal service and local competition are realized; one cannot be sacrificed in favor of the other.” The Fifth Circuit therefore concluded that “protection from competition” is “the very antithesis of the Act.” *See* 201 F.3d at 622.

There is little doubt that consumers in urban, low-cost areas see the benefits of having multiple points of access to the network. While some consumers limit themselves to one wireless or wireline connection to the network, it is clear that a larger group of consumers prefer to maintain both wireline and wireless connectivity to the network. The proliferation of wireless “family plans” also exposes a flaw in the idea of limiting consumers to one connection “per household.” Under the “family plan” model, multiple individuals in a household have points of access to the network – and this is becoming the norm, not the exception. Therefore, in practice, limiting support to one connection per household would deny consumers in rural high-cost areas the quality and variety of services available to consumers in non-rural, low-cost areas.

The Federal-State Joint Board on Universal Service’s “primary line” proposals also would have distorted the competitive marketplace. The Joint Board conceded that its proposals were meant to prevent or mitigate reductions in support available to rural incumbent carriers resulting from competitive entry. *See ETC Recommended Decision*, 19 FCC Rcd 4257, 4289, para. 76 (Jt. Bd. 2004). Even accounting for loss of customers as a result of healthy competition, none of the Joint Board’s proposals would have resulted in any overall loss of revenues (even in the long run) for the vast majority of rural incumbent LECs that are guaranteed profits under rate-of-return regulation. Designing high-cost mechanisms to insulate incumbent carriers from the rigors of the competitive marketplace by guaranteeing them support disregards the fact that the Act demands “sufficient funding for *customers*, not *providers*.” *See Alenco v. FCC*, 201 F.3d at 622.

CTIA also opposes Director Marron’s proposal to base support on each carrier’s own costs. While this proposal clearly is an attempt to curb spending on high-cost support, it would have the opposite effect. Under this proposal, both the incumbent and competitive eligible telecommunications carriers would have incentives to increase costs to receive more high-cost universal service support. This proposal also would distort the marketplace by giving unequal per-line support to competing eligible telecommunications carriers. The incumbent and competitors should not receive unequal high-cost universal service support. Unequal support will distort markets by creating artificial incentives for consumers to purchase certain services and dissuading market

entry by more efficient and innovative competitive alternatives. Importantly, giving less per-line support to one set of competitors puts policy-makers, not consumers, in the position of deciding which provider wins and loses in the competitive marketplace. Consumers lose out when policy-makers second guess the competitive market.

Policy-makers should not repeat the mistakes of the past by supporting universal service policies that distort the competitive market or create incentives for both incumbents and competitors to develop business models premised on receipt of greater and greater subsidies. If the experience of the wireless industry can be any guide, simplified regulations that encourage and reward efficiency will best benefit consumers by ensuring that universal service is targeted only to where it is most needed and is no more than is necessary. At the FCC, CTIA has proposed combining the current five high-cost universal service mechanisms into one mechanism that calculates support based on the most efficient technology – whether wireline or wireless – in a small geographic area. CTIA also has supported other efforts to reduce demand for universal service, while ensuring that support is available to both incumbent and competitive eligible telecommunications carriers on a non-discriminatory basis.

2a. In February 2004, the Federal-State Joint Board on Universal Service recommended supporting a single connection per household, as a means of reducing excessive growth in the fund: “We believe that limiting the scope of high-cost support to a single connection to the public telephone network would be more consistent with the goals of section 254 than the present system.” Please comment on whether you agree or disagree with this statement and explain your answer.

[See response to 1.]

2b. The Joint Board also determined “Section 254(b)(3) encourages access to connectivity, however, not unlimited connections at supported rates. Advanced services increasingly are being provided along with voice services over a single connection. Nothing in the Act supports the argument that multiple connections should be supported for access to dial-up Internet access or fax services, neither of which is a supported service.” Please comment on whether you agree or disagree with this statement and explain your answer.

Section 254(b)(3) of the Act demands that consumers in high-cost, rural areas have access to comparable telecommunications and information services without reference to a single connection or multiple connections. Under the Act, comparability must be measured by what services are available to consumers in urban areas. Consumers in urban areas clearly have access to services that include single and multiple connections, provided over a variety of technology platforms. At the same time, supporting unlimited customer connections may inflate the size of the universal service fund. It also is fair to question support for forms of connectivity that are not widely utilized by residential customers in low-cost, urban areas. CTIA is open to further discussions on how best to address this tension.

2c. The Joint Board also concluded “We believe that further growth due to supporting multiple connections presents a significant threat to fund sustainability.” Please comment on whether you agree or disagree with this statement and explain your answer.

Continuing to calculate high-cost support based on an incumbent carrier's embedded costs poses a far greater threat to the sustainability of the universal service fund than growth in support for multiple connections. Over the last five years, incumbent carriers have received greater levels of high-cost universal service support even though they continue to lose customers. From 2000 through 2005, incumbent carriers accounted for roughly two-thirds of the growth in the size of the high-cost universal service mechanisms. Since 1997, of the \$22 billion spent on high-cost universal service subsidies, \$20.9 billion has gone to incumbent LECs and only \$1.1 billion has gone to wireless carriers and other competitors. This inequity exists even as consumers are demanding more and more wireless services. In fact, there are now more mobile wireless subscribers than wireline switched access lines.

3a. Should only one provider receive universal service support in any given area? Please explain your answer.

CTIA opposes artificial limits on the number of eligible telecommunications carriers in a given area. While limiting fund growth is a worthwhile goal, limiting support to one provider in a given area would deny consumers the benefits of competition in terms of lower-priced, higher-quality, and new and innovative services. One proposal before the FCC in the recent eligible telecommunication carrier proceeding was to limit the number of eligible telecommunications carriers in those areas in which the incumbent receives more than a prescribed level of high-cost universal service support. Such a limitation would create powerful and perverse incentives for incumbent carriers to drive up the cost of universal service in order to avoid competitive entry. Incumbent carrier inefficiencies should be a reason to encourage, not discourage, entry by more efficient competitors.

The better answer is to make same per-line support available to both the incumbent and competitors based on the most efficient technology for a given market. That way, consumers, not regulators, would decide whether a particular market can sustain competition. Using universal service support to indefinitely maintain monopolies will never be good for consumers.

3b. Should only the provider that can serve the area at the lowest possible cost receive the universal service support? Please explain your answer.

Although CTIA has suggested that a cost model could be used to calculate high-cost universal service support, CTIA is open to a variety of market-driven proposals that would reward more efficient carriers that compete away the cost of universal service. CTIA has proposed combining the current five high-cost universal service mechanisms into one mechanism that calculates support based on the most efficient technology – whether wireline or wireless – in a small geographic area. CTIA also has expressed interest in other proposals, such as the use of reverse auctions to determine support amounts. A proposal to limit support to the lowest cost provider in a particular geographic area is similar to a version of reverse auctions under which the lowest bidder would receive all universal service support. While limiting support to the lowest cost provider in a particular geographic area could drive down the cost of high-cost universal service support, it does run the risk of distorting the competitive market. Similar to a “winner takes all” reverse auction, it also is not entirely clear what economic incentive an eligible telecommunications carrier would have to drive down the cost of universal service, knowing that it runs the risk of bidding away support amounts. The length of the winning eligible telecommunications carrier's period of exclusivity also may impact a carrier's costs levels and may factor into the decision of competitors to enter that market.

4a. In his testimony, Mr. Garnett asserts that “the high-cost mechanisms subsidize incumbent carriers based on what they spend and not necessarily based on whether they actually serve customers located in a rural, high-cost area.” Do you agree with the accuracy of this statement? Please explain your answer.

