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THE FUTURE OF RURAL COMMUNICATIONS: IS THE UNIVERSAL SERVICE FUND SUSTAINABLE?

HEARING

BEFORE THE

SUBCOMMITTEE ON RURAL ENTERPRISE, AGRICULTURE, & TECHNOLOGY

OF THE

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THURSDAY, SEPTEMBER 25, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON RURAL ENTERPRISE, AGRICULTURE AND TECHNOLOGY,
Washington, D.C.

The Subcommittee met, pursuant to call, at 10:07 a.m. in Room 2360, Rayburn House Office Building, Hon. Sam Graves [chairman of the Subcommittee] presiding.

Present: Representatives Graves, Ballance, Capito, Bordallo and Miller

Chairman GRAVES. Good morning, everybody. I appreciate everybody being here, and I want to welcome you to the Small Business Subcommittee on Agriculture, Rural Enterprise and Technology. I appreciate everybody's flexibility with moving the hearing time. We have a little bit or possibly a conflict with votes later on, so we wanted to make sure that we could get in a straight run because it messes up so many hearings when you have a big vote right in the middle of your hearing.

Our purpose today is to examine the Universal Service Fund, and its administration, and analyze the designation of eligible telecommunication carriers, ETCs. The stated goal of the universal service policy is to provide every American, regardless of location, affordability and high-quality access to telecommunication and information services.

Today, we bring together a variety, and we truly have a variety of telecommunication providers to discuss the effectiveness and efficiency of the Universal Service Fund, and the designation of telecommunication carriers, eligible telecommunication carriers, again ETCs.

As first outlined in the Communications Act of 1934, all Americans, both urban and rural, should have access to quality telecommunication services at affordable rates, and that is what is stated in the act. The goal is to increase the value of the network for Americans by ensuring a continued increase in its use.

The Universal Service Fund provides financial support to designated carriers. This cost recovery mechanism promotes infrastructure investment in underserved and high-cost areas. Today, we are going to be discussing the way state commissions and the

Federal Communications Commission designate eligible telecommunication carriers.

I look forward to today's expert testimony, and hope that his hearing serves as a forum to explore and challenge the future of the Universal Service Fund. The Universal Service Fund is very complex. The entire issue is extremely complex. By concentrating on ETC designation, I hope to focus our efforts and become better educated on this issue.

This is, again there is no real agenda here today. I am trying to learn more about it. We do get a lot of interest in my district, and I know in districts all across the nation about the future of the Universal Service Fund, and making sure that we continue with obviously the original stated goal of the telecommunications act back in 1934, and that is to make sure everybody has high-quality and modern service.

[Mr. Graves' statement may be found in the appendix.]

Chairman GRAVES. Now I would like to turn to the ranking member, Frank Ballance, for an opening statement. Frank.

Mr. BALLANCE. Thank you, Mr. Chairman, and good morning.

With 90 percent of the rural economic base, small businesses, the small farms, barber shops, main street store fronts, and offices, an indispensable component of the national economy, they provide services upon which communities rely and thrive, as well as local jobs.

Unfortunately, the rural small business community faces economic threats soon to rival conditions of the Great Depression. We are headed backwards, ladies and gentlemen, when we should be moving forward.

Rural towns across America are already suffering from double-digit unemployment, now see routine plant closings, pushing the job loss numbers up to record heights. Rural America needs our help by reviewing the challenges with the Universal Service Fund. During today's hearing, we can hopefully move closer to finding a workable solution to help rural small businesses.

The Universal Service Fund was established during the Great Depression to ensure telephone service was and is affordable to every American. Phone service is a right for every American, not a luxury for some.

This simple program subsidized the cost of providing telecommunications access in rural America by charging a couple of bucks on every phone bill. Without this assistance, many businesses, schools and citizens in rural communities would be unable to afford access to basic telephone services.

Disparity in access to the Internet already hurts small rural businesses, and would only expand with the help of the Universal Service Fund. Fairly priced phone service is critical for rural communities and businesses to be part of the nation's economic success. No longer do small companies in rural communities only do business in their local economies. With the held of the Internet and phones, small rural businesses now can serve clients across the country and around the world, bolstering their local communities while enhancing the national economy.

In 1996, Congress helped rural communities in a digital age when the Universal Service Fund was expanded to help rural

schools and libraries provide Internet service. Citizens cross our nation's countryside can now harness the knowledge power of the Internet.

However, these added benefits have come at a price. The added demands on the system, combined with an aging infrastructure, require more money from the Universal Service Fund. This is taking place as dollars into the fund are declining.

Some believe we must instead do the following: Drop the provisions added in the nineties that have benefitted millions of school children; have new industries such as cellular and cable users shoulder the burden, a solution that is still open to debate; raise overall costs already charged to your phone bills.

However, none of these solutions are viable. I hope that after today's hearing we can find an option that ensures that benefits continue without hurting America's consumers.

Thank you, Mr. Chairman.

Chairman GRAVES. Thanks, Mr. Ballance.

Our first witness today is Commissioner Kathleen Abernathy. She is a federal and state board commissioner with the FCC, and I appreciate very much, Ms. Abernathy, you being here, and I apologize for the change in time.

STATEMENT OF KATHLEEN Q. ABERNATHY, COMMISSIONER, FEDERAL COMMUNICATIONS COMMISSION

Ms. ABERNATHY. Not a problem at all, and I am very happy to be here today because this is an issue that is important across all of America, not just in rural America, but, frankly, we all benefit from universal service.

So again, Chairman Graves, thank you——

Chairman GRAVES. Thank you.

Ms. ABERNATHY [continuing]. For inviting me here today, and distinguished members of the Subcommittee. I do appreciate the opportunity to talk about an issue that I have been spending a lot of time in since coming to the FCC.

The goal of providing high-quality telecom services to all Americans at affordable rates is a cherished principle in U.S. telecom policy, and it is one of the cornerstones of the Telecommunications Act of 1996.

I think all too often we forget that in the not too distant past phone service was a luxury that few in rural America could afford. But fortunately today Universal Service Funding has guaranteed citizens throughout the country the ability to communicate at reasonable rates. As Chair of the Federal-State Joint Board on Universal Service, I make it one of my top priorities.

Now, I have submitted a written statement that provides details on a lot of the challenges that are confronting universal service and the various rule-making proceedings that are pending. But what I would like to do this morning is highlight a key issue that was in my written statement, and that is the issue of who qualifies for universal service support in areas served by rural telephone companies.

I think everyone agrees that for universal service to remain vital we have to ensure that sufficient funds continue to flow into the system, and then that the funding burden is spread among contrib-

utors in an equitable and nondiscriminatory manner, and then we have to determine once we get this funding pool of money who has rights to it, and how much should each of the carriers be entitled to, and what sort of cost basis or cost justification goes into being authorized to access this fund.

