Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
High-Cost Universal Service Support	)	WC Docket No. 05-337
	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45
	)	

REPLY COMMENTS OF
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Reform of high-cost universal service support is needed to ensure that the subsidy program fulfills the objectives contained in its statutory mandate[1] while also respecting the intent of the framers of the Telecommunications Act that, over time, the size of the program be greatly reduced.[2] Under the current regime, however, rather than realizing a steady reduction in the subsidy level as a result of effects of new competition and lower cost technologies, the FCC has found it necessary in order to finance the subsidies to impose an ever-increasing surcharge – which presently stands in the range of 11% – on all consumers' interstate calls.

In order to achieve more fundamental reform on a long-term basis, Congress should adopt a meaningful reform proposal along the lines of the discussion draft "Universal Service Reform, Accountability, and Efficiency Act of 2008," circulated by

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* These comments express the views of Randolph J. May, President of the Free State Foundation, an independent, non-profit free market-oriented think tank. They do not necessarily represent the views of the Board of Directors or others associated with FSF. The excellent assistance of Kate Manuel, Free State Foundation Research Associate, in the preparation of these comments is gratefully acknowledged.

[1] *See* 47 U.S.C. § 254(b) (3) & (5) (2006) (establishing "predictable and sufficient" funding mechanisms and ensuring comparable services and prices to residents of high-cost areas).

[2] *See, e.g.,* S. Rep. No. 23, 104th Cong., 1st Sess. 26 ("The Committee expects that competition and new technologies will reduce the actual cost of providing universal service over time, thus reducing or eliminating the need for universal service support mechanisms.").

Rep. Joe Barton.[3] In the meantime, however, the Commission's current proposals to implement reverse auctions and eliminate the "identical support" rule are steps in the right direction towards a universal service regime that takes advantage of competition and emerging technologies and targets support to individuals in high-cost areas who would not otherwise subscribe to telecommunications service. The proposed broadband fund possibly also could be such a step, but only if modeled along the lines of the Department of Agriculture's Rural Development Telecommunications Program ("RDTP"), not the current high-cost fund. It is important that any subsidies to support broadband service be carefully limited and targeted only to support build-out in unserved, high-cost areas.

I. Reverse Auctions Should Be Implemented

Opponents of reverse auctions typically characterize them as untested or risky. Some opponents thus claim that "[u]niversal service is an evolving set of service requirements that is difficult to forecast. The performance of auctions in this setting is theoretically and empirically untested."[4] Such opponents argue that reverse auctions should not be implemented until proponents provide more details on how they will work;[5] or until their deployment would cure inefficiencies, not "mere" duplication, in universal service provision;[6] or until carriers have recouped the costs of recent network upgrades.[7] Other opponents highlight the potential risks of reverse auctions, arguing that

[3] See Staff Discussion Draft, H.R. ___, "Universal Service Reform, Accountability, and Efficiency Act of 2008," available at: http://republicans.energycommerce.house.gov/Media/File/News/USF%20Reform%20Discussion%20Draft.pdf.
[4] Dale Lehman, Use of Reverse Auctions for Provision of Universal Service (2007), at 22, http://www.ntca.org/images/stories/Documents/Press_Center/2008_Releases/lehmanreverseauctioncomments0207.pdf.
[5] *See id.* at 24. *See also High-Cost Universal Service Support, Federal-State Joint Board on Universal Service*, WC Docket No. 05-337, CC Docket No. 96-45, Notice of Proposed Rulemaking, 23 FCC Rcd 1495, 1526, 1528 (2008) (Commissioners Michael J. Copps and Jonathan S. Adelstein, dissenting in part).
[6] *See* Lehman, *supra* note 4, at 23.
[7] *See Rural Telcos Give USF Reverse Auction the Brush-Off*, 4 Telecom Pol'y Rep. 1 (2006).

auctions could "seriously jeopardize the availability of 'reasonably comparable' services and rates to consumers in rural service areas."[8] These opponents assert that:

> Reverse auctions do not naturally encourage network upgrades and service quality improvements that are critical to ensuring that consumers in rural areas have access to high-quality services that are comparable to those in urban areas. . . . Also, a reverse auction mechanism would generate significant unpredictability for carriers, which is the enemy of network investment. . . . Another significant risk of reverse auctions is that should an auction winner . . . fail to fulfill the universal service obligations established by the Commission, . . . a backup carrier may not exist to take over the role.[9]

It is true that there are implementation details that would need to be specified if the Commission adopts the reverse auction mechanism. But the characterization of reverse auctions as untested or too risky is not persuasive. Studies of reverse auctions of telecommunications subsidies in other countries and of other goods provide empirical evidence that reverse auctions effectively create market dynamics and allocate goods and services more cost effectively.[10] Thus, reverse auctions would help to reach the Commission's goal of "reducing the amount of support needed for universal service,"[11] especially as duplicative subsidies are themselves inefficient. Waiting until all details of reverse auctions are specified, or until carriers recoup costs of network upgrades, would defer implementation indefinitely, since no plan can adequately address every contingency and carriers continuously invest in their networks. Similarly, formulations of the alleged risks of reverse auctions either fail to credit firms with rational decision-