Unlike the competitive market in which wireless carriers operate, the high-cost universal service mechanisms (and intercarrier compensation) actually reward rural incumbent local exchange carrier inefficiency (and encourage competitive carriers to seek universal service support in those markets served by inefficient incumbents). Absurdly, the high-cost mechanisms subsidize rural incumbent local exchange carriers based on what they spend, not necessarily based on whether they actually serve customers located in a rural, high-cost area. Specifically, the high-cost loop support, interstate common line support, and local switching support mechanisms determine support based on an incumbent carrier’s “actual” or embedded costs plus a prescribed 11.25% rate-of-return. In contrast, the high-cost support mechanism for so-called “non-rural” carriers calculates support based on the forward-looking economic costs – a measure of what it would cost an efficient wireline carrier to serve a particular geographic area. Because support for rural incumbent local exchange carriers is based on costs averaged over an incumbent carrier’s total costs, these mechanisms allow rural incumbent local exchange carriers to keep support even as they lose customers.

In a recent report entitled “*Universal Service Telephone Subsidies: What Does \$7 Billion Buy?*”, Professor Thomas W. Hazlett documents how the high-cost universal service works in practice. A full copy of the report is available at <http://www.senior.org/Documents/USF.Master.6.13.06.pdf>. According to Professor Hazlett, under the current high-cost support mechanisms, “[t]he more service costs, the more money the phone carrier receives – a clear incentive to *avoid* cost savings.” Under the current high-cost support mechanisms, “there appears to be no way to distinguish between ‘high costs’ and obsolete and inefficient ways of doing things.”

In his report, Professor Hazlett lists 16 incumbent carriers that receive over \$1,000 per line per year in so-called “corporate operations expenses,” an array of expenditures unrelated to installing and maintaining plant and equipment. As the FCC has noted, such costs “may be discretionary” and include, for example, “travel, lodging, and other expenses associated with attending industry conventions and corporate meetings.” See *Rural Task Force Order*, 16 FCC Rcd 11244, para. 63. According to Professor Hazlett, the average rural incumbent LEC corporate overhead expense is about \$99 per year per line and the average non-rural incumbent LEC corporate overhead expense is about \$75 per year per line. Professor Hazlett also lists the top 12 high-cost support per line recipients of high-cost support – with one carrier receiving an astonishing \$13,345 per line per year.

Accipiter Communications, Inc. (Accipiter), a rural incumbent local exchange carrier on both of these lists, receives \$6,927 per line per year in high-cost universal service support to serve 219 access lines. Accipiter has annual corporate operation expenses of \$2,113 per line. Accipiter recently filed a petition with the FCC to enable it to receive high-cost universal service support to defray the costs of serving potential customers in the Vistancia development, located in Peoria, Arizona. A copy of the petition is available at http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6518365842. Peoria, Arizona is a suburban community located just 25 miles from Phoenix. Maricopa County, in which Peoria is located, has the fourth highest number of millionaires of any county in the United States. For additional information, go to <http://moneycentral.msn.com/content/invest/extra/P148783.asp>. Vistancia includes two golf courses and 4,000 square foot homes costing over \$1 million. Vistancia advertises itself as “an innovative *urban* commercial and residential village.”

<http://www.vistancia.com/news/20060612.shtml> (emphasis on *urban* added). One of the two golf courses describes the community in this way:

In the peaceful hills of Peoria, Arizona – tucked within the friendly confines of Vistancia – a private country club community is taking shape. Home to a Jim Engh-designed golf course, a fully appointed clubhouse, and a superb selection of residences and homesites, Blackstone honors what we cherish most: family, fine living, and a world of new experiences.

Go to http://www.blackstonecountryclub.com/index_flash.html. For additional information on Vistancia’s many amenities, go to www.vistancia.com.

With customers like these, it is little wonder that Accipiter is interested in extending its network into the Vistancia development. But, should universal service support be used to fund that expansion? Cox Communications, which already serves customers in Vistancia, neither receives nor has asked for universal service subsidies. The area also is served by a long list of at least six wireless carrier competitors, which also do not receive high-cost universal service support to serve that area. Now Accipiter is asking for high-cost universal service support so it can “compete” with all of these unsubsidized competitors.

Given how the current universal service system is structured, this type of behavior is not surprising. According to Professor Hazlett, “there appears to be no mechanism in place to . . . rein in even the most egregious inefficiencies.” Professor Hazlett concludes that “incentives created by these subsidies encourage widespread inefficiency and block adoption of advanced technologies – such as wireless, satellite, and Internet-based services – that could provide superior voice and data links at a fraction of the cost of traditional fixed-line networks.”

4b. Do you believe that subsidizing incumbent carriers (or any carriers) based on what they spend rather than who they actually serve is the right policy outcome? Please explain your answer.

For the reasons detailed in my response to 4a., absolutely not.

5. As Mr. Garnett points out in his testimony, “CTIA has proposed combining the current five high-cost universal service mechanisms into one mechanism that calculates support based on the most efficient technology – whether wireline or wireless – in a small geographic area.” Please comment on whether you support or oppose such a proposal and why?

The best way to answer this question is to first look at all that is wrong with the current high-cost universal service mechanisms – which represent an increasing majority of the overall universal service fund. There are numerous problems with the high-cost mechanisms, such as: (1) incentives for inefficiency; (2) enrichment of incumbent LEC profits; and (3) impenetrable administrative complexity. Taken together, these problems result in a bloated fund that does not effectively target the appropriate levels of support to different high-cost areas. As a result, the high-cost support mechanisms do a poor job of ensuring that all Americans have access to high-quality, affordable telecommunications and information services. Moreover, the high-cost support mechanisms undermine the efficient development of competition as envisioned by the Act.

Incentives for Inefficiency. Embedded, cost-based, high-cost universal service mechanisms reward inefficiency by creating incentives and opportunities for carriers to engineer higher embedded costs to receive more support. Despite industry-wide efficiency gains, advances in technology, and amortization of depreciated equipment, high-cost universal service subsidies continue to increase rather than decrease over time. To debunk one frequently repeated myth, it is new support for incumbents, not competitors, that has been the primary cause of fund growth. Since competitive eligible telecommunications carriers receive high-cost support based on the incumbent carrier's costs, increased incumbent LEC costs mean more support for both incumbents and competitors.

In practice, the FCC's high-cost support mechanisms compound incentives for inefficiency inherent in embedded cost support mechanisms. For example, the high-cost support mechanisms discourage carriers from taking advantage of economies of scale normally associated with combining operations. Under the high-cost mechanisms, smaller rural incumbent LECs are eligible for more support than larger carriers. Incumbent LECs that increase their customer base risk reducing or eliminating their qualification for high-cost support. The embedded high-cost mechanisms' preference for small carriers also creates incentives for carriers to appear small when, in fact, they are much larger. Incumbent LECs do this by operating numerous "study areas" in a given state or by balkanizing their operations among the various states. One incumbent LEC, for example, operates in 18 study areas in Wisconsin.

Guaranteeing Universal Service Profits. In addition to reimbursing incumbent LECs for their service-related costs, the high-cost universal service mechanisms also are designed to guarantee a prescribed level of profits for incumbent LECs. For example, the federal high-cost support mechanisms for rural and rate-of-return incumbent LECs include a guaranteed rate of return of 11.25%. This rate-of-return is based on the cost of capital for Regional Bell Operating Companies in 1991. The 11.25% return was based on the RBOCs' 8.8% cost of debt in 1991. We estimate that today rural incumbent LECs have an average cost of debt of only 5.46%. This would allow rural carriers to earn a 15.06% return on equity from the universal service mechanisms. To make matters worse, many incumbent LECs have reported to the FCC that they had profits far in excess of the prescribed rate-of-return. These elevated universal service profits do not translate to improved telecommunications services in high-cost areas. Instead, they simply enrich carriers, while increasing the overall size of the fund to the detriment of other carriers and consumers who end up paying higher universal service pass through charges.