One primary source of instability in the universal service regime that we believe is growing is how do you define the support mechanism for carriers that are serving rural areas.

This component has grown substantially over time. This increase in demand for the funds, together with the fact that we have a decreasing revenue base for universal service, is responsible for the fact that we now have a contribution factor that is approaching double digits that consumers see on their long distance bills.

One of the funding issues that has received particular attention is the intersection of competition and universal service in rural areas. So while new competitors, including the wireless providers, currently receive a very small percentage of overall USF support, their share has been growing rapidly along with a surge in what are called ETC applications; that is, eligible telecommunication carrier applications. That is where a carrier says I now believe that I am qualified and should receive funding from USF.

This trend, together with the fact that incumbent carriers do not lose any support if a customer switches to a new competitor service, suggest that rural changes may be necessary to avoid placing too great a strain on our high-cost support mechanisms.

The FCC has therefore asked the USF Joint Board to consider a variety of issues that relate to the designation of competitive ETCs, and the manner in which these carriers receive support. The comment cycle has closed, and the joint board held a very productive public forum in July.

What we did there is after the comment cycle closed we found in the past that it is very helpful to bring in—we had several different panels, parties on all sides of the issues, and let them debate and talk about it in front of us all the pros and cons before we actually start writing an item.

A range of interested parties proposed significant changes to our portability rules and we are hard at work analyzing those various proposals.

I want to assure you that as Chair of the joint board I have made this proceeding our top priority, and we are committed to providing a recommended decision as expeditiously as possible.

The way this process works administratively is the FCC refers this issue over to this joint board composed of both federal and state public utility regulators. We then analyze the issues, we come up with a recommended decision, the joint board does, and then that recommended decision comes back to the Federal Communication Commission who puts it out for comment, and then by statute has to within a year to resolve the issues that have been brought up.

So in closing, while universal service is facing a number of challenges, and I know that I am confident though that the FCC, with your help and guidance of Congress, that we will be able to initiate the various rule-making proceedings, we will be able to figure out ways to ensure that the fund is sustainable, and we will continue

to be able to ensure that all Americans across the country have reasonable, affordable rates, and that they can call anywhere they want.

So again I thank you for the opportunity to testify, and I am happy to answer any questions that you might have.

[Ms. Abernathy's statement may be found in the appendix.]

Chairman GRAVES. Thank you very much, Commissioner. I do have a question on specifics as far as an ETC. Can you kind of walk through what the criteria is?

Ms. ABERNATHY. Sure.

Chairman GRAVES. And be as specific as you can be, too.

Ms. ABERNATHY. Sure. There are a couple of ways where a carrier could become an ETC. It is in the 1996 Telecom Act, Section 214. And basically it says that a carrier may be designated as an eligible telecommunications carrier if it offers all of the supported services that are supported by the USF, the basic services; and that if it advertises the availability of such services throughout the service area.

And then in accordance with another section of 214, such designation must also be in the public interest, convenience and necessity. So it is not only that you are capable of doing it, at the same time, it is usually the state PUC has to determine whether or not this is in the public interest.

Now, to the extent that some of these ETC applications do come to the FCC, that happens if a state determines that they—the state commission determines it does not have jurisdiction over ETC designation, and it wants to refer it to the FCC, or if we are dealing sometimes with tribal lands.

Most of the ETC designations, frankly, go through the state public utility commissions, of course, pursuant to the guidelines I just spoke about that is in the communications act.

Chairman GRAVES. Now, you mentioned that you are going to be taking a look at those guidelines.

Ms. ABERNATHY. Yes. Absolutely.

Chairman GRAVES. What changes do you perceive?

Ms. ABERNATHY. Well, there is a number of changes that are being recommended. When this whole process came into being right after the 1996 act, I think that people did not really know what made the most sense, and so some decisions were made that are not up for debate.

For example, multiple lines are supported. There are some very real questions about whether or not a government funding mechanism should bring down costs for multiple lines to a consumer's home, or should we only be supporting a single line to the consumer's home with the idea that, yes, the act entitles you to reasonable, affordable service, but it is a single line, it is not multiple lines.

Another issue that came up is should funding remain the same for the incumbent even when lines are taken away by the new competitor.

What happens today is the incumbent continues to receive the same amount of support that they received before even if they are no longer serving some of these customers, the ETC is. So you are giving money both to the incumbent and to the ETC.

There are arguments on both sides about which makes sense, but the reality is today, even when the—the fund will only go up, it will never go down, because with each new ETC you are funding yet another entity, and the prior entity is not receiving any reducing funding at all.

A question is, how does the new carrier calculate the amount of support that they are entitled to?

Previously, when the previous FCC after the 1996 act implemented this statute, the FCC decided that it should be based on the incumbent's costs, not the new competitor's costs. So however much support per line that the incumbent receives from the USF Fund, that is how much support the new competitor will receive, so it is not cost-based for the new competitor.

One of the arguments is, well, maybe it should be based on costs. Would it be embedded? Would it be forward-looking? Is there some proxy model that you could use instead? That is another issue.

And then a final issue is perhaps it is appropriate and in fact many parties have urged the FCC to establish guidelines for the states to follow in designating ETCs. The reason for this is that it varies dramatically from state to state.

So the ETCs and the carriers themselves do not really know what the rules of the road might be from state to state, and it might for consistency purposes and for purposes of understanding what it means for the ETC application to be in the public interest, it may be very appropriate for the FCC to come up with some guidelines that should be followed when analyzing whether or not a particular carrier should be designated as an ETC.

So those are all of the debates on the table today. There is probably more, but that just gives you an example of some of the issues.

Chairman GRAVES. Do you have any time table on how soon?

Ms. ABERNATHY. Yes. Our goal at the joint board, because we do think this is a very important proceeding, is our goal has been to provide the FCC with our recommended decision by the end of the year. Staff is working hard on our proposal.

I recently heard that thanks to Isabel they lost about, you know, three - four days of work, and they are concerned now about the timing. I think the latest would be January because again all of the joint board members are very strongly committed to moving this out.

So once that referral comes back to the FCC, that means the FCC by statute must act within a year.

Chairman GRAVES. Mr. Ballance?

Mr. BALLANCE. Thank you very much, Ms. Abernathy.

As you know, the FCC's February 20, 2003 review of network elements involved several highly controversial votes. In effect, the FCC ruled to essentially allow Bell companies to deny competitors access to their local telephone networks when the Bell companies upgrade from copper to fiber.

I am concerned about how this is going to affect small businesses whose innovations have allowed true competition as mandated in the 1996 act.

Could you comment on that?

Ms. ABERNATHY. Sure. Sure. The way it will work is most companies will continue to get access to all the facilities and the DSL capabilities that they receive access to today.

In greenfield situations, brand new builds of broadband where competitors go in and compete for that new build opportunity, then if an RBAC puts in a new build, then they do not have to sell that capacity at TELRIC prices, but they still continue to make the——.