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[8] Comments of the Organization for the Promotion and Advancement of Small Telecommunications Companies in the Matter of High-Cost Universal Service Support, WC Docket No. 05-337 (Apr. 17, 2008), at 4.
[9] *Id*. at 17-18.
[10] *See, e.g.,* Dawn Pearcy, Larry Giunipero & Andrew Wilson, *A Model of Relational Governance in Reverse Auctions*, 43 J. Supply Chain Mgmt. 4 (2007); *Bid4Spots Brings Unique Reverse Auction Model to Internet Radio*, Internet Wire, Nov. 7, 2006, at 1; Hank Intven & McCarthy Tetrault, Telecommunications Regulation Handbook (2000) (average winning subsidy in 1995-1999 was one-half the maximum subsidy in Chile and one-fourth the maximum subsidy in Peru).
[11] *High-Cost Universal Service Support*, *supra* note 5, at 1496.

making or convert normal market operations into failings. Winners of reverse auctions would, for example, have ample incentives to maintain their networks without guaranteed future subsidies because they would hope to bid successfully again. Doing so requires network maintenance.[12] Higher costs of capital in the absence of guaranteed future subsidies is, likewise, not a failing of auctions, as the higher costs reflect true market values, not values artificially distorted by subsidies.

Indeed, beyond taking advantage of competition to drive costs down, a reverse auction system could—and should—further universal service goals by promoting use of new lower-cost technologies, not subsidizing duplicative service.[13] Meeting these goals would require rejecting proposals like that of Alltel Communications, which is broadly in favor of reverse auctions but would conduct two auctions—one for wireline carriers and another for wireless carriers—within each service area.[14] One problem with such an approach is that it writes current technologies (wireline and wireless) into the regulations. It also duplicates costs by establishing two subsidized carriers, even in high-cost areas that may not profitably support one, at least at this time.[15]

II. The "Identical Support" Rule Should Be Eliminated

Opponents of the FCC's proposal to eliminate the "identical support" rule[16] argue that current problems with the high-cost fund cannot be attributed to subsidies to

[12] Any short-term gains a winning firm might realize by not using its subsidy for network upgrades would be more than offset by future losses when its competitors, who modernized their networks and can provide service at lower costs, win future auctions, leaving the firm with an old network and no subsidy.
[13] Depending on the way in which the auction is structured, it is possible it might also accomplish the goal of helping to target subsidies to low-income persons in high-cost areas.
[14] Comments of Alltel Communications, LLC Before the Federal Communications Commission in the Matter of High-Cost Universal Service Support (April 17, 2008), at 40-41.
[15] *See High-Cost Universal Service Support*, *supra* note 5, at 1500.
[16] *See High-Cost Universal Service Support, Federal-State Joint Board on Universal Service*, WC Docket No. 05-337, CC Docket No. 96-45, Notice of Proposed Rulemaking, 23 FCC Rcd 1467 (2008).

competitive eligible telecommunications carriers ("CETCs"). They claim that "the real problem with the existing system is not support for wireless service in rural areas;" rather, "the real problem is that [incumbent local exchange carriers ("ILECs")] do not lose funding even when they lose customers" to CETCs.[17] These opponents further argue that elimination of the "identical support" rule would be "patently unfair" and "pose litigation risk."[18] The proposal's unfairness arises, they say, primarily from the fact that providing CETCs with a lower amount of support than ILECs favors ILECs and eliminates incentives for the ILECs to become more efficient.[19] However, they also object to the "unfairness" of CETCs contributing "substantially greater amounts" to the universal service fund ("USF") than ILECs do, while ILECs receive 75% of USF money.[20] They further note that eliminating the "identical support" rule, or imposing caps on subsidies to CETCs, "poses significant risk of litigation" because it favors wireline ILECs over wireless CETCs in violation of FCC regulations requiring competitive and technological neutrality in USF implementation.[21]

Arguments in favor of maintaining the identical support rule are misguided in their failure to acknowledge the role that the rule has played in requiring ever-higher subscriber surcharges – now in the 11% range – to fund ever-higher CETC subsidy payments. While surely not the only problem in the current universal service program, subsidies to CETCs under the "identical support" rule account for much of the recent increase in USF spending. High-cost subsidies increased 105% between 2000 and 2006,

[17] Comments of Alltel Communications, *supra* note 14, at 2, 26.
[18] *Id*. at 32.
[19] *Id*. at 2.
[20] *Id*. at 3.
[21] *Id*. at 2-3.