Impenetrable Administrative Complexity. The five separate high-cost support mechanisms, in conjunction with the waivers and other loopholes carriers use to receive additional high cost support, make the system an administrative and enforcement nightmare. Also, support calculations under the various federal high-cost support mechanisms rely on archaic and complicated cost accounting, jurisdictional separations, and reporting rules that have existed in one form or another since 1984. This administrative complexity makes it exceedingly difficult for the Universal Service Administrative Company ("USAC"), the FCC's independent universal service fund administrator, to audit incumbent LEC cost data submitted for purposes of calculating high-cost support. These wasteful administrative costs are paid by consumers through higher rates for service, as well as higher universal service pass-through charges.

At the FCC, CTIA has put forth market-oriented proposals to address these problems. CTIA has supported efforts to reduce demand for universal service, while ensuring that support is available to both incumbent and competitive eligible telecommunications carriers on a non-discriminatory basis. Specifically, CTIA has proposed calculating support based on the most efficient technology – whether wireline or wireless – in a small geographic area. Under this proposal, incumbent and competitive eligible telecommunications carriers would receive the same level of "per-line" support

based on the most efficient wireline or wireless technology for a given area. As in the competitive market, eligible telecommunications carriers would only receive support to the extent that they win customers. More customers would equate to more support. At the same time, incumbents and competitors that lose customers would lose support (a novel concept under the current mechanisms).

Although CTIA has suggested that a cost model could be used to calculate support, as noted previously, CTIA is open to other market-driven proposals (such as reverse auctions) that would reward more efficient carriers that compete away the cost of universal service. CTIA also has proposed shorter term reforms within the context of the current mechanisms that would reduce support for carriers that do not need it and potentially increase support to those carriers with legitimate needs. For example, CTIA has supported:

- (1) Eliminating profit guarantees in high-cost mechanisms (We think carriers should get their profits from their own customers, not through the universal service mechanisms);
- (2) Requiring carriers to combine study areas in a given state (The current rules allow large, low-cost incumbents to appear small and high-cost by balkanizing their operations within a state); and
- (3) Transitioning larger rural incumbent carriers to the non-rural high-cost mechanisms.

Increased accountability must be central to any universal service reforms. That's why CTIA has supported technology neutral "carrier of last resort" obligations for both incumbent and competitive eligible telecommunications carriers. CTIA also has supported requirements that both incumbent and competitive eligible telecommunications carriers achieve measurable results – for example, showing how universal service dollars have been used to improve service quality and coverage. We are open to other proposals and look forward to a continuing dialogue on these important issues.

RESPONSE FOR THE RECORD OF STACI L. PIES, VICE PRESIDENT, POINTONE COMMUNICATIONS, ON BEHALF OF VOICE ON THE NET (VON) COALITION

1. In his testimony, Director Marron states that “spending for the [high-cost] program could be curbed by limiting high-cost support to one connection per household, by basing supporting on each carrier’s own costs rather than on a cost standard set by the incumbent carrier, or both.” Please comment on whether you agree or disagree with these two reform proposals and explain your answer.

As Congress and the FCC examine whether and how the nation’s Universal Service system should be reformed, the focus should always be delivering competitive, innovative and robust services to all consumers nationwide, at just, reasonable, affordable and reasonably comparable rates. For too long, the primary beneficiaries of USF have been the companies that receive the funds rather than the consumers that may or may not benefit from USF policies.

In keeping with the principle that consumer impact should drive USF policy implementation, the VON Coalition supports reforms that recognize that competition creates additional pressure for USF recipients to operate efficiently thereby minimizing the need for subsidies. As the Coalition stated in its testimony, to help accelerate the transition to a nationwide broadband network, Congress should adopt policies that create incentives rather than disincentives for efficient network deployment and exchanging traffic between Internet networks and the legacy phone network -- thus geometrically increasing the value of both of America’s communications networks.

As the Fifth Circuit explained, “The Act does *not* guarantee all local telephone service providers a sufficient return on investment; quite to the contrary, it is intended to introduce competition into the market. Competition necessarily brings the risk that some telephone service providers will be unable to compete.”¹ Thus, “[t]he Act only promises universal service, and that is a goal that requires sufficient funding of customers, not *providers*.”² As the Fifth Circuit recognized, “So long as there is sufficient and competitively-neutral funding to enable all customers to receive basic telecommunications services, the FCC has satisfied the Act and is not further required to ensure sufficient funding of every local telephone provider as well.”³

2.a. In February 2004, the Federal State Joint Board on Universal Service recommended supporting a single connection per household, as a means of reducing excessive growth in the fund: “We believe that limiting the scope of high-cost support to a single connection to the public telephone network would be more consistent with the goals of section 254 than the present system.” Please comment on whether you agree or disagree with this statement and explain your answer.

As stated in response to question 1, the VON Coalition urges Congress to focus on the benefits to consumers of any particular proposal as well as ensuring that USF policies create incentives for efficient network deployment and the utilization of the most efficient technologies. Moreover, USF reforms should ensure that all providers of a substitute service to the same customer receive the same amount of support, regardless of the identity of the provider or the underlying technology.

¹ *Alenco Communications, Inc. v. FCC*, 201 F.3d 608, 620 (5th Cir. 2000).

² *Id.* (emphasis in original).

³ *Id.*

2.b. The Joint Board also determined “Section 254(b)(3) encourages access to connectivity, however, not unlimited connections at supported rates. Advanced services increasingly are being provided along with voice services over a single connection. Nothing in the Act supports the argument that multiple connections should be supported for access to dial-up Internet access or fax services, neither of which is a supported service.” Please comment on whether you agree or disagree with this statement and explain your answer.

The VON Coalition believes that Congress and the FCC should view the Universal Service subsidy system in a new light. While the Joint Board’s focus on “services’ may be useful in the circuit switched world, as the Joint Board also recognized, in a broadband world, multiple services are provided over the same network. In focusing on the types of services that qualify for subsidies, the USF regime emphasizes voice services to the detriment of data and Internet services and ensures that most money stays or flows exclusively to incumbent carriers. The USF fund should not constrain us to the confines of the 100 year old analog voice regime when the world is moving to broadband based voice.

A shift away from the focus on services or application and instead towards a focus on the transmission when determining whether a connection should be subsidized will provide appropriate incentives for broadband buildout. Broadband enabled networks and VoIP are facilitating transformative improvements in the way we communicate that harness the power of the Internet. VoIP is not just another flavor of telephone service. In contrast to traditional plain old telephone service (“POTS”), VoIP voice is an application, just like e-mail, streaming audio, streaming video, and web browsing and can occur over any packet data network, including the Internet. VoIP has the ability to decouple voice from the legacy copper telephone network, so that innovation can happen on Internet time, and consumers can connect from any broadband network. By transforming voice communications into a software application, VoIP can integrate communications and data in entirely new ways. Soon a voice component can be added to any type of device, application or service that uses a microprocessor or touches the Internet. Accelerating VoIP adoption can mean cost savings for consumers and businesses, reduced operational costs for providers, advanced features unavailable with traditional phones, increased competition among network and service providers, increased infrastructure investment, accelerated broadband deployment, improvements in emergency services, lower cost communications for rural and government users, increased access for persons with disabilities, and increased worker productivity.

2.c. The Joint Board also concluded “We believe that further growth due to supporting multiple connections presents a significant threat to fund sustainability.” Please comment on whether you agree or disagree with this statement and explain your answer.

The VON Coalition agrees with the reasoning articulated by the Fifth Circuit in the *Alenco v. FCC*. In that decision, the Court pointed out, “excessive funding may itself violate the sufficiency requirements of the Act.”⁴ The reason is that “universal service is funded by a general pool subsidized by all telecommunications providers—and thus indirectly by the customers.”⁵ In other words, because customers bear the ultimate cost of supporting universal service, “excess subsidization in some cases may detract from

⁴ *Alenco*, 201 F.3d at 620.