Mr. BALLANCE. May I interrupt? At what prices?

Ms. ABERNATHY. I am sorry. I live this stuff every day. At TELRIC prices. These are the prices that by statute are defined as forward-looking costs that are effectively a discounted price for the new competitors to be able to come in and compete.

So they will still provide access to this service on a competitive basis, to the new capacity on a competitive basis, but they would no longer sell it at this TELRIC price, which is the forward-looking reduced price, but it is only for new broadband builds.

So what we are talking about is that throughout the country today you will continue to get access to all of the capacity that is out there today, and you will continue to get it at what are called these TELRIC prices.

The goal in all instances is to encourage new competition, and where the new competitors lack the scale and scope to be able to effectively compete with some part of the incumbent's network, so for example the loop, it is very unlikely, given the technology we have today, that entities can go out and build a loop to everyone's home.

It is a barrier that cannot be surmounted because of the historical monopoly position of the Bell companies, and that is why they can get access to the loop from the phone company at these, you know, effectively reduced prices as compared to if it were a true competitive environment where you had multiple providers who could give you access to a loop, you would get the best price. You would go and bargain your best price. You cannot do that.

So all of that remains in place. What we are really talking about is new broadband deployment, and what we were trying to do is balance two competing, sometimes two competing goals in the act that are sometimes in tension.

One goal says under the unbundling provision says unbundle access for new competitors. Another provision of the act says continue to encourage and promote investment in new broadband deployment.

What helps one does not necessarily help the other, and so what we are always doing is trying to balance those two goals.

Mr. BALLANCE. Are you satisfied that there will be true competition?

Ms. ABERNATHY. Yes. You know why?

Mr. BALLANCE. In the new——.

Ms. ABERNATHY. You know why I think yes? And not because I think any other regulators are particularly brilliant people, necessarily. I'll tell you why I truly believe there will be competition, because we have in the United States some of the best new technologies available. And every single day I see new opportunities for consumers to be served by competitive providers.

And at the end of the day, once these new competitors are out there offering wireless access to the homes, satellite access to the home, the incumbent, Bell Telephone companies then have to ask themselves do I want to price my facilities in a way that attracts people to them, or do I want everyone to ditch me and go to wireless, or go to satellite.

So at the end of the day we will see competition, partly because I think we are crafting a reasonable regulatory regime, but primarily because technology continues to move forward and offer us choice.

Mr. BALLANCE. My time is about up, but would you support a legislative initiative that require contributions to the USF based on total telecommunications revenues?

Ms. ABERNATHY. Yes, I do actually. That is one of the issues about how do you collect sufficient funding. And right now, because of a court decision, we are expected to try and distinguish between interstate and intrastate revenues, and only target interstate revenues.

With bundled service offerings today, it makes it very difficult for anyone to isolate the right amount of funds. Not only that, we know that the long distant funds are decreasing. So what we really need to do is be able to spread the tax across as many players as possible just basically for telecommunication services, whether they are inter or intrastate.

Mr. BALLANCE. Thank you.

Chairman GRAVES. Ms. Capito.

Ms. CAPITO. Yes, thank you, and welcome.

In your statement that you submitted, you make the statement that certain nonrural carriers receive support in eight states, one of which is my state, West Virginia, because their cost exceeds the national average.

What do you think the future for those kinds of—those states in particular are in terms of being able to get the competition and to keep our prices within reach?

Ms. ABERNATHY. Well, I think the Universal Service Fund is here to stay, regardless of how far technology goes, unless and until we reach nirvana, I guess, where it does not matter that you live in rural America, the costs have been driven down so low that there is competition everywhere.

I do not see that necessarily happening anytime soon. So the Universal Service Fund is a critical part of the funding for rural America, and it will remain in place, and our job is to make sure that it remains stable, and that it is appropriately distributed among the parties who are serving high-cost rural America.

I guess I have to make it clear, if you are low-cost rural America, and there are some places where it is denser, you do not need the support. What we are really trying to identify and support are the higher cost areas of the country.

Ms. CAPITO. So is my understanding correct then that that fund helps like say—I am assuming this is Verizon—helps service the more rural areas in a state like West Virginia; is that correct?

Ms. ABERNATHY. That is correct. It would help whose ever is serving the high-cost areas. There was a debate yesterday about who gets what amount of money. It really has to do with are you

serving a high-cost part of the state or are you serving a larger city where you may not need USF.

Sometimes the Bell companies are serving high-cost areas, sometimes it is smaller rural carriers.

Ms. CAPITO. Okay.

Ms. ABERNATHY. So it just depends.

Ms. CAPITO. Okay. I am interested in the E-Rate. You mentioned that also in your opening statement.

How is that program, is it growing? Is it reaching the rural areas? Is it meeting the expectations where more monies are being given for, or a lower rate is being given to school and library programs?

Ms. ABERNATHY. You know, the E-Rate program has been a tremendous success in my opinion. It is growing. I think over 95 percent, somewhere between 90 and 95 percent, maybe more, of all schools are connected to the Internet. And what the E-Rate program then allows is to build a very robust broadband system in the schools with USF dollars.

And I think we are obligated, again, because USF dollars are fundamentally coming from you, and me, and everyone else in this room, we need to show the value of it, and this program in my mind is a tremendous value.

Like any other program that is a pool of money distributed, you know, via a bidding process, there is ways to improve it. There is ways to make it easier to apply and also ways to ensure that there is no waste, fraud or abuse so that the same school does not get it over again, and some of the less sophisticated schools find that somehow there is never enough money left for them.

So we are continuing to look at ways to improve it, but I think the program has been a tremendous success.

Ms. CAPITO. And my final question is, under the Department of Agriculture, they have what used to be the Rural Utility Service where part of their mission, is my understanding, of course, is to deliver those utilities in all forms to the rural areas, and which, I think, there is a more heightened emphasis on the telecommunications facet of that in terms of funding.

Do you integrate your programs, or I mean, what can you tell me about the way you are working with that?

Ms. ABERNATHY. We coordinate with the RUS in Ag. Department because what they do that we do not do, they have money that they actually give as loans to many smaller companies so that they can provide brand new products and services primarily to rural America.

Sometimes it is wire lines, sometimes it is wireless. A new program is trying to figure out what some of the new YFI applications are.

We coordinate with them around our regulatory environment and how it complements their funding environment. When it comes to the E-Rate program, though, that is strictly administered through what is called USAC, and the funding comes from the Universal Service Fund, so it is just a different pool of money. But we are very well aware of the folks over there, Ms. Legg, and we work with them because, again, it has been a tremendous benefit to rural America. We deal with the regulatory environment, they deal

more with the funding aspects in some respects, but they need to complement each other and be coordinated with each other.

Ms. CAPITO. Thank you.

Chairman GRAVES. I have another question. You mentioned that obviously we continue to see a rise in the cost to the consumer on their phone bill.

