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

In the Matter of	)	
Connect America Fund	)	WC Docket No. 10-90
A National Broadband Plan for Our Future	)	GN Docket No. 09-51
Establishing Just and Reasonable Rates for Local Exchange Carriers	)	WC Docket No. 07-135
High-Cost Universal Service Support	)	WC Docket No. 05-337
Developing an Unified Intercarrier Compensation Regime	)	CC Docket No. 01-92

COMMENTS OF

THE FREE STATE FOUNDATION*

These comments are submitted in response to the Commission's proposals for comprehensively reforming and modernizing the Universal Service Fund (USF) and intercarrier compensation (ICC) systems. The Commission proposes certain near-term changes to the USF and ICC systems while simultaneously laying the groundwork for long-term reforms leading to a simpler, unified system.

I. Introduction and Summary

The USF and ICC systems are outdated, wasteful, and inefficient, imposing increasing financial burdens on consumers. Comprehensive reforms to the USF and ICC

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systems are urgently needed. The Commission's Notice proposing overhauls of the USF and ICC systems is long overdue but nonetheless welcome.

These comments offer our views concerning the principles and priorities that should guide the Commission's comprehensive USF and ICC reforms. Critical to ensuring the success of the Commission's entire slate of reform proposals is reducing the financial burden on consumers of telecommunications services and making certain that any reformed USF subsidy system is fiscally responsible. This means, foremost, that the current high rate of USF surcharges or taxes that consumers pay each month – now near fifteen percent – must come down substantially if the USF regime is to meet the "fiscally responsible" principle to which it professes adherence.

And in order to ensure continued discipline in the USF system consistent with the "fiscally responsible" principle, the Commission must impose a cap on the overall size of the high-cost fund at a level no higher than $4.3 billion per year, if not less. Otherwise, the Commission's reform efforts will be susceptible to an ongoing upward trajectory that will render the subsidy program unsustainable. The high-cost fund must be contained, and a hard cap is necessary to accomplish this.

By setting a hard cap on the overall size of the fund that extends to all high-cost fund-related programs, the Commission can establish a pathway for future reductions in the overall size of the fund, corresponding to lower levels for the cap. Since the Commission's proposals for the new Mobility Fund and for Phase I of the Connect America Fund both call for one-time disbursements, the Commission should consider capping the overall size of the fund at an even lower amount once those one-year disbursements are completed.

The Commission should unify the ICC rate system by bringing all telecommunications traffic exchanged with LECs within the reciprocal compensation framework and adopt a bill-and-keep methodology. There should be a reasonable – but firm – transition to the abolition of existing access charges. And all subsidies should then be identified and separated from the ICC system and replaced by explicit – but targeted – subsidies in the reformed USF.

Finally, this point bears particular emphasis. The Commission commendably identifies "market-driven" as a principle that must guide a reformed USF regime. We agree, and the proposal for using some form of reverse auctions as a subsidy disbursement mechanism warrants adoption, perhaps using a couple of different experimental models. But the Commission too often fails to appreciate that if its regulatory policies were, on the whole, more market-driven and less costly, there would be less need for subsidies because service providers, competing in the marketplace, would have greater incentives to serve presently unserved areas. In other words, the Commission too often ignores the fact that if it would pay more attention to reducing burdensome, costly regulations that are no longer necessary to protect consumers, it would, at the same time, promote universal service through a broader adherence to "market-driven" policies.

II. USF Reform Priorities and Principles

In its Notice, the Commission maintains that limiting the contribution burden on households is one of a handful of competing priorities that it will consider in carrying out its near-term and long-term USF reform project.[1] The Commission also insists that "fiscal

[1] *See* Notice of Proposed Rulemaking and Further Notice of Proposed Rulemaking ("Notice"), In the Matter of Connect America Fund, et al., WC Docket No. 10-90, GN Docket No. 09-51, WC Docket No. 07-135,

responsibility" will be one of the guiding principles of its USF reform efforts.[2] However, a greater emphasis on its priority for minimizing the burden on telecommunications consumers will be essential to successful completion of the task that the Commission has before it. This means that USF surcharges – in practical effect, taxes – hovering at 15 percent are substantially too high and must be cut. Sharper focus on fiscal responsibility is crucial to the Commission's task. Imposing a cap on the overall size of the USF high-cost fund is a necessary safeguard to ensuring that the Commission's reforms are adopted and implemented in a fiscally responsible manner.