⁵ *Id.*

universal service by causing rates unnecessarily to rise, thereby pricing some consumers out of the market.”⁶

3.a. Should only one provider receive universal service in any given area? Please explain your answer.

The VON Coalition suggests that limiting support in a given area to one provider eliminates incentives for that provider to deploy the most advanced and economically efficient technologies, thus harming the very consumers that the Universal Service Fund is intended to benefit. Congress should ensure that even with USF subsidies, the market behaves as must like a competitive market as possible. Accordingly, federal USF policies must not discriminate between providers of substitute services to the same customers. All providers in a given area must be eligible to receive the same amount of support, regardless of the identity of the provider or the underlying technology. Importantly, such a support basis mimics the risks and rewards of an unsubsidized market and benefits consumers by enabling companies to deliver competitive, innovative and robust services to all consumers nationwide, at just, reasonable, affordable and reasonably comparable rates.

3.b. Should only the provider that can serve the area at the lowest possible cost receive the universal service support? Please explain your answer.

Rather than requiring the government to identify and select the least-cost supplier of services, a solution that would be fraught with problems, the VON Coalition believes that a better approach to lowering the costs of universal service and ensuring sustainability of the fund is to focus on accelerating VoIP driven benefits to consumers, businesses, and the economy by establishing incentives for carriers to make cost-effective investment decisions while improving service to consumers in their areas by increasing the availability of broadband services. The VON Coalition agrees that all Americans benefit from the fact that residents of rural areas have access to high quality telephone service. However, the incentives for providers to improve economic efficiency by deploying IP-based networks and services are adversely impacted by the manner in which the fund is currently administered given that high cost carriers generally receive subsidies based on their costs.

4.a. In his testimony, Mr. Garnett asserts that “the high-cost mechanisms subsidize incumbent carriers based on what they spend . . . not necessarily based on whether they actually service customer located in a rural, high cost area.” Do you agree with the accuracy of this statement? Please explain your answer.

As stated in 3.b. above, the VON Coalition is equally concerned that the current distribution system does not provide the proper incentives for deploying economically efficient technology. High-cost support provides subsidies to make carriers whole, regardless of their investment decisions or business models by guaranteeing ‘reasonable’ rates of return. Utilizing traditional, circuit switched technology, it is generally agreed that in those areas, basing end-user retail prices strictly on the cost of service would likely create a barrier to subscription and frustrate the achievement of Universal Service goals. However, with the advent of more efficient, lower cost technologies such as VoIP, the

⁶ *Id.*

cost of providing service in rural and high cost areas can decrease significantly. Not only does VoIP enable robust, innovative communications experiences for all Americans, it significantly lowers the cost of network deployment and the provision of services to enterprises and residential consumers.

4.b. Do you believe that subsidizing incumbent carriers or any carriers based on what they spend rather than who they actually serve is the right policy outcome? Please explain your answer.

Subsidizing any provider based on the actual costs without appropriate auditing and oversight increases significantly the burden on the Fund. Moreover, such a policy outcome is detrimental to consumers because providers have no incentives to operate more efficiently or deploy new technologies that might offer lower costs.

5. As Mr. Garnett points out in his testimony, “CTIA has proposed combining the current five high-cost universal service mechanisms into one mechanism that calculates support based on the most efficient technology – whether wireline or wireless – in a small geographic area.” Please comment on whether you support oppose such a proposal and why.

The VON Coalition supports Universal Service reforms that eliminate the current incentives for carriers to ignore technological innovations that would reduce their dependency on or qualifications for subsidies. A single mechanism that calculates support based on the most efficient technology would provide appropriate, market driven incentives for high cost telephone companies to deploy less expensive, more robust and feature rich broadband technologies thereby benefiting consumers with lower cost service and less expensive universal service payments. The current USF subsidies mechanism assures a regular and predictable revenue flow with little to no risk and significant rewards.

RESPONSE FOR THE RECORD OF GEOFF FEISS, GENERAL MANAGER, MONTANA
TELECOMMUNICATIONS ASSOCIATION

1. In his testimony, Director Marron states that “[s]pending for the [high-cost] program could be curbed by limiting high-cost support to one connection per household, by basing support on each carrier’s own costs rather than on a cost standard set by the incumbent carrier, or both.” Please comment on whether you agree or disagree with these two reform proposals and explain your answer.

I disagree in large part with Director Marron’s suggestion that high-cost support can be limited in any practical manner to one connection per household. This suggestion is commonly referred to as a “primary line restriction.” I agree with his suggestion that support should be based on each carrier’s own costs rather than on a cost standard set by the incumbent carrier. This suggestion is commonly referred to as the “identical support rule.” I’ll address each suggestion separately.

First, I should point out that as Director Marron’s testimony attests, most of the so-called growth in the Universal Service Fund (USF) has resulted from regulatory cost shifting, as directed by Congress, from “implicit” support mechanisms (i.e., intercarrier compensation or access revenues) to “explicit” support (i.e., universal service). Economically speaking, consumers are paying no more to support investment in ubiquitous, affordable, advanced telecommunications infrastructure. Instead of paying implicit support through intercarrier compensation for maintaining investment in a national telecommunications infrastructure, they’re paying the same amount explicitly through universal service support. As my testimony shows, the amount of support received by incumbent ETCs has remained essentially the same.

This is not so, however, with regard to “new” support created by recent and growing designation of new, mostly wireless, eligible telecommunications carriers (ETCs). CBO notes that designation of new ETCs is where the “new” growth of universal service funding is found. FCC Chairman Kevin Martin also has noted this phenomenon in a speech to USTelecom in October, 2006.

...a lot of the Fund’s growth in recent years is attributable to new competitive eligible telecommunications carriers (or CETCs), particularly wireless CETCs that have begun to receive funding. The number of CETCs is increasing dramatically and is one of the primary drivers of fund growth. Since 2000, CETC high cost payments have grown from about \$1.5 million annually to about \$333 million annually. (FCC Chairman Kevin Martin, speech to USTelecom, 10/26/05)

CBO points out in its testimony that “[f]urther growth in the number of wireless telephone carriers that become eligible to receive USF support for providing service in rural areas could increase spending for the High-Cost Program by between \$0.6 billion and \$1.2 billion.”

So, while the Fund (explicit support) has grown, intercarrier compensation (implicit support) has shrunk. As CBO notes, the next intercarrier compensation reform proposal in the pipeline will bring more of the same regulatory shift from implicit support to explicit support, notwithstanding the “new” support obligations resulting from continuing designation of additional ETCs. In fact, it is the designation of additional, multiple ETCs serving the same area that has led to recommendations aimed at curbing the growth of the USF. Among those recommendations is the so-called primary line restriction.

Primary line restriction. Conceptually, there are attractive arguments in favor of a primary line restriction. As indicated in following questions below (e.g., 2a.), the Federal-State Joint Board on Universal Service in 2004 enumerated a number of

rationales justifying adoption a primary line restriction. Among them: it is necessary to protect the sustainability of the Fund and to mitigate “uncontrolled” growth as more and more new ETCs are designated in high-cost areas; restrictions should be considered that would curtail artificial inducements for competitive entry; and, preventing automatic support of multiple connections might curtail incentives by states to designate ETCs to attract more universal service funding to their states. I do not disagree with any of these observations. However, I do disagree with the proposed solution and believe that fund growth can be addressed through alternative means that do not harm rural economic development and that preserve the integrity of the universal service program. (See below.)