Ms. ABERNATHY. Yes.

Chairman GRAVES. And what worries me, is there an end to that? I mean, can it just continue to go through the—you know, is there a point where there is a limit on that?

Ms. ABERNATHY. Well, I think several of the funds are capped. For example, the E-Rate funding is capped. That cannot grow. We distribute the funds that we have across X number of providers.

The high-cost fund is not capped. And to the extent that we do not get a handle on all the parties that should qualify for high-cost funding, and accountability about how they spend that money, we will continue to see upward pressure.

The other issue is that because today the revenues are only assessed on interstate minutes, long distance minutes, and long distance minutes are in decline in the sense that most people do not even think about long distance. Many of us just get bundled service minutes, or voice over IP, for example. Those minutes do not count.

So all of a sudden you are seeing a decline in total interstate minutes. Even if the fund remains stable and does not grow, guess what? Your assessment of contribution on long distance minutes has to go up as you have fewer minutes that you can assess.

So what we are looking at, at the FCC, is a way to spread this cost across—in a different way other than just simply targeting interstate revenues for interstate carriers.

We have looked at two different proposals. One is a connection-based approach where every telecom carrier that has a connection to a consumer or a business pays per connection. Another approach is to numbers, based on numbers that you use. You then spread the cost across a greater number of entities. It is then a lesser hit on any single customer's bill.

And there are legal issues associated with all of these proposals, but the Commission is committed to a change because fundamentally we know that this upward pressure on just long distance minutes cannot continue.

Chairman GRAVES. Well, you know, obviously for small businesses to compete in the rural area, so we have got to continue to get, you know, the best and the latest technology if at all possible to those rural areas, so if we continue to dilute this fund, you know, what worries me is we are going to have—we are just not going to be able to provide that service. And the incumbent carrier tends to be the one that is trying to stay ahead, trying to continue to provide that service, and we keep having more and more ETCs.

In fact, you know, is there a surge, are we continuing to see a growing number of designations? And if we continue to dilute that, are we ever going to get that technology that you stated, you know, the best and new technology for small business to be able to compete on a global market?

Ms. ABERNATHY. Well, you know, it is not clear that in every instance you do not want an ETC, because in some instances they

are coming to the table with new technology, cheaper technology and deployed very effectively.

The real question is for rural America where you are subsidizing the competition, in other words, you are using the high-cost fund to bring down the cost because it is so high cost, how many of those folks are you going to be willing to subsidize? How much competition is enough subsidized competition?

Because I think you are right, it cannot be that five or six different companies can come to a single location and get subsidized because we know that that will cause the downfall of the fund. It is just too much stress on the funding of USF.

So again, what we are looking at in the ETC context is what is the right balance. Competition in rural America, even where it requires subsidies, is part of the statutory act. It says we will promote competition in rural America. But what we need to make sure is are we managing that in a way that the money that is being spent by the new ETCs is going back into the infrastructure for that community; that we are not funding, maybe we do not want to be funding multiple lines, maybe we want to be only funding a single line; and giving greater guidance about when competition is in the public interest for a community or not.

I think all those are very important questions that we have got to address so that rural America does see all the new technology, but at the same time it does not put such a great stress on the fund that the whole basis for how we deliver service across the U.S. starts to become endangered.

Chairman GRAVES. I will look forward to the recommendations. Thank you, Commissioner. I appreciate it.

And I also want to welcome Congresswoman Bordallo to the panel today. She services on the Small Business Committee in general. She is our delegate from Guam to the Congress, and she has an opening statement. I appreciate you being mere, and welcome.

Ms. BORDALLO. Thank you very much, Mr. Chairman, for allowing me to be a guest, and of course, to our ranking member, Frank Ballance, and to the other members of the Committee, and my statement would be actually geared to you, Ms. Abernathy, with the FCC.

I do have a longer statement, Mr. Chairman, if I could have unanimous consent.

Chairman GRAVES. Absolutely, and I do want to tell everyone too that everyone's statement, witnesses, and members, their statements will be placed in the record in their entirety. So yes, absolutely.

Ms. BORDALLO. Thank you, Mr. Chairman.

I would like to take the time to compliment the FCC in its efforts to bridge the telecommunications gap in rural and high-cost areas. The FCC has implemented programs designed to assist residents in rural and high-cost areas in obtaining equitable technology and reasonable prices.

As the Chairman stated, I am the representative from Guam, so hailing from a designated rural and high-cost area I can attest to the virtues of this program that has helped small businesses to compete in the telecommunications market and offer technology comparable to that in urban areas in the United States.

For example, one business wireless provider on Guam used Universal Service Fund reimbursements to build three new cell sites. In addition, this same small provider plans to build ten new cell sites that would give better access to the entire Island of Guam. And furthermore, the provider is now offering special low-cost rates through the Lifeline program.

So the USF has been critical to helping telecommunication providers to increase competition and provide equitable technology in rural and high cost areas. Congress should ensure that the USF is maintained in changing telecommunications environment.

The USF brings equity for callers everywhere. Unfortunately, when it comes to wireless calling Guam is denied that equity.

Section 254 of the Telecommunications Act of 1996 stipulates that the FCC should adopt rules to require that the rates charged by providers of interexchange telecommunication services to subscribers in rural and high-cost areas shall be no higher than the rates charged by each such provider to its subscribers in urban areas.

Furthermore, Section 254 states, "Such rules shall also require that a provider of interstate, interexchange telecommunication services shall provide such services to its subscribers in each state at rates no higher than the rates charged to it subscribers in any other state."

It appears clear that the congressional intent of this statute was to create equitable rates for call originating from any point in the United States to any point in the United States.

Furthermore, under the Telecommunications Act of 1996, the term "state" is generally defined to include the District of Columbia, and the territories, and the possessions. In fact, the FCC ruled that these provisions in Section 254 should apply to commercial, mobile, radio services, CMRS, which includes cellular and PCS wireless service.

Unfortunately, the FCC decision was challenged in court on the basis that wireless communication does not meet the definition of a telephone exchange service. Thus, it is still not clear whether these important consumer protections in Section 254 apply to wireless customers. This has repercussions for Guam.

Two major service providers to Guam have proposed increasing rates between the continental United States and the territories to make it an international call. The apparent difference of the definition of telephone exchange service has allowed for a loophole to exist, which could impose unreasonable costs on rural and high-cost territories such as Guam.

So it is important that we review these provisions in the Telecommunications Act of 1996 to ensure that customers in rural and high-cost areas have access to the same technology at the same prices as their urban counterparts. It seems clear to me that Congress had intended for the consumer price protection measures embedded in Section 254 to apply to wireless, and it is clear that the FCC has interpreted it as such. So I look to the panel for guidance on this issue.

