Response to Questions in the Fifth White Paper

"Universal Service Policy and the Role of the Federal Communications Commission"

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before the

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I. Introduction and Summary

Once again, we commend the Committee for undertaking this effort to review and update the Communications Act. And we also commend the Committee for using the Fifth White Paper to focus on universal service reform. As the Committee correctly noted, "[t]he principle of universal service has been at the heart of federal and state telephone policy" nearly from its inception.[1] And rightfully so.

The universal service principle, which supports access to basic communications service for all Americans, is an important component of the social safety net. Keeping all members of society connected, regardless of income or social status, redounds to the benefit of those who can afford to pay as well as those who cannot afford to pay for access to the network. And, in so doing, this helps reduce America's digital divide,

[*] While the signatories to this Response are in general agreement with the views expressed in these comments, their participation as signatories should not necessarily be taken as agreement on every aspect of the submission. The views expressed should not be attributed to the institutions with which the signatories are identified.

[1] "Universal Service Policy and the Role of the Federal Communications Commission" ("Fifth White Paper"), House Commerce Committee, at 1.

which, parenthetically, we observe is also narrowed by adoption of efficiency measures that reduce the costs of access for all.

But while universal service is a laudatory goal, its execution has often left much to be desired. In the nearly two decades since the system was overhauled in the Telecommunications Act of 1996, Universal Service Fund expenditures have doubled in size to $8.3 billion annually.[2] Yet much of that new funding has been spent on projects that have little to do with the traditional goals of universal service. The Federal Communications Commission has admitted that the current system distorts investment and competition in myriad ways, while the Government Accountability Office pointedly has criticized the program's lack of oversight and accountability.

At the same time, advances in technology that have eroded legacy jurisdictional boundaries and service distinctions mean that the fund is drawing from a shrinking base of interstate and international telecommunications revenue. The increased USF payouts, coupled with the shrinking revenue base, has caused the USF "surcharge" paid by consumers to skyrocket from 3% in 1998 to 16.1% in the fourth quarter of 2014.[3] This 16.1% surcharge necessarily operates as a tax on all interstate and international calls. It is counterproductive to fund universal service by taxing the very same services the Commission seeks to promote.

To the Commission's credit, it has recently begun to reform the most troubling portions of the current Universal Service program, and it has begun to shift the program's focus from supporting ordinary telephone to supporting broadband service, recognizing

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[2] USAC 2013 Annual Report at 35, available at http://usac.org/_res/documents/about/pdf/annual-reports/usac-annual-report-Interactive-Layout-2013.pdf.
[3] See Michael O'Rielly, *Disturbing Trend in USF Spending*, Official FCC Blog, July 7, 2014, available at http://usac.org/_res/documents/about/pdf/annual-reports/usac-annual-report-Interactive-Layout-2013.pdf.

the importance of high-speed Internet access to modern society. But these reforms, while not insignificant, represent only the first steps in what should be a complete reform-minded overhaul of the program. As part of its Communications Act Update process, the Committee should refocus the Universal Service program on what ought to be its core mission: (1) assisting consumers who cannot afford broadband access, through market-based, consumer-empowering initiatives that befit an increasingly competitive broadband marketplace; and (2) supporting build-outs only in unserved areas and then only through economically efficient mechanisms such as reverse auctions (whereby firms bid the lowest rate that they will accept to supply narrowly targeted subsidy support.) In addition, any Lifeline program that is maintained for those who cannot otherwise afford service must also be operated in a way that incorporates means to prevent fraud and waste.

Moreover, the Commission should abandon the antiquated contribution mechanism currently in place, with the present USF surcharge set at a 16.1% tax on all interstate and international calls. Instead, it should avoid within sector distortions by funding subsidies through appropriations from the general treasury where they are subject to more intensive scrutiny. This approach would allow Congress to set a hard budgetary cap on expenditures for a definite period, which, in turn, will encourage the Commission to wring inefficiencies out of the system in order to live within the congressional funding restraints. It would also make today's hidden tax more transparent in a way that provides for greater accountability to Congress and taxpayers.

II. The Troubled Universal Service Program at a Crossroads

The basic tenet of universal service – that the government should assist those who cannot afford basic access to the telecommunications network or those who live in

unserved areas – has been a cornerstone of telecommunications policy for nearly a century. In economic terms, this assistance is justified by network effects: the larger the number of people a network reaches, the more valuable that network is to each user. A public policy to maximize telecommunications subscribership levels benefits not only those who cannot otherwise afford access, but all other subscribers as well. Universal service also helps maximize the utility of the network for society as a whole, by improving civic participation levels, economic opportunities, and public safety.