Indeed, there is widespread opposition to a “primary line restriction.” In fact, Congress twice has enacted one-year moratoria on imposition of any primary line restriction, and rural telecom companies support a permanent moratorium/prohibition on the primary line restriction. One problem with a primary line restriction lies in its practical (or should I say “impractical”) implementation. First, it would be very difficult to determine which line is “primary,” and which one(s) is (are) not. There would be tremendous opportunity to game the system; to slam, cram, or otherwise attempt to (mis)characterize line(s) as “primary.” If one of the intentions for universal service reform is to reduce arbitrage and “gaming,” this potential reform may go in the opposite direction. For example, wireless companies offer each member of a household a separate phone and number—each of which receives universal service support if the wireless carrier is an ETC. Wireline households may have multiple phones but only one universal service-supported line. Thus, where universal service supports one wireline to a household, it now supports five “lines” for a household of four, if all members of the household each have a wireless phone, plus a supported wireline. (This is one reason why the primary line concept is attractive.) If there were a primary line restriction, would each member of the family choose a “primary” line, or would one “household” choose a single primary line? And then how would you determine what a household is, and who in the household gets to chose the primary line? How would you police such a system, even if you could devise a system which accurately determines what a primary line is? And so on.

A second problem with the primary line restriction is if only the primary line receives universal service support, then all other lines would be priced according to their actual costs. (Remember, wireless carriers do not even account for their actual costs today.) Presumably, non-primary lines would then be more expensive. (if they weren’t, they wouldn’t need universal service support.) In Montana, unsupported lines could be hundreds of dollars more expensive. (My testimony indicated that Montanans would pay between \$330 and \$600 more.) This would be a significant deterrent to small business (i.e., multi-line commercial enterprises) development in rural areas, and I do not believe Congress intends to thwart rural economic development. To the extent that consumers would purchase less telecommunications capability, carriers would be left with less revenue with which to recover their substantial investment in services and infrastructure, leaving rural America with less investment in basic as well as advanced investment incentives. Moreover, businesses would be left with fewer telecommunications assets with which to maintain and grow their operations.

In short, any potential advantages of a primary line restriction would be far outweighed in the form of diminished investment incentives, impossible administrative burden, and reduced economic development potential in rural America. Furthermore, it is questionable whether a primary line restriction would comply with the Telecommunications Act’s universal service principles, particularly that universal service is “specific, predictable, and sufficient.” 47 U.S.C. 254 (b)(5). If consumers could chose, and switch among supported lines, then carriers would have a difficult time at best determining what lines are supported, and predicting investment accordingly.

Identical support rule. As noted above, there are practical alternatives to a primary line restriction, the most effective of which is the elimination of the “identical support rule.” The identical support rule effectively says that any new ETC receives the same level of universal service support as the incumbent. For example, say a wireless carrier is designated as an ETC in the service area of an incumbent carrier. The new wireless ETC uses a combination of its own facilities and those of the incumbent. It provides a different level of service quality, does not have carrier-of-last-resort or other state or federal obligations imposed on the incumbent, deploys a different type of network architecture, and generally has a different cost structure than the incumbent. As a result, its costs are significantly less than the incumbent’s. Yet, under the identical support rule, the wireless ETC receives the same level of universal service support as the incumbent. The identical support rule effectively becomes a windfall rule for the new ETC.

This effect has been illustrated on numerous occasions. For example, FCC Chairman Martin noted in the same October, 2005, speech to USTelecom,

I have also expressed concern over how CETC support is calculated. For example, even if [new ETCs’] costs are lower, they receive support based on [the incumbent’s] higher costs.

The Montana Public Service Commission (MTPSC) recognized the windfall effects of the identical support rule in comments the MTPSC filed with the FCC in 2004:

To further illustrate the need to eliminate the identical support rule we offer the following information. Western Wireless’ CEO, John Stanton, in his presentation to this fall’s Qwest Regional Oversight Committee (ROC) meeting of September 12 and 13, [2004] Missoula, Montana, presented estimates of relative wireline and wireless investment costs. Those costs are as follows: (1) national wireline carriers’ cost is \$2,492; (2) national wireless carriers’ cost is \$920; (3) rural wireline carriers’ cost is \$7,195; and (4) rural wireless carriers’ cost is \$1,734. It is apparent from the presentation that to base support to wireless carriers upon the cost of the ILEC would bequeath an extraordinary subsidy to the wireless industry. As OPASTCO comments, and the Montana PSC agrees, the “identical support” rule must be eliminated. Reply Comments of the Montana Public Service Commission. *In the Matter of the Federal-State Joint Board on Universal Service, Request for Comments on Certain of the Commission’s Rules Relating to High-cost Universal Service Support.* CC Docket No. 96-45. December 14, 2004. [Note: Western Wireless has been acquired by Alltel since these comments were filed.]

It should be noted that wireless facilities need only reach from the end user to the nearest point of presence on the wireline network, thus saving the wireless carriers considerable expense. Indeed, wireless carriers (and VOIP providers, for that matter) rely on quality, ubiquitous wireline infrastructure to complete their calls. Yet, wireless ETCs are receiving universal service windfalls as they receive universal service support based on incumbent ETCs’ support, and not on their own costs, which generally are considered less because they don’t have the level of infrastructure investment, quality, ubiquity, etc. that the incumbent has.

Does it make sense effectively to subsidize competitors with windfalls at the expense of universal service support? Emphatically not. Elimination of the identical support rule is an effective means by which to reduce the gaming of the universal service program and to mitigate uncontrolled growth of the Universal Service Fund.

2a. In February, 2004, the Federal-State Joint Board on Universal Service recommended supporting a single connection per household, as a means of reducing excessive growth in the fund: “We believe that limiting the scope of high-cost support to a single connection to the public telephone network would be more consistent with the goals of section 254 than the present system.” Please comment on whether you agree or disagree with this statement and explain your answer.

As I noted above, the Joint Board observed that the Universal Service Fund is growing primarily as a result of the designation of new, mostly wireless ETCs. It recommended, on a 5-3 vote, to adopt a primary line restriction as a means by which to protect the sustainability of the Fund. While the symptoms were properly diagnosed, the remedy remains contentious; and even the slim majority recognized that a number of conditions and caveats needed to be present if a primary line restriction were to be considered seriously by the FCC. (It should also be noted that the Joint Board’s recommendation was just that: a recommendation for further consideration by the FCC. Moreover, as additional and dissenting comments pointed out, the Joint Board did not address such central issues regarding the growth of the Fund as subsidization of competition, appropriate controls over designation of ETCs, or determination of an appropriate basis of support—e.g., the identical support rule. These more central issues could more effectively accomplish the same objective as an identical support rule without threatening economic development, investment in a national infrastructure, or imposition of insurmountable administrative burden which could result in more—not less—gaming of the universal service program.)

The Joint Board acknowledged that a primary line restriction could have significant negative effects on investment in rural telecommunications infrastructure. For example, it requested the FCC to examine the effect of its recommendations on businesses with multiple connections. As I noted in my response to the previous question, a primary line restriction would likely increase significantly the cost/price of additional lines. Most “multiline” businesses in rural America are small. In Montana, the overwhelming majority of businesses have fewer than 5 lines, if they are multiline at all. Significantly increasing the price of these few additional lines would impose a tremendous burden on these small businesses, and would negatively affect their ability to maintain multiple lines, thereby affecting not only the businesses’ ability to retain and grow their operations, but negatively affecting telecom carriers’ return on investment.

The Joint Board advanced options to “avoid or mitigate reductions in the amount of high-cost support flowing to rural areas as a result of implementing a primary line restriction.” Among the options was a hold harmless proposal that recognizes the substantial investment that rural carriers have made in infrastructure and thus would hold these carriers harmless from loss of universal service support.

Further, the Joint Board recommendations were conditioned on the FCC’s ability to develop competitively neutral rules and procedures that do not create undue administrative burdens on carriers. As noted above, this condition may well be impossible to meet. Not only is a primary line restriction difficult to administer, but it likely would result in more, not less, manipulation (gaming) of the system, which Congress, the FCC and industry alike would prefer to eliminate rather than foster. Given more effective and more efficient solutions (elimination of identical support) the Joint Board’s recommendation likely does not meet its own conditions.