And basically I would like to wrap it up, it is not fair that Guam and the territories be denied equal call rates in Section 254 just because of confusion over the definition of telecommunications and

wireless. So this issue I am looking forward to be fixed, and I am looking for your guidance in this.

Thank you, Mr. Chairman.

Chairman GRAVES. Thank you very much. We appreciate it very much you coming in today, Ms. Abernathy. Thank you very much.

Ms. ABERNATHY. Thank you. And again, we will be touch with your office.

Ms. BORDALLO. Thank you.

Chairman GRAVES. We will go ahead and set our second panel, so if those folks want to go ahead and come forward, and we will set it up.

I want to thank our second panel for being here, and I will run down through our panelists, and Ms. Capito is going to introduce one of our panelists. But our first one today is Bob Williams, who is the owner of the Oregon Farmers Mutual Telephone Company in Oregon, Missouri, and I appreciate you coming all the way out here for that.

Also, Dr. Brian Staihr, who is a senior regulatory economist with Sprint; Michael Balhoff, who is a managing director of telecommunications research at Legg Mason; and Glenn Brown, President of McLean & Brown.

We were not able to get, evidently make contact with Mr. Gregg who was supposed to be here today, but I apologize for that, but I will now turn it over to Ms. Capito for her introduction.

Ms. CAPITO. Thank you. I just want to extend a very warm welcome to one of my fellow West Virginians, and one who is in absentia but maybe he will come while we are here. It always gives me great pleasure to have mountaineers here. Tom Attar is the vice president for corporate development for Highland Cellular. He has ever eight years of experience in this field and has developed a very successful growth plan that has helped to transform Highland's business. So welcome.

Mr. Billy Jack Gregg, who is not here, unfortunately, but maybe will be later, is the director—but I know his statement will be very—he is a long-time consumer advocate in the State of West Virginia, and very well known in his field. He is the director of the West Virginia Consumer Advocate Division of the Public Service Commission (PSC), yes. His division is responsible for representing our state's utility rate payers in all state and federal proceedings. He is also a former member of the board of directors of the universal service administrative company, and currently serves on the Federal-State Joint Board of Universal Service.

Welcome. Thank you.

Chairman GRAVES. I will now call on our first panelist, again, Bob Williams, who is a friend of mine from Oregon Farmers Mutual Telephone Company there in Oregon, Missouri. And you are also, I did not realize this, but a member of the Organization for the Promotion and Advancement of Small Telecommunications Companies.

I appreciate your being here, Bob. Bob is one of the first people that brought this attention to me, and we kind of started looking into it from that point, and I appreciate you being here and coming out.

Mr. WILLIAMS. Thank you, Mr. Chairman.

Chairman GRAVES. I might too real quick explain the lights, the way those work for those of you that may not know. There is five minutes on each testimony, green, and I think when there is one minute left it turns yellow, and then red. We want to stay as close to those as possible because we will have a vote coming up in about an hour. But I mean, if you run over, I am not going to cut you off or anything like that, but I appreciate your being here.

Bob, go ahead.

STATEMENT OF ROBERT WILLIAMS, PRESIDENT, OREGON FARMERS MUTUAL TELEPHONE COMPANY, ON BEHALF OF THE NATIONAL TELECOMMUNICATIONS COOPERATIVE ASSOCIATION AND THE ORGANIZATION FOR THE PROMOTION AND ADVANCEMENT OF SMALL TELECOMMUNICATIONS COMPANIES

Mr. WILLIAMS. Thank you, Congressman. Chairman Graves, members of the Subcommittee, my name is Bob Williams, and I am the president of Oregon Farmers Mutual Telephone Company, which is a family-owned, directed, and managed rural local exchange carrier located in Oregon, Missouri. We are a true small company serving approximately 165 square miles of territory and 1,000 customers.

Mr. Chairman, I greatly appreciate this opportunity to discuss the future of the rural telecommunications, and the future of the federal Universal Service Fund. On behalf of my fellow small businesses in your district and throughout Missouri, thank you for helping small telecommunication providers communicate our views about regulatory decisions that threaten the sustainability of the USF and the ability of rural consumers to remain connected to the network.

I am very pleased today to testify on behalf of the National Telecommunications Cooperative Association and the Organization for the Promotion and Advancement of Small Telecommunications Companies.

Collectively, these national trade organizations represent hundreds of locally owned small, rural telecommunications companies and cooperatives nationwide.

The high-cost universal service program has been put at great risk largely due to ill-advised decisions made by federal and state regulators governing eligibility for high-cost support.

As you know, the Federal-State Joint Board on universal service is currently reviewing whether to recommend that the FCC adopt more stringent requirements for the competitive eligible telecommunication carrier designation process. For the sake of hundreds of small business and millions of consumers nationwide, I strongly urge this Committee to support such action by the FCC.

As a small business owner and consumer, I fear that absent the adoption of federal CETC guidelines and principles for use by regulators the Universal Service Fund will continue to grown at an unsustainable level.

This means that rural subscribers will lose. Your constituents, including many of our friends and neighbors in Missouri, may no longer have access to the affordable and reasonably comparable

services and rates that are called for in the Telecommunications Act of 1996.

In recent years, the number of CETC study areas and the support received by CETCs have skyrocketed. The total amount of support going to CETCs has increased from $3.1 million in 2000, to more than $250 million by the end of this year. Changes to the CETC designation process are desperately needed to ensure the long-term sustainability of the USF.

Mr. Chairman, a substantial number of the decisions on ETC applications for rural service areas have placed an overemphasis on the benefits of—the perceived benefits of competition, and have equated the introduction of financially supported competition to serving the public interest. Far less attention has been paid to ensuring that all consumers in the area will retain and gain access to affordable, high-quality services, including advance services that are reasonably comparable to the services and rates offered in urban areas.

Simply put, these regulatory decision have overlooked or ignored the often significant costs and detriment to rural consumers that Congress recognized could result from financially supporting competition in rural service areas. Notably, FCC Commissioners Kevin Martin and Jonathan Adelstein have expressed similar views.

Mr. Chairman, I am pleased that both NTCA and OPASTCO have developed recommendations to strengthen the public interest standard governing the CETC designation process. NTCA has proposed a seven-point public interest test for evaluation of the ETC designation in rural telco service areas.

The NTCA test would require regulators to evaluate ETC designations in rural telco service areas based on more thoughtful criteria. This includes whether the carriers requesting ETC designation is willing to demonstrate its cost to provide universal service to consumers living in rural ILEC service territory.

Also, states would have to consider whether the potential benefits of a CETC designation outweigh the ultimate burden on consumers that will occur through the growth and added Universal Service Funds.

I have also worked very hard within OPASTCO to develop an industry white paper entitled "The Universal Service, a Congressional Mandate at Risk." And this is that paper, I have a copy of it here.

This paper recommends that the FCC should adopt universal service public interest principles, qualifications, and requirements to guide state commissions in their consideration of ETC applications for rural telephone companies service areas.