Unfortunately, however, less than a quarter of the Universal Service Fund's $8.3 billion annually goes toward Lifeline and Link Up, the two programs that directly serve this laudable goal.[4] Over $2.2 billion in 2013 went to E-Rate, a program that provides computers and broadband access to schools and libraries, which should be funded through ordinary education budgets, usually at the state and local level.[5] Congress, the GAO, and the Commission's own Office of the Inspector General have criticized E-Rate for lax oversight and the potential for abuse, including purchasing wasted resources or resources far exceeding the beneficiary's reasonable needs.

Even this $2.2 billion is dwarfed by the $4.2 billion—half of all USF contributions—spent on the Universal Service program's High-Cost Fund, which directly subsidizes the operations of telephone companies in rural areas and other so-called "high-cost" markets.[6] Ostensibly, the High-Cost Fund is designed to defray the costs of wiring and serving customers in unconventional, expensive service areas. But in practice, the fund is a wasteful form of corporate welfare that distorts competition and inhibits cost reduction in those areas it claims to serve.

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[4] See 2013 Annual Report, supra note 2, at 35.
[5] *Id.*
[6] *Id.*

The High-Cost Fund routinely subsidizes service in many areas where subsidies are unnecessary or harmful. Worse, it often has perverse distributional effects, by subsidizing wealthy rural consumers, who are never subject to means-testing, but who can easily afford to pay the full cost of access. For example, economist Thomas Hazlett notes that in 2005, residents in the Jackson Hole, Wyoming, service area received $282 per subscriber in annual subsidies, even though their incomes and net worth were well above the national average.[7]

The High-Cost Fund also encourages inefficient investment, a fact the Commission has readily acknowledged. For rate-of-return carriers, which consume over $2 billion annually in subsidies despite serving less than five percent of all telephone users, subsidies are calculated based upon the carrier's "embedded costs." Perversely, the higher the firm's costs, the more it will receive in subsidies. There are few mechanisms in place to prevent "gold plating," that is, the installation of equipment far more expensive than necessary to meet a community's needs, solely to increase the company's rate base. Until recently, there was also no cap on per-line support, which allowed Hawaii's Sandwich Isles Communications Company to receive over $10,000 per line per year in subsidies between 2005 and 2010.[8] Similarly, Beaver Creek Telephone Company received over $454,000 in 2008 to serve just 27 lines, which amounted to a cost of almost

[7] Thomas Hazlett, *"Universal Service" Telephone Subsidies: What Does $7 Billion Buy?* at 3 (2006).

[8] See http://transition.fcc.gov/wcb/iatd/monitor.html; Federal Communications Commission Response to United States House of Representatives Committee on Energy and Commerce Universal Service Fund Data Request of April 1, 2009.

$17,000 per line.[9] Other companies receive thousands per line in annual subsidies, often in areas that wireless providers can serve at a fraction of the cost.[10]

Finally, the High-Cost Fund lacks sufficient oversight and accountability. And the government is the first to admit this shortcoming. The GAO released a scathing report in June 2008 entitled "FCC Needs to Improve Performance Management and Strengthen Oversight of the High-Cost Program."[11] Indeed, the Commission's own audits concluded that in 2006-07, the fund made "erroneous" payments totaling $970 million, or almost 25 percent of all high-cost spending.[12] The assessment concluded that the fund was "at risk" under the Improper Payments Information Act of 2002, which labels any federal program risky if its error rate exceeds $10 million or 2.5 percent of annual disbursements.

To its credit, the Commission has sought in recent years to reform various Universal Service programs while maintaining fidelity to its view of its statutory mandate. For example, its 2011 order placed a "firm budget" on the High-Cost Fund, holding HCF spending to the 2011 level of $4.5 billion – though it falls short of the "hard cap" that many commenters recommended, as the Commission, unfortunately, has committed only to "an automatic review trigger" if annual claims against the fund threaten to exceed that amount.[13] The Commission also has capped the amount of annual

[9] *Id.*
[10] See Hazlett, supra note 7, at 20 (noting that Nextel offered wireless service throughout the Sandwich Isles Communications Company service area, and that even satellite phone service can be less expensive than the per-line amounts paid to some carriers.)
[11] GAO 08-633, 2008 WLNR 13168534 (July 14, 2008).
[12] Office of Inspector General, Federal Communications Commission, The High Cost Program Initial Statistical Analysis of Data from the 2007/2008 Compliance Attestation Examinations, November 2008.
[13] See Connect America Fund, Report and Order and Further Notice of Proposed Rulemaking, FCC 11-161 (Nov. 18, 2011), at ¶ 563 (explaining that in the event that HCF demand exceeds $4.5 billion in a year, the Wireline Bureau will "provide to the Commissioners a recommendation and specific action plan to immediately bring expenditures back to no more than $4.5 billion.").

assistance that a carrier may receive to $3000 per line. But the handful of carriers that currently receive assistance above the capped amount may petition the Commission to waive the cap under standards that seem unclear and indefinite. These mild limitations are welcome first steps toward arresting the growth of a fund that has been spiraling out of control for nearly a decade. But they are half measures at best.