2b. The Joint Board also determined “Section 254(b)(3) encourages access to connectivity, however, not unlimited connections at supported rates. Advanced services increasingly are being provided along with voice services over a single connection. Nothing in the Act supports the argument that multiple connections should be supported

for access to dial-up Internet access or fax services, neither of which is a supported service.” Please comment on whether you agree or disagree with this statement and explain your answer.

I disagree with the implication of this statement that connections to the nation’s telecommunications infrastructure should somehow limit consumers’ access to advanced telecommunications capabilities. In fact, we should be, and are, encouraging precisely the opposite policy as a matter of national economic competitiveness and domestic economic development. In Montana, rural telecommunications providers have pushed broadband access to between 80% and often as much as 100% of their service areas. Over 250 rural Montana communities have access to DSL, starting at 256Kbps, and often reaching well over megabit speeds. In a state where the largest city has a population of 100,000, reaching 250 communities often means that towns of 100 residents or less have access to DSL technology. Many Montana rural telcos report that over 50% of their Internet customers subscribe to broadband services rather than dial-up Internet. Businesses are sprouting up in remote communities across the nation as a result of consumers’ and entrepreneurs’ access to advanced telecommunications capabilities. Economic opportunity no longer exists only in our nation’s cities. Anyone anywhere can start a business and instantly gain access to world markets. Access to advanced telecommunications infrastructure is critical to this economic vibrancy. And universal service is in no small degree contributing to this economic growth and vitality. I seriously doubt that Congress intends to curtail investment in the telecommunications platform that provides the foundation of economic growth.

Section 254(b)(3), as referenced by the Joint Board, states

Consumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas. [Emphasis added.]

The Joint Board statement appears to imply that access to advanced telecommunications and information service is OK for one line, but not for any other line(s). I don’t know how that’s possible. If a family or business has two lines, should only one be used for Internet access or fax capabilities even though both lines—and the network they’re attached to—are perfectly capable of providing advanced services? And I certainly don’t think that’s a desirable policy for the United States. For more than 70 years, universal service has supported carriers’ investment in networks “for the provision, maintenance and upgrading of facilities and services for which the support is intended. Any such support should be explicit and sufficient to achieve the purposes of this section.” 47 U.S.C. 254(e). [Emphasis added.] The rural telecommunications providers of Montana and the nation have been investing in and upgrading their networks to bring supported services to consumers in all corners of the nation.

Continual investment in telecommunications infrastructure including facilities for which universal service support is intended has brought a number of additional benefits to rural consumers. For example, by investing in advanced, high capacity fiber backbones and digital “softswitches,” telecom providers have been able to increase network efficiency, enhance cost effectiveness of network investment, and simultaneously deliver more robust services and applications for consumers’ personal and commercial benefit. Two companies alone in Montana are drawing \$2 million less in universal service support today than in 2004. Meanwhile, their investment in advanced

telecommunications capabilities has meant that more of their customers have access to more advanced telecommunications applications choices than ever before. Universal service support facilitates investment in networks for the purpose of providing supported services. Such investment also facilitates the delivery of advanced communications capabilities. Investing in a fiber backbone, for example, facilitates delivery of supported services, and enables more bandwidth to be deployed throughout the network.

The question implies that universal service is static, and that it is preferable that we provide only dial tone, without the capability of supporting advanced services, notwithstanding the principles set forth by Sections 254 and Sec. 706, which encourage an evolving definition of universal including support for advanced services. The Act defines universal service as

an evolving level of telecommunications services that the Commission shall establish periodically [taking into account] the extent to which such telecommunications services—(A) are essential to education, public health, or public safety; (B) have, through the operation of market choices by customers, been subscribed to by a substantial majority of residential customers; (C) are being deployed in public telecommunications networks by telecommunications carriers; and (D) are consistent with the public interest, convenience and necessity. 47 U.S.C. 254(c)(1).

Moreover, as I pointed out in my testimony, members of Congress on both sides of the aisle and the President are calling for more—not less—investment in broadband capabilities as a means of maintaining our nation’s international economic competitiveness. Dial-up Internet access and fax services hardly qualify as advanced telecommunications capabilities which will ensure our nation’s international economic competitiveness.

2c. The Joint Board also concluded “We believe that further growth due to supporting multiple connections presents a significant threat to fund sustainability.” Please comment on whether you agree or disagree with this statement and explain your answer.

I do not disagree with the statement, inasmuch as it indicates that growth of the Fund due to the designation of multiple ETCs threatens the Fund’s long term sustainability. As FCC Chairman Martin said in the aforementioned speech to USTelecom,

I do not think it is viable in the long term to continue subsidizing multiple competitors to serve areas in which costs are prohibitively expensive for even one carrier.

Then-Commissioner Martin made the same point in additional comments dissenting in part, and concurring in part to the Joint Board’s recommendation. He noted that the Joint Board’s recommendations may continue to make it difficult for any one carrier to achieve the economies of scale necessary to serve all of the customers in rural areas.

For reasons cited above, however, I do not agree with the statement that multiple “connections” to the network are the culprit, especially considering the negative economic effects of implementing a primary line restriction, as discussed above.

3a. Should only one provider receive universal service support in any given area? Please explain your answer.

From the perspective maintaining the sustainability of the Fund, the question is valid. As noted above, we should consider whether it is good policy to subsidize competition rather than to promote universal service.

However, a “single-carrier” approach may in fact result in unintended, negative consequences, much as a primary line restriction could result in negative investment and economic development consequences. How would states or the FCC determine which single provider would qualify for universal service support? (Suggestions regarding a “least-cost-provider,” or “most-efficient-technology” approach are discussed below.) As noted earlier, wireless calls (and VOIP services) rely on an underlying wired infrastructure. But if a wireless provider, for example, were chosen as the single provider eligible for universal service support, investment in the underlying network upon which the wireless provider depends, may cease as the underlying carrier would be unable to sustain an adequate (e.g., sufficient, specific and predictable) level of investment in its network.

A more effective way to curtail growth in the Universal Service Fund is to implement current law more strictly by applying appropriate public interest standards prior to the designation of additional ETCs and by controlling the distribution of funds by eliminating the identical support rule. If it appears that designating a second ETC to serve an area already served by an ETC merely subsidizes the second carrier at the expense of unnecessary growth of the Fund, then a state Commission or the FCC should deny designating the second carrier as an ETC in that area. If other public interest standards are not met by designating a second carrier, then the second ETC should not be designated. I am not aware of any ETC applications having been denied anywhere in the nation. It can be argued that current law has not been implemented as strictly as it should.

I should note that H.R.5072 accomplishes the very solutions that are designed effectively to limit the growth of the Universal Service Fund while preserving the valid intent of universal service to support ubiquitous access to advanced, quality telecommunications. For example, H.R.5072 clearly states that state commissions shall conduct thorough reviews of ETC applications prior to designating additional ETCs. The bill further eliminates the identical support rule as an effective means of curtailing the growth of the Fund.

3b. Should only the provider that can serve the area at the lowest possible cost receive universal service support? Please explain your answer.

As noted above, a single-provider approach to universal service may result in negative repercussions for investment in underlying network infrastructure. As Western Wireless’ Chairman John Stanton was quoted in the MTPSC December, 2004, reply comments to the FCC (above), his company’s investment costs were substantially lower than incumbents’ costs. However, I doubt whether the figures cited by Mr. Stanton compared actual consumer value on an apples-to-apples basis. For example, did the data cited by Mr. Stanton include comparable quality of service, network redundancy, backbone infrastructure, bandwidth and advanced service capability, ubiquitous carrier-of-last-resort obligations throughout the comparable service area, equal access, emergency service capabilities, compliance with other federal and state requirements, etc.? My suspicion is that the wireless carrier’s costs were “less,” because the wireless carrier did not account for many of the investments and obligations that it counts on the wireline network to make in its behalf.