A. Minimizing the USF System's Financial Burden on Consumers Must Be a Top Priority for the Commission in Order to Achieve Meaningful Reform

Today, the enormous size of the high-cost fund weighs down consumers with significant financial burdens. To this extent, the USF system actually works to undermine its underlying purpose in making telecommunications services universally available and affordable to consumers. Given the current system's trajectory, moreover, the financial burden on consumers of telecommunications services will only continue to grow heavier. In order to ensure that a reformed and repurposed system for making voice telecommunications and broadband available and affordable serves that basic purpose, minimizing this burden should be a Commission priority that pervades the entirety of its proposed reforms.

The Commission needs to approach comprehensive USF reform as a consumer protection measure. Indeed, the Commission should approach USF reform as a tax

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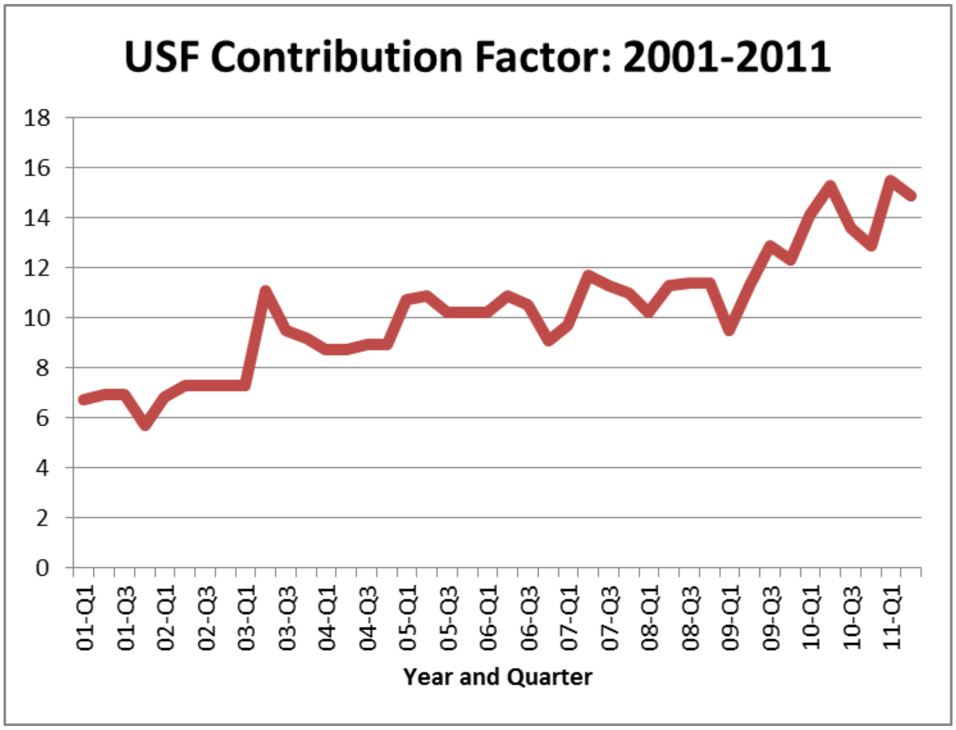
WC Docket No. 05-337, CC Docket No. 01-92, CC Docket No. 96-45, WC Docket No. 03-109 (released February 9, 2011), at 9, para. 16, available at: http://www.fcc.gov/Daily_Releases/Daily_Business/2011/db0209/FCC-11-13A1.pdf.