More monumentally, the Commission began reorienting the fund's focus from telephone service to broadband access. Price-cap carriers receiving High-Cost Fund assistance for voice telephony must also offer their customers fixed broadband service at specific speeds, while rate-of-return carriers must make such service available upon a customer's reasonable request. The Commission has also established a new Connect America Fund to bring broadband service to underserved areas. In 2012, it followed this initiative with a pilot program to test whether it is feasible to extend Lifeline support to include broadband access as well as traditional telephone service.

Importantly, the Commission's order also signaled a sea change in the agency's philosophy for administering the Universal Service program. The Commission has explicitly and repeatedly endorsed a "more incentive-based, market-driven approach" to distributing subsidies. For example, the 2011 order eliminates High-Cost subsidies to any carrier whose service area is already served by an unsubsidized provider. Any such aid distorts competition without furthering the goal of providing telecommunications services to those who do not have reasonable access. In areas where two or more subsidized providers are competing, assistance will be based on each carrier's costs rather than the arcane and wasteful "identical support rule" that paid new providers on the basis of the incumbent's legacy cost structure. And most significantly, the Commission has endorsed

reverse auctions as the ultimate mechanism to administer CAF subsidies so that providers will compete for subsidies by bidding to provide predetermined service throughout a defined service area at the lowest cost.

III. Pursuing More Fundamental Universal Service Reforms

The Commission's recent reforms respond to two significant changes in the telecommunications marketplace. The first is the shift from monopoly to competition. The industry is no longer dominated by monolithic legacy telephone companies that agreed to serve everyone in a service area in exchange for state protection from competition. Today, over 99 percent of U.S. census tracts are served by two or more fixed broadband providers at the benchmark speed of 3 Mbps downstream and 768 kbps upstream, and that number remains at 82 percent even at the higher 10 Mbps/1.5 Mbps threshold. These numbers increase to 99 percent and 98 percent respectively if wireless broadband is included.[14] The Commission's endorsement of incentive-based, market-driven policies recognizes that the fund should capitalize on this shift by embracing competition to aid the unserved.

The second is the shift from circuit-switched voice telephony to IP-based broadband networks. The Commission is absolutely right that high-speed Internet access will be the primary telecommunications network of the future, with voice service representing one of many applications available to consumers. The Communications Act recognizes that universal service is an evolving level of telecommunications service, and high-speed Internet access is increasingly required to participate in modern economic and civic life.

[14] See Federal Communications Commission, Internet Access Services: Status as of June 30, 2013, at 9 fig.5(a), 10 fig.5(b) (2014), *available at* https://apps.fcc.gov/edocs_public/attachmatch/DOC-327829A1.pdf.

Yet the Commission's efforts do not reflect the magnitude of reforms demanded by these fundamental industry shifts. The Commission seems content to focus on individual components of the universal service program by modifying existing programs used to support the old telephone industry to fit today's very different broadband market. This piecemeal approach squanders major opportunities presented by the migration to broadband by importing defective programs in the current system into a dynamic new marketplace. The correct mission is to design new and better subsidy programs that are tailored to meet the unique challenges that broadband presents.

The Commission's reforms are also hobbled by statutory language that has allowed the USF program to stray far from its core mandate of assisting those who genuinely cannot afford access to the network. The 1996 Act's extension of subsidies to high-cost carriers, libraries, schools, and rural health care facilities drove both the monumental growth in fund expenditures and the well-deserved complaints about waste and corruption in the fund's administration. In the process, it created a host of new recipients whose voices are shaping the reform debate. It is no surprise that the 2011 reforms adopted many elements of the so-called "ABC Plan," an earlier comprehensive proposal backed by a consortium of subsidy-receiving telephone companies. While it's rational that these companies would seek a voice in reform negotiations, their concern with preserving existing subsidies is ultimately in tension with efforts to achieve more fundamental change.