A least-cost-provider approach to universal service may result in a race to the lowest-common-denominator of network investment. The company that can invest the least would receive universal service, despite what services may or may not be available

as a result of such minimal investment. If the least-cost provider happens to have little, if any, backbone infrastructure then consumers will have little effective access to “universal” communications capabilities because the “more expensive” infrastructure provider would not be able to recover its investment.

Again, as noted above, continual investment in access to ubiquitous, quality, advanced telecommunications networks facilitates all applications and services that are dependent on such an underlying infrastructure, including quality wireless services and new Internet-based services.

Finally, a least-cost provider approach relies on an affirmative showing of providers’ actual costs of providing service (however “costs” and “service” are defined.) Wireless carriers do not provide any sort of cost data and at least to date have strongly resisted revealing any cost information for public scrutiny.

4a. In his testimony, Mr. Garnett asserts that “the high-cost mechanisms subsidize incumbent carriers based on what they spend...not necessarily based on whether they actually serve customers located in a rural, high-cost area.” Do you agree with the accuracy of this statement? Please explain your answer.

I disagree with Mr. Garnett’s statement. Rural carriers by definition serve customers located in rural, high-cost areas. As I noted in my testimony, Montana’s rural telcos serve *on average* fewer than three access lines per mile. Moreover, only expenditures “for the provision, maintenance and upgrading of facilities and services for which the support is intended” are permitted. Incumbent ETCs must file revenue requirements, comply with extremely detailed cost accounting standards and be subject to audits by the National Exchange Carriers Association (NECA) as well as the Universal Service Administrative Corporation (USAC). (Wireless ETCs, on the other hand, have no cost accounting standards, since they automatically receive the incumbent’s level of universal service support under the identical support rule.)

As noted earlier, universal service supports network investment, not per customer investment. (See also discussion of a voucher system, below.) Mr. Garnett also implies that rural, high-cost incumbent carriers receive more universal service support the more they need. This is the “gold plating” allegation. However, as noted above, rural carriers are actually creating efficiencies and drawing less support from the Fund while providing more services through their continual investment in advanced more efficient and effective technologies. Moreover, rural carriers’ investments are fully accounted for, contrary to the windfalls that wireless ETCs receive as a result of the identical support rule. Rural telcos’ investment in rural, high-cost areas, supported in part by universal service, have resulted in tangible, significant benefits to rural American consumers and to the nation’s economy in general. Economic opportunity is not limited to a single geographic area. Total economic activity is enhanced by continual investment in the nation’s telecommunications infrastructure and by access to this investment by all consumers, no matter where they live.

Therefore, I disagree with the assertion that such investment fails to benefit consumers located in rural, high cost areas—as well as consumers in urban areas who in turn benefit from ubiquitous access to consumers and businesses anywhere in the nation or the world.

4b. Do you believe that subsidizing incumbent carriers (or any carriers) based on what they spend rather than who they actually serve is the right policy outcome? Please explain your answer.

I believe that universal service support should be based on an ETC's own verifiable costs associated with the provision of supported services. Rural telecom providers have demonstrated clearly that universal service support is money invested in supported services and has resulted in deployment of affordable, quality, advanced telecommunications capabilities to Americans living in high-cost rural areas.

I do not believe that universal service should support individuals rather than networks. This concept often is referred to as a "voucher system." First, ETCs must by law (47 U.S.C 214(e)) serve an entire study area (unless granted a smaller, re-defined service area, a concept with which MTA does not necessarily concur as it invites gaming, arbitrage and creamskimming). Universal service therefore supports network investment. It cannot support costs associated with providing access to telecommunications services to one consumer and not a different consumer next door. Much like a primary line restriction, implementation of a customer-specific voucher system would be nearly impossible. How would you determine which customer receives universal service and who does not? What sort of information would be required to be divulged by consumers to what government entities? How would a voucher mechanism, if one could be devised, be policed? Would telephone companies be expected to investigate whether consumers are eligible or ineligible for universal service? What enforcement mechanisms would be required? What if the "ineligible" consumer moves and an "eligible consumer" moves into the same residence using the same, previously unsupported line?

In short, a voucher system ignores network/infrastructure costs. The network needs to be built, operated, maintained and upgraded regardless of who is on the end of the line placing and receiving communications.

5. As Mr. Garnett points out in his testimony, "CTIA has proposed combining the current five high-cost universal service mechanisms into one mechanism that calculates support based on the most efficient technology—whether wireline or wireless—in a small geographic area." Please comment on whether you support or oppose such a proposal and why?

In my response to question 3b, I explained that supporting the least-cost provider may not result in sufficient investment in telecommunications infrastructure upon which a variety of telecommunications applications, including wireless and VOIP, depend.

Similarly, supporting the most "efficient" technology could lead to similar consequences. Also, comparing apples to apples again would be problematic. How would one compare the efficiency of a portion of high frequency spectrum to the efficiency of fiber optics? I might argue, for example, that nothing beats the unlimited bandwidth and therefore efficiency of fiber optics, as measured on a cost-per-byte basis since there is practically no limit to the amount of data one can push down fiber. However a spectrum advocate might argue that transmitting data through the air is more efficient than transmitting it through glass (notwithstanding the fact that the communications eventually end up being transmitted through wired—most likely fiber—infrastructure.) Further does, or should, an efficiency analysis include such factors as quality, redundancy, reliability, bandwidth, etc? Does support for an efficient technology limit consideration to other network factors? As noted above, rural telcos are investing in more efficient technologies and thereby providing more robust service options for consumers while simultaneously drawing less universal service support. Would support be directed at one "technology" at the expense of investment in a network?

Mr. Garnett suggests a cost model could be used to calculate support. Unfortunately, no cost model has yet been devised that accurately depicts the actual costs of investing in and operating a telecommunications network. In fact, existing cost models are so complicated that only a few carriers have been able to run them on their

systems. And those that have have found interesting anomalies. For example, some rural carriers would receive more, not less, universal service support if they used existing cost models.

In conclusion, MTA does not contest the assertion that the Universal Service Fund is threatened by the dual problem of diminishing revenues combined with uncontrolled, increasing distribution growth. MTA believes that universal service is as valid today as it has ever been. Perhaps it is even more important than ever before, as advanced telecommunications capabilities are essential to our nation's economic vitality and competitiveness. The revenues side of universal service funding can be addressed by broadening the base of contributions to include all communications providers (who, after all, rely on a robust, ubiquitous, advanced telecommunications network infrastructure). And the uncontrolled growth on distribution side of the universal service funding equation can be addressed effectively by controlling the designation of new ETCs and eliminating the automatic portability of incumbent support levels regardless of a carrier's own costs. More radical recommendations such as a primary line restriction, a voucher system, or a least-cost/most-efficient-technology approach are untested, highly problematic approaches which very likely could result in less investment in our nation's telecommunications infrastructure at a time when we should be promoting ubiquitous, affordable access to the most advanced telecommunications capabilities we can deploy.

H.R.5072 incorporates many of the suggestions I have made herein regarding reasonable approaches to resolving the current contribution and distribution deficiencies facing the Universal Service Fund. As I mentioned in my testimony, MTA endorses H.R.5072 and strongly urges the Energy and Commerce Committee to adopt the provisions of this legislation.

Finally, I should note that while my responses reflect my views and those of the Montana Telecommunications Association, these responses encompass the views of hundreds U.S. rural telecommunications providers and others nationwide.

It is an honor to have this opportunity to respond to the Subcommittee's interest in universal service. Please do not hesitate to contact me if I can be of any further assistance.

Respectfully submitted,

/s/

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RESPONSE FOR THE RECORD OF DR. MARK COOPER, DIRECTOR OF RESEARCH, CONSUMER
FEDERATION OF AMERICA

1) In his testimony, Director Marron states that “[s]pending for [the high cost] program could be curbed by limiting high-cost support to one connection per household, by basing support on each carriers own costs rather than on a cost standard set by the incumbent carrier, or both. Please comment on whether you agree with these two reform proposals and explain your answer.