Among its recommendations the OPASTCO paper recommends that state commissions and the FCC require that any service quality standards, reporting requirements, and customer billing requirement should be applied equally to all ETCs in the state. Furthermore, a requesting carrier must demonstrate its ability and willingness to provide all of the services supported by the high-cost program throughout the incumbent's entire service area.

Both NTCA and OPASTCO firmly believe that regulators should ensure that high-cost support mechanisms will not be used to incent uneconomic competition in the area served by rural tele-

phone companies. Above all else, regulators should treat the USF as a scarce national resource that must be carefully managed to serve the public interest.

Mr. Chairman, in conclusion, the perfunctory designation of CETCs by various state commission and the FCC does not take into consideration the potential cost of such decisions to consumers, the ultimate contributors to the USF. It is imperative that the House of Representatives support the adoption of additional standards that will guide regulators throughout the ETC designation process.

Thank you.

[Mr. Williams' statement may be found in the appendix.]

Chairman GRAVES. Thanks, Mr. Williams.

We are now going to hear from Tom Attar who Ms. Capito introduced earlier, but representing the Rural Cellular Association.

Thank you, Tom for being here. I appreciate it.

STATEMENT OF TOM ATTAR OF HIGHLAND CELLULAR, INC., ON BEHALF OF THE RURAL CELLULAR ASSOCIATION

Mr. ATTAR. Thanks for this opportunity, Mr. Chairman, members of the Subcommittee, thanks for the opportunity to testify on behalf of the Rural Cellular Association.

The RCA represents a group of close to 100 locally focused operators who provide wireless services to 14 million people in 135 rural and small metropolitan markets. Highland Cellular is a locally-owned and operated cellular telephone company in southern West Virginia, and Virginia. We provide service to approximately 40,000 customers, and are licensed to provide service to an area covering eight counties, with a total population of 300,000 people.

As one of the wireless companies that has recently started receiving USF support, we hope to provide you with our perspective on how high-cost funds are improving and will continue to improve the rural communities that Highland serves in West Virginia.

In addition, I would like to review some of the commonly discussed policy issues as they relate to wireless company use of USF monies.

Our experience in southern West Virginia tells us that there is a critical need for both competition and wireless coverage within small towns. Access to the USF helps us accomplish both. In our case, without high-cost support Highland would not find it economically feasible to expand its network into the most rural parts of southern West Virginia. While you may think that wireless competition within our markets would encourage this type of investment, the fact is that competition is focused on the larger towns where USF is not available.

Today, we are using these funds to plan and construct five to seven additional sites in rural communities which do not have any wireless coverage. This is extremely significant when you consider that we have built 50 sites over the past 12 years. New wireless coverage enables crucial wireless services such as public access to 911 and fire department use of wireless.

One other commonly overlooked area is the impact of competition on the service options available to low-income consumers. We have identified low participation in the Lifeline program in West Vir-

ginia. We hope to change this trend with an aggressive Lifeline program which will allow eligible subscribers to access wireless services for less than $5 per month. We are within weeks of bringing this plan before the West Virginia State PSC.

With regard to policy issues, I would like to touch on a few key issues.

First, high-cost support advances universal service and drives critical infrastructure development in rural areas.

Second, high-cost support will bring economic development to rural area. In our experience, more and more companies and people today rely on wireless phones to improve efficiencies and manage their businesses, especially in rural areas where the distances between job sites can be large, and in the case of farms and ranches, the job site itself can be quite large.

At Highland, we believe that new cell sites will result in rural communities being better positioned to attract and keep business. We urge the Congress and the FCC to recognize the substantial economic benefits that can accrue to rural America as a result of the provision of high-cost support to wireless carriers.

Third, wireless carriers pay into the fund and are entitled to draw from it.

Fourth, Congress should ensure that the FCC continues to enforce the 1996 act and administer all federal ETC rules in a competitively neutral manner.

We believe that Congress gave clear direction here, and if it wanted a lengthy list of eligibility criteria, it would have specified them in the act, or directed the FCC to do so. It is not competitively neutral to make ETC designations easy for ILECs and difficult for others.

Fifth, portability of support is essential to promoting competition and universal service.

Sixth, the high-cost fund is not exploding as a result of CETC designations.

And seventh, fund growth must be managed in a competitively neutral fashion. According to CTIA, over the past three years high-cost support to CETCs increased by approximately $175 million. During that same period high-cost support to rural ILECs increased by approximately $2.1 billion. It is my understanding that in 2001, rural ILECs successfully lobbied the FCC to provide them with a major increase in high-cost funding through 2006.

In conclusion we can think of few achievable goals more important than driving rural investment in areas that need this critical infrastructure. We request the understanding of this Subcommittee that high-cost support to wireless carriers allows improvements to infrastructure. Better infrastructure is a key component to attracting small business and capital investment in rural communities. Business development provides jobs, jobs promote economic stability, and economic growth provides quality of life for rural residents and helps keep young people interested in remaining in their communities.

We urge the members of this Subcommittee to support the continuation of the current USF system that allows wireless carriers to qualify for and draw high-cost support in a competitively neutral fashion, and in a pro-competitive manner.

We appreciate the fact that when Congress enacted the Telecommunications Act of 1996 it had the foresight to provide for competition in rural areas. Allowing wireless carriers to receive USF support is central to that goal.

Thank you for this opportunity to testify.

[Mr. Attar's statement may be found in the appendix.]

Chairman GRAVES. Thank you, Mr. Attar, appreciate it.

Next is Brian Staihr, who is the senior research economist with Spring. I appreciate you being here. We just met, and thank you for coming over.

STATEMENT OF BRIAN K. STAIHR, SENIOR REGULATORY ECONOMIST, SPRINT CORPORATION

Mr. STAIHR. Thank you very much.

As the Chairman said, I am Brian Staihr. I am an economist and I work for Sprint.

Now, Sprint has kind of a unique position in this industry. We are a long distance telephone company. We are also a local company. We are a wireless company. We are also a wireline company. We are an incumbent local carriers. We are a competitive local carrier. We are the local telephone company in some of the most rural parts of this country; places like Pickering, Missouri; places like Norline in North Carolina; places like Possum Kingdom, Texas, Sprint is the local telephone company.

What this means is we draw money from the high-cost fund, but because we are all these other things too, we pay in a lot of money. We pay in a lot more than we draw out. We pay in about a half a billion dollars a year.

What this also means is we can understand everybody's position on this panel because we are all of these things. And when we take these competing interests in Sprint and balance them, just like policymakers have to do, we come up with four conclusions regarding sustainability of this fund.

First, sustainability is going to be affected by who can draw out and what they can draw out for, and who pays in and what those payments are based on.

Second, competition and universal service cannot be considered competing goals. The Fifth Circuit Court has dictated that the FCC must see to it that one is not sacrificed in the name of the other.