America's migration to broadband networks presents a once-in-a-generation opportunity to transform an outdated, mismanaged subsidy program. Congress should capitalize on this window of opportunity by adopting market-based initiatives with the

objective of assisting low-income persons who cannot afford basic broadband Internet access and ensuring that any subsidies directed to service providers are narrowly targeted only to unserved geographic areas and then are provided only in the most economically efficient manner. And support for low income persons should be provided directly to them, rather than to supporting carriers as their proxies in ways that distort broadband competition. Finally, these efforts should be undertaken in a financially responsible manner, minimizing costs and funding those costs in a way that does not overly burden broadband consumers and providers.

A. Reinventing Lifeline

On the subsidy side, we recommend that Congress maintain a reformed Lifeline subsidy program to assist eligible low-income persons. The Lifeline program might consist of a voucher program similar to a telecommunications version of the food stamp program, or a fund-provided broadband phone card. Eligibility should be determined by the means-testing currently undertaken for Lifeline eligibility: proof of income below an appropriate income level, or participation in one of many other means-testing programs such as Medicaid, food stamps, SSI, or the Section 8 Housing Program. States could adopt alternative eligibility criteria with Commission approval, which would help ensure the program is flexible enough to meet each state's unique needs.

The voucher would be designed to provide "basic broadband service" to eligible recipients. Numerous advocates have pushed the Commission to define broadband service in terms of minimum speeds—often defined as speeds sufficient to stream high-quality video. But the current universal service program does not fund video service, which we consider outside the core of basic social services to which all should have

access. To avoid this ambiguous mission creep, Congress should define "basic broadband service" by listing those essential services that the program should facilitate online, such as including emergency assistance,[15] voice service, access to government services and information, and perhaps basic e-commerce. The Commission should then define the minimum speed necessary for a broadband connection that provides reliable access to those services that Congress deems essential.

Like Lifeline today, the voucher would allow eligible consumers to purchase basic broadband service for a Commission-defined subsidized rate. Eligible consumers would receive a nontransferable voucher equal to the average market rate for basic broadband service in the service area, minus the subsidized rate. In service areas where one broadband provider has market power, the Commission could prevent price-gouging by limiting the voucher to an amount sufficient to assure a reasonable rate of return to a reasonably efficient provider in that service area.

But the voucher itself would be set at a fixed, portable amount that the consumer could take to any participating telecommunications provider. Any provider that accepts a voucher must agree to provide basic broadband service to voucher holders throughout the service area at no more than the subsidized rate plus the voucher amount. The consumer need not use the voucher to purchase basic broadband service; he or she could instead choose to apply the voucher to receive (presumably less expensive) voice-only service, or as a credit toward a suite of more advanced telecommunications services, if the provider makes these alternatives available to the public generally. This flexibility extends the

[15] Many states currently impose high E911 surcharge fees on providers of Lifeline services. This seems counterproductive because one of the reasons for creating a Lifeline service is to help ensure that low-income persons have access to these services. And, in any event, it has been shown that these fees often bear little or no relationship to the cost of providing E911 or other forms of emergency assistance, but rather are imposed as general revenue-raising measures.

promise of at least voice access to those eligible households that cannot afford broadband even at the subsidized rate, without locking in voucher recipients to basic broadband if they are willing to pay for additional services.

Perhaps there are other ways to operate an efficient and effective Lifeline program. But a portable voucher structure gives purchasing power directly to low-income individuals, allowing them to participate in the telecommunications marketplace like any other consumer. And it allows the fund to benefit directly from competition among broadband providers. To attract recipients and avoid customer defection, providers must compete on price and service as they do in the marketplace generally. Moreover, because the voucher amount depends upon the average market price for broadband service, less efficient providers have economic incentives to improve their operations while hyper-efficient competitors are rewarded accordingly. Furthermore, the vouchers are technologically neutral: any provider willing to offer basic broadband service would be eligible to participate, regardless of the platform through which the customer is served.

B. Funding Buildouts

Of course, vouchers do not help those areas of the country that are not yet wired for broadband service because extending the network would be cost-prohibitive without some subsidy. For these areas, Congress may wish to maintain the buildout assistance contemplated in the Commission's 2011 order for a limited transition period. Funding, however, should flow only to those areas not currently served by an unsubsidized broadband provider, and recipients should meet stringent buildout requirements and agree to provide service throughout the service area. This aid should be distributed through

reverse auctions, and the total amount should be subject to an annual cap that is reduced over time as the market fills in the existing gaps in our broadband network.