The designation of a single USF line explicitly violates the language of section 254 of the Act, which states:

“Consumers in all regions of the Nation, including low income consumers and those in rural, insular and high cost areas, should have access to telecommunications and information services, including interexchange access services and advanced telecommunication and information services that are reasonably comparable to those services provided in urban area and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas.” I believe that this broad commitment to universal service should not be abandoned. Second lines in rural areas are telecommunications service that would no longer be available at reasonable rates.

The designation of a single USF eligible line would likely discourage investment in rural areas, as well as be administratively difficult to implement. How is a household defined? Who in each dwelling gets the authority to make the designation of primary line? A possible compromise that would reign in the growth of ETC cost is the implementation of so-called “reverse auctions” that does not restrict the services to be provided. The Commission could design a process that would award subsidies to the lowest provider bidder plus all other bidders within a certain range of that figure. This built-in ex ante competition comes with a trade-off: the benefits of in-market competition and the costs associated with giving subsidies to less efficient bidders. However, if the auction is designed well, consumers will still enjoy the benefits of competition — particularly on vertically integrated services — while overall program costs are kept in check.

I agree that USF distributions should be based on each carrier's own forward looking cost, and not the cost of the incumbent. There is a perverse outcome to the current system — as ETC's capture incumbent customers, the incumbent's per line costs increases, which in turn increases the total subsidy to both the incumbent and the competitor. Engineering models have advanced to the point where accurately determining own-forward looking costs is completely feasible, and there is no good reason to continue with the status quo.

2a) In February 2004, the Federal-State Joint Board on Universal Service recommended supporting a single connection per household as a means of reducing excessive growth in the fund; “We believe that limiting the scope of high-cost support to a single connection the public telephone network would be more consistent with the goals of section 254 than the present system.” Please comment on whether you agree or disagree with this statement and explain your answer.

It is simply impossible to read the Act and reach that conclusion. The designation of a single USF line explicitly violates the language of section 254 of the Act, which states: “Consumers in all regions of the Nation, including low income consumers and those in rural, insular and high cost areas, should have access to telecommunications and information services, including interexchange access services, that are reasonably comparable to those services provided in urban area and that are available at rates that are

reasonably comparable to rates charged for similar services in urban areas.” I believe that this broad commitment to universal service should not be abandoned.

In 2004, the Federal-State Joint Board proposed limiting USF support to just a single customer-designated primary line. However, the FCC never acted on this recommendation. The Joint Board members who dissented in the 2004 decision were concerned that the designation of a single USF eligible line would discourage investment in rural areas, as well as be administratively difficult to implement. Prior to issuing the recommendation, the Joint-Board received a letter from Senators of both parties stating that a primary line designation policy would be “a major step backward that would thwart the essential purpose of universal service”.

Limiting service to a single line would harm consumers by limiting competition and raising prices. Carriers would be unwilling to invest in network upgrades in rural areas due to uncertainty, which in light of the current problems with the digital divide is unacceptable. Reverse auctions are a better way of addressing the concerns with the growth of ETC distributions while maintaining maximum consumer benefits.

2b) The Joint Board also determined “Section 254(b)(3) encourages access to connectivity, however, not unlimited connects at supported rates. Advanced services increasingly are being provided along with voice services over a single connection. Nothing in the Act supported the argument that multiple connections should be supported for access to dial-up Internet access or fax services, neither of which is a supported service.” Please comment on whether you agree or disagree with this statement and explain your answer.

Disagree. Section 254(b)(3) of the statute directs the FCC to make reasonably comparable services available to consumers nationwide at reasonably comparable rates. “Consumers in all regions of the Nation, including low-income consumers and those in rural, insular and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and are available at rates that are reasonably comparable to rates charged for similar services in urban areas.” The section gives a long list of services that covers all of the services which the Joint board would like to cut out. Dial-tone is a telecommunications services. Fax and Internet are applications that flow over a telecommunications service. They are information services or advanced information services that are directly covered by the section as well. Notice the emphasis on access in addition to rates. Also notice how the Act covers advanced telecommunications services and information services in addition to basic services. Limiting support to a single dial tone line would deny rural households access to 21st century critical advanced services.

2c) The Joint Board also concluded “We believe that further growth due to supporting multiple connections presents a significant threat to fund sustainability.” Please comment on whether you agree or disagree with this statement and explain you answer.

The growth in ETC support is a part of the concern about the stability of the Fund. However, the real problem is with how rural incumbent carriers are supported (historical costs versus forward looking costs) and how ETC’s are supported (based on the incumbents cost, not their own cost). Addressing these flaws in the Fund will strengthen the long-term viability of the program, without harming consumers or running counter to the purpose of the Act.

3a) Should only one provider receive universal service support in any given area? Please explain your answer.

Universal support should be administered in a manner that fulfills the purpose of section 254 of the Act: providing reasonably comparable telecommunications and advanced information services to all Americans. If the Commission implements a well designed reverse auction program, and only one carrier bids for support, then that carrier will be the sole recipient of support. However, it runs counter to the purpose of the Act to arbitrarily limit support to one carrier.

3b) Should only the provider that can serve the area at the lowest possible cost receive the universal service support? Please explain your answer.

The purpose of the universal service fund is to ensure reasonably comparable services at reasonably comparable rates for consumers. One carrier in an area could be designated as the sole recipient of universal service support only if that carrier stood ready to serve all consumers in the area at reasonably comparable rates. The reverse auction is the way to accomplish this. Other approaches that cut off support to a carrier might leave customers unable to obtain reasonably comparable services at reasonably comparable rates.

4a) In his testimony, Mr. Garnett asserts that “high-cost mechanisms subsidize incumbent carriers based on what they spend...not necessarily based on whether they actually serve customers in a rural, high cost area.” Do you agree with the accuracy of this statement? Please explain your answer.

This statement is not wholly accurate. Small rural incumbent carriers (as designated by the Commission, not “rural” per se in a geographic sense) receive high-cost support based on their historic embedded costs, and not their forward looking long-run incremental costs. In addition, many of these carriers are subject to rate-of-return regulation and not price-cap regulation. Thus, they do not have much incentive to hold down costs. This could be easily remedied by moving these carriers in line with the regulatory treatment of RBOC and other non-rural carriers.

4b) Do you believe that subsidizing incumbent carriers (or any carriers) based on what they spend rather than who they actually serve is the right policy? Please explain you answer.

Carriers should be subsidized for delivering high cost services to consumers at rates that are reasonably comparable to the rates for urban customers. Given that consumers have the freedom to join and leave a network as they wish; it is not the right framework to think of support exclusively based on customers “actually served”. Providers have to make decisions about rolling out and maintaining infrastructure. Since many rural and high cost areas lack competition, rates in those areas are and must remain regulated. Regulation should ensure that what carriers spend to serve customers should be the efficient, forward looking cost of serving those customers.

5) As Mr. Garnett point out in his testimony, “CTIA has proposed combining the current five high-cost universal service mechanisms into one mechanism that

calculates support based on the most efficient technology – whether wireline or wireless – in a small geographic area.” Please comment on whether you support or oppose such a policy proposal and why?

If the goal of the Act is to ensure “access to telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and are available at rates that are reasonably comparable to rates charged for similar services in urban areas”, then basing costs on a single technologies own-cost is bad public policy. It will leave consumers unserved. Moreover, it is important not to allow inferior services to set an artificially low figure for support. If a given technology cannot deliver the full range of telecommunications and advanced telecommunications, information and advanced information services, but it were used to set the subsidy, it would undermine access to the services contemplated by the Act. That said, regulators should drive costs to the level of forward looking economic cost. A better way is to base it on each carriers own-cost, and pick a host of carriers through a system of reverse auctions.