[2] Notice, at 7, para. 10.

protection measure. Consumers are ultimately the USF system's bankrollers. It is consumers who end up paying for USF distributions to eligible telecommunications carriers (ETCs) through USF surcharges that are the functional equivalents of taxes. The tax has now reached a rate of 15 percent.[3] And it is consumers who are most likely to internalize the welfare losses that result from the high tax rate driven by the USF system's inefficiency and wastefulness – as discussed further below.

The USF contribution factor corresponds to the amount of USF surcharges that carriers are allowed to impose on consumers. Accordingly, increases in the USF contribution factor have coincided with surging USF surcharges. Just ten years ago, the USF contribution factor was only in the 5 - 6 percent range. But since that time the USF contribution surcharge has made an uneven but nonetheless steady march upward. The current system now imposes a near-15 percent surcharge on consumers' monthly bills. The chart below shows the steady climb of USF contribution rates over the past decade, which has resulted in the steady climb of USF surcharges.[4]

[3] *See* Proposed Second Quarter 2011 Universal Service Contribution Factor, CC Docket No. 96-45 (March 10, 2011) (announcing a contribution factor for the second quarter of 2011 at 14.9 percent), available at: http://www.fcc.gov/Daily_Releases/Daily_Business/2011/db0310/DA-11-473A1.pdf.
[4] This chart is based on information available at: http://www.fcc.gov/omd/contribution-factor.html.



From a consumer's perspective, USF surcharges are effectively USF taxes. A 15 percent USF contribution factor translates into a 15 percent line item tax on consumers' bills for voice services. This telecom tax burden is already too heavy. For purposes of near-term and long term reform, prioritizing the minimization of the financial burden on consumers should mean capping and reducing the size of the fund in order to reduce USF surcharges on consumers. (This will be discussed in the next section.)

USF tax relief is needed, particularly if the fund is going to be redirected to support broadband Internet services. Unless the existing financial burden placed on consumers by the fund is reduced, the Commission will perpetuate the existing system's partial undermining of the system's ostensible reason for being. Assessing a fifteen percent (or more) tax on voice and broadband Internet services will prove counterproductive to furthering the universal availability, affordability, and adoption of such services.

Putting stiff surcharges or taxes on a service does not constitute a policy for promoting usage of that service; it does just the opposite. This is certainly the case when it comes to broadband Internet services. If anything, federal policy to date has recognized the necessity of encouraging innovation, investment, and adoption of broadband Internet by eliminating or reducing tax barriers and in some cases creating tax incentives. A *de facto* fifteen percent (or more) tax on broadband Internet services under the guise of USF or the newly-proposed Connect America Fund (CAF) runs contrary to the spirit – though perhaps not the letter – of the federal tax moratorium on Internet access taxes.[5] The pro-growth approach to broadband Internet calls for reducing the USF system's burden on consumers.

Studies over the past decade have pointed to large-scale waste and inefficiencies in the USF system.[6] A study from the late 1990s concludes that "welfare losses endured in the name of universal service totaled tens of billions of dollars over the years."[7] But if the exponential growth of the high-cost fund over the last decade is any indication, such losses have substantially increased. Once recent study, for example, suggests that as much as $0.59 of every dollar in USF subsidies going to incumbent local exchange carriers goes to general and administrative costs, not to constructing and operating infrastructure.[8] These findings should not be surprising given the Commission's

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[5] The federal moratorium on federal, state, and local Internet access taxes and certain e-commerce taxes is codified at 47 U.S.C. **§** 151 note.

[6] *See, e.g.* Thomas Hazlett, "'Universal Service' Telephone Subsidies: What Does $7 Billion Buy?" (June 2006), Robert W. Crandall and Leonard Waverman, Who Pays for Universal Service? (2000).

[7] A.H. Barnett and David L. Kaserman, "The Simple Welfare Economics of Network Externalities and the Uneasy Case for Subscribership Subsidies," 13 J. of Regulatory Econ. (1998).