Third, the contribution mechanism which Commissioner Abernathy talked about is broken, it has to be fixed, but it has to be fixed in a competitively neutral way.

Fourth, and more importantly for this proceeding here, in terms of who can receive from the fund, people are worried about the fund growth. Understandably. If we need to do something about that, we need to do something about that in a competitively neutral way.

Fixing the contribution side is easy. The FCC has a proposal in front of it to base contributions on telephone numbers. It makes great sense. It is competitively neutral. It is administratively workable. Absolutely, they should do it.

Fixing the receiving side is more difficult. Who can withdraw from this fund and what for? Right now everybody who meets the criteria for being an ETC can get money. Wireline carriers, wireless

carriers, incumbent carriers, competitive carriers, if they meet the criteria, they can get money. What that means is right now it is competitively neutral.

But the fund is growing. People are concerned we need to find a way to limit the growth. Unfortunately, some of the suggestions with regard to how we should limit that growth have the effect of making this not competitively neutral, and have the effect of essentially excluding wireless carriers.

Now, Sprint, as I said, pays a lot of money into this fund. You would think we are interested in controlling the fund size. I guarantee you we are, but in a way that is competitively neutral. And some of the suggestions that are floating around there simply are not.

There is a suggestion to base things on primary lines. First off, who knows what a primary line is? As a person who works for a telephone company, it is not administratively feasible, it is not technologically neutral, and there are questions of whether it is consistent with the act.

There are other proposals that say let us limit the funding just to the incumbent because the incumbent has the network there. Well, that is fine if you want to relegate large portions of rural America to a monopoly environment for telecom services.

Personally, Sprint thinks that people who live in rural America should have the same choices that people in urban areas have.

There are alternatives. There are alternatives to limiting the growth of the fund that are not competitively un- or non-neutral. There are things like capping study area totals. There are things of looking at calculating costs in different ways. To this point, I am not sure the FCC has invested these alternatives as well as they should have.

Sprint's concern is competitive neutrality. Sprint's concern is that we limit the size of the fund, but we do it in a way so that rural residents are not disadvantaged, that they have the same choices, and the same benefits from competition that their urban counterparts have.

With that I will stop, and I appreciate being able to be here.

[Mr. Staihr's statement may be found in the appendix.]

Chairman GRAVES. Thank you very much, Brian. I appreciate it.

Next is Michael Balhoff who is the managing director of telecommunications research with Legg Mason. I appreciate you being here. Thank you for testifying.

STATEMENT OF MICHAEL J. BALHOFF, CFA, LEGG MASON WOOD WALKER, INC.

Mr. BALHOFF. Thank you very much, Chairman Graves, and Ranking Member Ballance, and members of the Subcommittee. Good morning.

I am very privileged to have the opportunity to be here. The real reason I am here is because we have published more extensively on rural issues and your universal service issues than any other financial analysts that are out there on the street, or at least that is my opinion.

I do head equity research at Legg Mason, and I am a financial analyst covering the incumbent telephone companies, including the

rural carriers. There are various ways I could have offered my testimony, but I would like to limit my testimony not to get into issues of policy as to which CETCs should be approved and what the various criteria and so on should be, but I want to give you the benefit of the expertise that I think that we have, or at least the experience that we have, and that is that we talk to fidelity funds, and banks, and pension plans, and we know what the interests are of the financial community.

They want predictability and stability within this area, whether it is for wireless carriers or for incumbent carriers or whatever, because that is the way in which they can make money for their clients who are you and your constituents.

So what I am attempting to do here is to parse my remarks to give you some insight into what the financial community thinks about this. If you want my opinions, I am happy to respond in the question period on that.

Basically, there appear to be three problems that the investment community is worried about. One of them is relatively straightforward, it has already been articulated; that is, that the Universal Service Fund requirements continue to go up, and the revenues from which they are drawn continue to shrink year over year because of what is going on in long distance; that is, the so-called contribution methodology difficulty.

In many ways, I do not think that there really is an issue there. I agree with Mr. Staihr that that can be resolved ultimately, and can be resolved in a way that is constructive for the various constituents that are out there.

Does that mean that it is not complex and thorny problem? No. There are real issues that people are going to need to deal with in the contribution system, especially whether or not you have cable providers for their high-speed data or voice-over IP, provide universal service monies into the fund, so-called taxing the Internet. But my constituencies by and large do not really care that much about it. They want to know what the rules are and they want them to be predictable.

The second issue is the one that you have explicitly raised here, which is the CETC question. And in this particular case, I will tell you that the financial community's concern is that there is an arbitrage that is being created, and the difficulty is that it really is not tied to real costs and real businesses.

So when they look at this particular situation right now they can analyze the rural telephone companies and say that the legacy system has basically said here is what the costs are that are fairly carefully well analyzed, and here are comparable rates and comparable services that we have talked about, and therefore the government has chosen to make up the difference in the universal service monies that are out there.

So that is the way in which the system has worked and it is analyzable by the investment community.

The CETCs, however, have been approved without a real regular criteria that goes from state to state, and actually it is not cost-based, and that is extremely troublesome to my constituents, because they are saying will this be there, will it not be there, how can it continue to grow at this particular rate.

So my constituencies candidly are saying is there a system that we can really invest in and believe that it will be there next year and the year after and so on, and among others, how does it affect the incumbents in whom we have invested in the past. So portable universal service issues, the CETC question is extremely important.

There is a third issue that has not really been raised very satisfactorily here today, and in some ways it is more complicated. I am hesitant to bring it up. It is in my written testimony. But it is about the subject of intercarrier compensation, which is access charges.

I talked to a lot of the regional Bell companies and they want access charges to be changed because they see the Internet and voice-over IP not being taxed, not having access charges associated with it. And the Bell companies want to push to eliminate access charges so that the arbitrage between one type of business that is offering the same types of service looks like the others. They want this arbitrage eliminated, and so the Bell companies are pushing hard.

The problem is that access charges in urban areas are very different from what they are in rural areas. So in urban areas that are about a half a penny per minute, and in rural areas the federal numbers are 2.2 cents, and the intrastate numbers are even higher than that.

Can we bill the customer for the half-cent? Yes, we can in the urban markets. Can we bill the customer for the larger amounts in the rural areas? The answer is probably not, because the bill would go through the roof. In certain extreme instances, it could go as high as an additional $170 per month.

So the real question that people are beginning to ask is if we begin to go through this necessary change in this new IP world, how in the world are we going to deal with the CETC question where we are automatically doling out money to incumbents and also to wireless carriers. Will the fund grow at a meteoric rate?

In my testimony what I basically say to you is that the financial community believes that it has got a dog in this fight, and that is, its capital is at work here. It wants to be part of the discussion because it wants to believe that there is a predictable regime that is here that is cost-based that makes sense, and that provides for a fundamental business environment.