and much of this growth reflects increasing subsidization of wireless CETCs.[22] These subsidies to CETCs are problematic not only because they are unsustainable at current growth rates, but also because they generally fund duplicative services.[23] The subscribers whom CETCs are enrolling generally are not newcomers to the network who had been unserved, or even transfers from wireline to wireless. They are, rather, generally individuals who are subscribing to wireless as well as wireline, leading to no increase in the penetration rate as a result of the subsidies.[24]

The opponents' sense of fairness and the law is as mistaken as their sense of the problem's causes. Fairness does not require that carriers be compensated for more than their *own* costs, much less that subsidies to certain types of carriers be proportionate to their contributions. Similarly, competitive neutrality most likely does not legally mandate that wireline and wireless carriers receive equal subsidies. It requires only "that the universal service support mechanisms and rules neither unfairly advantage nor disadvantage one provider over another."[25]

Beyond diminishing current subsidies for duplicate services, removal of the "identical support" rule would also promote more effective competition between carriers by subsidizing only carriers' own actual costs. Capping subsidies, something to which opponents of elimination of the "identical support" rule also generally object,[26] would have the additional benefit of encouraging use of newer, less expensive technologies since carriers would have incentives to keep costs below the cap. Completely removing

[22] *See* Kevin W. Caves & Jeffrey A. Eisenach, The Effects of Providing Universal Services Subsidies to Wireless Carriers (June 13, 2007), at 7-8, available at http://search.ssrn.com/sol3/papers.cfm?abstract_id=993621.
[23] *See id*. at 11-12.
[24] *See id*.
[25] *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Report and Order, 12 FCC Rcd 8776, 8801 (1997).
[26] Comments of Alltel Communications, *supra* note 14, at 29.

duplicative subsidies, as well as tying subsidies to marginal consumers instead of to service to a geographic area, would create yet further benefits.

III. Future Support for Broadband Should Be Carefully Tailored

Even supporters of the Commission's proposal to implement a separate fund to provide universal service support for broadband[27] have faulted the concomitant proposal to limit use of this fund to "programs [such] as 'construction grants'" or "capital expenditures."[28] In objecting to the proposed fund's failure to cover operating costs, critics note that broadband costs are "substantial," and they worry that a fund limited to capital expenditures cannot ensure broadband service in high-costs areas.[29] Such critics also implicitly argue in favor of structuring the broadband fund like the current high-cost fund, which covers operating costs, and against structuring it upon the model of the Department of Agriculture's Rural Development Telecommunications Program, which funds only capital investments in rural areas.[30]

Adopting the views of those who favor covering broadband provision operating costs would be a mistake, however, since doing so would perpetuate the failings of the current high-cost fund, which the Commission's proposals for implementing reverse auctions and eliminating "identical support" otherwise seek to address. The USF generally —and the high-cost fund in particular— has continuously expanded in both its

[27] *See High-Cost Universal Service Support, Federal-State Joint Board on Universal Service*, WC Docket No. 05-337, CC Docket No. 96-45, Notice of Proposed Rulemaking, 23 FCC Rcd 1531 (2008).
[28] Comments of Alltel Communications, *supra* note 14, at 17.
[29] *See id.*
[30] *See* United States Department of Agriculture, Rural Development Telecommunications Program, http://www.usda.gov/rus/telecom/index.htm (last accessed May 27, 2008).

mission and spending. If there is to be support provided for broadband services at all,[31] a model along the lines of the RDTP might avoid these problems since the RDTP limits subsidies to one-time, rather than ongoing, expenditures. Such a model would also be better able to take advantage of competition and newer technologies, as well as target subsidies to low-income individuals in high-cost areas. Its funds would not be as easily locked in to supporting rural incumbents; financing capital costs, as opposed to operating costs, would allow more rapid support for new technologies; and support need not be channeled through carriers to entire regions.

IV. Conclusion

Implementing reverse auctions and eliminating the "identical support" rule are important steps that the FCC can take on the road towards reforming the current broken universal service regime. Both changes move in the direction of relying on competition and emerging technologies to drive prices down, as well as providing a basis for targeting support to low-income individuals in high-cost areas. More extensive, fundamental long-term changes in the universal service regime are still needed, however, to align its focus more closely with supporting low-income subscribers and not carriers generally.

[31] Rather than creating a new broadband fund under the rubric of the FCC-administered universal service program, consideration should be given to continuing to use the RDTP program as the means for providing support for broadband services on a carefully targeted basis in demonstrably high-cost unserved areas.

Representative Joe Barton's recently released discussion draft on USF is a very useful benchmark for considering how such fundamental reform might be accomplished.[32]

Respectfully submitted,

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[32] See Staff Discussion Draft, *supra* note 3.