C. State Block Grants as an Alternative

Obstacles to universal broadband service vary considerably by geography and are often informed by local knowledge. Given the variation in conditions, it may be wise for state regulators to take the lead going forward. Though universal service is a national goal with positive spillover effects that cross jurisdictions, Congress may consider using block grants to harness this state-level knowledge in pursuit of broader federal goals. Under this proposal, a state could choose to opt out of the federal program, and instead receive a block grant from the Commission equal to the estimated total payout of vouchers to residents of that state. The state would then be free to administer a state-level universal service fund with this money, funding end-users, high-cost carriers, equipment purchases, or whatever else it determines is necessary to overcome key stumbling blocks to furthering universal service in that state. The state's continued funding would be contingent upon its compliance with Commission-determined performance metrics (such as the state's broadband adoption rate) to assure that the state is spending its dollars in ways that help achieve the overall federal objective.

D. Eliminating High-Cost Fund and E-Rate

The primary obstacle to these reforms, as with any broadband universal service proposal, is cost. Broadband access is more expensive than the voice service that the fund currently provides, so any attempt to subsidize broadband service necessarily would increase the size of the fund. But substantial savings may be obtained by phasing out those programs that do not directly serve the goal of bringing access to those who cannot

afford it. Thomas Hazlett notes that much of E-Rate's library and school funding probably replaces other sources of funding that would have provided the same services through other means. This is particularly true in wealthier E-Rate communities such as Beverly Hills, California, and Fairfax County, Virginia, where income is well above the national average.[16] But even setting aside this objection, broadband access is no more integral to a library or school's mission than textbooks or laboratories. The costs of this access should be incorporated into the institution's own budget to be paid the same way as its other expenses, so the local community can make an accurate assessment of whether it needs such service, and, if so, at what level or cost.

Similarly, Congress should commit the Commission to slowly but firmly phasing out the High-Cost Fund assistance given directly to carriers, by steadily decreasing the amount of annual subsidies available until the program is eliminated. This means that in areas with high annual operating costs, the cost of broadband access may rise, perhaps substantially, to reflect the true costs of service. But this is not necessarily a significant problem. Like E-Rate, High-Cost Fund support is not means-tested, so much of it flows to communities where few would drop off the network even if forced to pay full market rates. And the voucher program is targeted to local area rates, which will help mitigate the effect of the price increase on those who are genuinely at risk of cancelling service at an unsubsidized rate.

More fundamentally, the simple fact that a community's telecommunications costs are high is not, alone, a reason to subsidize the community as a whole. There are a wide range of goods integral to modern life whose costs vary dramatically by location—for example, housing, food, or gasoline. Yet few suggest that the higher cost of a two-

[16] See Hazlett, supra note 7, at 51-52.

bedroom apartment in Manhattan compared to Houston means all Big Apple residents should receive a hefty federal housing subsidy. Similarly, the Universal Service program should not subsidize what is effectively a lifestyle choice by those who could afford broadband access in most areas but choose instead to live in a region with a high cost of service.

IV. Implementing a New Contribution Regime

Finally, Congress should abandon the fund's increasingly arcane contribution methodology. The existing contribution system relies on anachronistic distinctions between interstate and intrastate service and between telecommunications and information services. Yet both of these are largely irrelevant in the broadband age.[17] There is no reason to preserve a regime that induces consumers and carriers to adopt technology based in part on its regulatory classification rather than its intrinsic value. Moreover, it seems counterproductive to fund universal service by taxing the very services the Commission seeks to promote. As the Federal-State Joint Board noted, "larger USF contributions increase the risk that telecommunications services will become unaffordable for some, or even a substantial number, of consumers."[18] At 16 percent of every bill, the surcharge may already be retarding telecommunications use.

The simplest and most elegant solution to the contribution problem is simply to fund universal service through a line item in the federal budget like most other entitlement programs. Other proposed solutions, such as a tax on telephone numbers or IP addresses, while likely an improvement over the existing revenue-based regime, suffer

[17] High-Cost Universal Service Support, Order on Remand and Report and Order and Further Notice of Proposed Rulemaking, 24 FCC Rcd 6475, 6656 (Nov. 5, 2008).
[18] High-Cost Universal Service Support, Federal-State Joint Board on Universal Service Recommended Decision, 22 FCC Rcd 20477, 20483 (Nov. 19, 2007).

from similar problems as the current methodology: they are underinclusive and encourage strategic behavior by consumers, while discouraging provision of the very services the program seeks to subsidize. Paying for universal service from the general treasury would improve the transparency of the program by vesting oversight in Congress or the Commission rather than the murky, semi-private Universal Service Administrative Company. It would also apply a hard budgetary cap to expenditures established for a defined period of time, requiring the Commission to wring inefficiencies out of the system in order to serve the public within congressional funding restraints. A primary objection to such a shift might be the public's distaste for new entitlement programs. But in reality this approach would not create a new entitlement; rather, it would simply make a hidden tax more transparent, in a way that provides for greater accountability to Congress and taxpayers.

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