[8] *See, e.g.*, Scott J. Wallsten, "The Universal Service Fund: What Do High-Cost Subsidies Subsidize?" Technology Policy Institute (February 23, 2010)

recognition that its high-cost funding mechanisms "provide poor incentives for rate-of-return carriers to operate and invest efficiently."[9]

The likely multi-billion dollar welfare losses sustained by consumers due to waste and inefficiencies in the high-cost fund's operation also points to the high priority that the Commission must put on minimizing the financial burden that consumers bear in subsidizing the USF system. Positive network effects of universal service may be claimed to provide an underpinning for the USF system in voice service and provide similar benefits to all consumers under a broadband Internet repurposed CAF. But there is good reason to conclude that increases in the size of the fund over the last ten years have resulted in, at most, marginal benefits that are slim to nonexistent in promoting universal service, while at the same time depressing usage. As the Commission itself acknowledges, "there are few, if any, benchmarks for determining whether network investment is justified or appropriate, allowing a company to spend millions of dollars to build a state-of-the-art network that may serve only a few customers."[10]

In many parts across the nation, the fund provides subsidies to multiple carriers serving the same area,[11] including subsidies to carriers that face competition from non-subsided companies. The Commission's proposal to eliminate the identical support rule for competitive ETCs over the next several years is therefore a welcome response to this problem.[12] Moreover, in some cases the fund may provide subsidies for service in areas where residents can easily afford to pay for services priced closer to actual costs. As Professor John Mayo points out: "Many rural residents can, however, fully afford to pay

[9] Notice, at 12, para. 21.
[10] Notice, at 12, para. 21.
[11] *See, e.g.*, *Notice*, at 13, para. 21 ("Under the Commission's identical support rule…the funding is poorly targeted – in some areas, as many as four or more providers are receiving redundant ETC funding").
[12] *See* Notice, at 13, para. 21.

for the costs that their subscription imposes on the public switched network. Surely residents of the rural resorts such as Vail, Colorado, Deer Valley, Utah, and Sun Valley, Idaho can afford to pay for the costs that their subscription causes society to incur as a result of their subscription."[13] Consumers must be unburdened from paying high surcharge rates into a fund that is characterized by such wastefulness and inefficiencies.

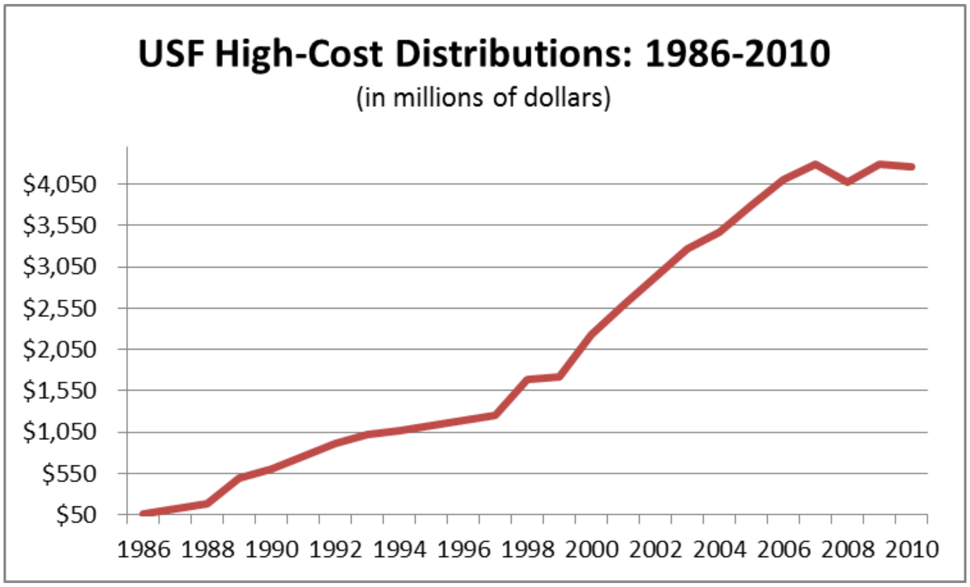
B. A Cap on the Overall Size of the USF High-Cost Fund Must Be Adopted as Part of the Commission's Fiscal Responsibility Principle in Order to Ensure Meaningful Reform

The Commission claims that "fiscal responsibility" will be one of the guiding principles of its USF reform efforts. To give this fiscal responsibility principle any real meaning, going forward, it is crucial that a cap on the overall size of the high-cost fund be a core component of the USF regime.

The last decade has witnessed continuously growing USF disbursements to incumbent and competitive local exchange carriers, including significant increases in the high-cost program disbursements. Beginning in 1986, high-cost support distributions totaled some $86 million.[14] By 2000, distributions reached over $2.2 billion, and by 2006 distributions surpassed the $4.1 billion mark. The chat below shows the trajectory of USF disbursements made from the high cost fund over the last several years.

[13] John W. Mayo, "Universal Service: Can We Do More With Less?" in New Directions in Communications Policy (Randolph J. May, ed.) (2009), at 111-112.

[14] Data in this paragraph and the chart are supplied by Federal and State Staff for the Federal-State Joint Board on Universal Service, Universal Service Monitoring Report ("Monitoring Report") (2010), CC Docket No. 98-202, CC Docket No. 96-45, at 3-15, 3-16, available (in pertinent part) at: http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-303886A5.pdf.



Corresponding to escalating USF disbursements is the continuously growing USF contribution factor discussed earlier. Carriers pass on their USF contribution costs to consumers in the form of USF surcharges.

Imposing a cap on the overall size of the fund is a necessary step for assuring discipline in the USF reform process. The record of last decade includes steady increases in contributions to and distributions from an oversized fund. This record also includes programs designated as temporary measures that last years beyond what they were initially intended to last. The high-cost fund's Interstate Access Support (IAS) program, for instance, was originally established in 2000 with the understanding that it would only operate for five years.[15] However, the program is still running today, distributing a total of approximately $545 million in 2010 alone and over $3.7 billion total in the five years the since the program was supposed to have concluded.[16] The Commission should now proceed with its proposal to eliminate the program as part of its near-term USF reforms.

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[15] *See* Notice at 12, para. 21.
[16] *See* Notice at 11, Figure 2; Monitoring Report, at 3-15, Table 3.1.

Now that the Commission is proposing a new Mobility Fund as a near-term reform measure as well as a CAF that will eventually supplant USF and ICC subsidies, there will be temptation to put additional infusions of money into the USF system to satisfy contending carriers instead of putting in place firm limits in order to better protect consumers from higher surcharges. This makes the placement of a cap on the overall size of the fund particularly critical to ensuring the Commission's reform efforts are fiscally responsible. It is therefore imperative that the cap extends to all USF-related programs, including the reformed USF, the Mobility Fund and the CAF. There is precedent for the Commission placing caps on certain programs within the high-cost fund, such as the IAS and the High-Cost Loop Support (HCLS) programs. The concept should now be extended to the entirety of the high-cost fund and related new programs.

The Federal-State Joint Board's examination of the USF system led it to conclude that "further growth in universal service funding presents substantial risks," and that "[l]arger USF contributions increase the risk that telecommunications services will become unaffordable for some, or even a substantial number, of consumers."[17] In November, 2007, the Joint Board recommended the Commission cap the fund at its then-projected annual level of approximately $4.5 billion.[18] In ascertaining a suitable size for a cap, the Joint Board's recommendation provides the Commission with a useful threshold. Since the final amount of USF distributions in 2008 proved to be lower than projections relied upon by the Joint Board, the Commission could similarly consider a cap set at no higher than $4.3 billion,[19] consistent with the Joint Board's recommendation. As

[17] Recommended Decision, at 7, para. 24.
[18] *See* Recommended Decision, at 8, para. 26.
[19] *See* Monitoring Report, at 3-15, Table 3.1 (listing total high-cost support for 2007 at $4.289 billion).

important as the specific amount at which to set a cap is the change in direction that setting a cap will help ensure.

Substantially reducing total disbursements from the high-cost fund in the future is also the most fiscally responsible approach. And if implemented such reductions would minimize future burdens on consumers. By setting a hard cap on the overall size of the fund that extends to all high-cost fund-related programs, the Commission can establish a pathway for future reductions in the overall size of the fund, corresponding to lower levels for the cap. For starters, since the Commission's proposals for the new Mobility Fund and for Phase I of the Connect America Fund both call for one-time disbursements,[20] the Commission should consider capping the overall size of the fund at an even lower amount once those one-year disbursements are completed.

Unforeseeable future circumstances could necessitate future revisions to the cap amount that include temporary upward adjustments. But the existence of a cap will help ensure that any such adjustments only take place after careful consideration in a context conducive to fiscal responsibility.

Consistent with a cap of no more than $4.3 billion per year on the size of the overall fund, the Commission should also adopt a limit on total support per-line. The Commission's proposal for "a process in which companies operating in the continental United States receiving in excess of $250 per month per line would have to justify higher amounts of support" provides a sensible way to help ensure that USF distributions stay

[20] *See* Notice of Proposed Rulemaking, In the Matter of Universal Service Mobility Fund, WT Docket No. 10-208 (October 14, 2010), at 4, para. 5, available at: http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-10-182A1.pdf; Notice, at 13, para. 24.

under an overall cap threshold.[21] The Commission should seriously consider reducing the support level each year as a means of driving efficiency gains.

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In sum, the Commission's reform efforts must be premised on the need to reduce the fifteen percent USF surcharge that telecommunications consumers are required to pay as part of their monthly bills. As it transitions universal service from a voice-centric to a broadband-centric program, the Commission must not allow the USF high-cost fund to be transformed into a burdensome broadband Internet tax. To best ensure that consumers are protected, the overall size of the USF high-cost fund must be contained, and reduced substantially. The Commission should cap the high-cost fund in order to prevent the unsustainable expansion this fund has experienced in the last several years. While the Commission has proposed reforms such as elimination of the identical support rule for competitive ETCs and adoption of reverse auctions as a more market-based mechanism for determining which carriers should receive distributions, the benefits of such reforms will be substantially or entirely undermined unless fiscal responsibility is adhered to throughout the reform process. A cap provides the simplest and surest way that the Commission can ensure that its near-term and long term USF reform efforts are carried out in a fiscally responsible manner.

III. ICC Reform Priorities and Principles

Like the USF system, the ICC system is broken and outdated. As the Commission itself recognizes, "the system is based on outdated concepts and a per-minute rate structure from the 1980s that no longer matches industry realities."[22] Advanced

[21] Notice, at 12, para. 21.
[22] Notice, at 150, para. 495.

telecommunications services have been the subject of dynamic market disruption and innovation in recent years that has upset the underlying assumptions of policymakers in 1986, 1996, and even 2000.

For instance, the telecommunications services market has witnessed the sharp rise in voice services competition from cable telephony and wireless. Changing business patterns and new technologies have blurred whatever clear distinctions once existed between long-distance and local exchange service, as many consumers now enjoy unlimited calling plans without domestic geographic restrictions. Continuing migration of voice services from circuit-switched systems to all-IP systems has also eroded the basis for per-minute access charges. But as the Commission observes in its Notice: "The wildly varying and disparate rates within the intercarrier compensation system create arbitrage opportunities and introduce layers of regulatory complexity and associated costs, which hinder deployment of IP networks."[23] Comprehensive ICC reform is urgently needed.

As a general matter, the Commission's proposal to unify the ICC rate system by applying section 251(b)(5) to all telecommunications traffic exchanged with LECs offers the most straightforward way to modernize the ICC system. The Commission should bring all telecommunications traffic exchanged with LECs within the reciprocal compensation framework and adopt a bill-and-keep methodology. These reforms should point to the way to the eventual abolition of access charges. And they should ultimately lead to the separation of all subsidies from the ICC system, to be replaced by explicit subsidies in the USF/CAF system.

We may offer more particular insights regarding comprehensive ICC reform later in this proceeding.

[23] Notice, at 151, para. 496.

IV. Conclusion

For the foregoing reasons, the Commission should act in accordance with the views expressed herein.

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