I basically say establish the reform based upon real cost. Do not disassociate them from costs. Make the environment predictable so that the financial community can understand what it is dealing with, and ultimately draw us into the discussion because we care about the capital investment that all of you care about.

Mr. Ballance, you were very articulate in talking about the small businesses, and the importance of those small businesses. We want to make capital available to those small businesses, but we cannot do it if it is not a predictable environment.

I thank you for the opportunity to make this presentation, and I look forward to working with you in the future.

[Mr. Balhoff's statement may be found in the appendix.]

Chairman GRAVES. Thank you, Mr. Balhoff.

We are going to recess for 15 minutes. We have got final passage on H.J.R. 69 on the floor right now.

Mr. Brown, we will be back. Give us 15 minutes for one vote, run over real quick, and then we will be right back. But we will recess for just a few minutes.

[Recess.]

Chairman GRAVES. Thanks everybody for your patience. I appreciate it.

Next, we are going to have Glenn Brown who is president of McLean & Brown. Mr. Brown, I appreciate you being here today. Thanks for your testimony.

STATEMENT OF GLENN H. BROWN, PRESIDENT, MCLEAN & BROWN

Mr. BROWN. Thank you very much, Chairman Graves, and Ranking Member Ballance.

My name is Glenn Brown, and I am president of McLean & Brown, which is a telecommunications research and consulting company specializing in universal service and rural telephony issues. And I want to commend you for having this hearing. I think this is a critical topic, and I think it is very important that Congress weigh in on it, particularly as to the intent of the 1996 act.

The title of this hearing is "The Future of Rural Telecommunications: Is the Universal Service Fund Sustainable?" And as I detail in my written testimony, I believe, and I have been looking at this for many years, that unless something is done and done soon to restore some rationality to the process indeed the fund as we know it will not be sustainable, and the losers are going to be the small businesses and the consumers in rural America.

In January of 2002, my firm published a paper titled "The Coming Trade Wreck in Universal Service Funding: Why is it coming—and how do we avoid it?"

And what we saw back then is what others have been talking about in this hearing. You have rapidly increasing demands on a fund that is funded by a declining revenue source, and train wreck is indeed coming.

One of the other things, and the reason why I think this hearing is so important is I think there is imbalance in the way the current program is administered. I do not think there is a proper balancing of benefits and costs, and I really do not think that the public interest test is applied to the right question.

What we see a lot is that decisions get made this way. Someone comes in an applies for ETC status. They say we complete, competition is in the public interest, and therefore approving me for ETC status is in the public interest. What is missing here, however, is what are the goals we are trying to get for spending this public money, because we are talking about a scarce public resource here. And really, part of the problem is twofold.

First of all, there really are no requirements that you expand out to serve the unserved areas, and most of rural America the towns where people are clustered are relatively economical to serve. It is out in the hinterlands where it gets expensive, but someone can apply, and they probably have a customer base in that town, they

get funding for that customer base, and there is no requirement to go out and serve. So, in essence, they get funds.

And the second problem is that the funding is based upon the incumbent's costs that does the serve the whole area. So if you only stay in that relatively low-cost area, you get support based upon the cost of somebody that does without necessarily having to.

So I think that is a prescription for people—I know there are companies such as Mr. Attar's company, and situations in Guam where there are areas that are not served, and where companies are coming in and saying we are going to serve this area if you give us the money.

I think what has to be done—I have made four recommendations in my written testimony.

Number one is we need to have much more focus on what are the goals that we are trying to accomplish with the funding. If you go back historically, the Universal Service Fund as we know it had its genesis in driving wireline telephony throughout rural America so everyone had a telephone, and the current system has been very successful in that respect.

I think that probably an equally valid public goal is to get wireless ubiquity. In other words, you have everyone everywhere has access to wireless service, but the way we have got the funds set up now does not accomplish that, because there is no requirement. You do not say if you give me this money, I will serve this area. You get the money for what you are doing today with the hope that you will serve it, and I think that is part of the problem.

The second thing I would recommend is that there be accountability. Wireless companies are not regulated. Mr. Williams talked about some recommendations that OPASTCO has made. I will endorse those. I think there needs to be assurance that they are using the money for the purpose it was intended; that service quality, service ordering, and that is well taken care of.

Third, I think that the funding ought to be based upon the reasonable costs of achieving a defined public objective, not necessarily—and if companies do not serve the same service areas, if they do not provide the same services, if they do not have the same data rates, if they do not have the same disaster survivability, they probably ought not get the same funding. The funding ought to be based on the cost for determining the public goal.

And then finally, to address this problem of the declining interstate revenue, I would recommend that Congress do what is necessary to clarify that the fund can be assessed on both intrastate and interstate revenues.

Thank you, Mr. Chairman. I will look forward to your questions.

[Mr. Brown's statement may be found in the appendix.]

Chairman GRAVES. I want to follow up on what you just brought up, and for that matter, anybody can answer this question, but one of the things that we do continue to hear about is there is, you know, companies applying for ETC are not regulated the same as maybe the incumbent carrier, or by the same token do not have the same standards, or do not have to follow the same standards.

Can you elaborate on that a little bit more? Give me a specific or two.

Mr. BROWN. Well, yes, sir, a couple of things.

First of all, I think another misconception is that wireless and wireline are direct competitors. I think for most customers they are complementary. They serve different needs. Customers need mobility. The wireless offers a bigger calling area. Wireline has advantages of data speeds that is available ubiquitously now, and their costs are different.

So to say that somebody who has an obligation to serve a large area that someone else that can serve a small areas gets the same funding, I think that is problematic.

And the other thing that I think is the real problem is the system lacks incentives to do what I think is the ultimate goal we are trying to achieve, which is to get ubiquity of different technologies: wireline, wireless. So let us define the goal, and then let us have the regulatory community find ways to incent people to achieve that goal.

In many communities, we see one carrier get ETC status. There are four or five other competing wireless carriers. They all come in and get money. But we have lost sight of what is the goal we are trying to achieve, so refocusing that public interest standard to be goal focused, I think, would go a long way.

Chairman GRAVES. Dr. Staihr.

Mr. STAIHR. We need to be clear about two things. There are criteria established to be an ETC, and every ETC has to meet it whether it is wireless, wireline, the incumbent or a competitive wireline carrier, with regard to voice grade access to the network, E–911, discounts for low-income customers, these criteria are there.

It just happens that incumbent telephone companies are also required to do some other things. It is not that the ETC criteria is different for a wireless or wireline carrier. That is not correct. They are the same. It is just that incumbents, because they have historically been government-supported monopolies, have additional requirements. So we need to make a distinction between the two.

And then just very quickly to address the second point in terms of whether wireless and wireline are complements or substitutes. A couple of years ago I might have agreed with Mr. Brown, but lately we have been finding that the number of people cutting the cord, getting rid of their wireline phone, just keeping their wireless, not only is it growing, but it is growing faster in rural areas than it is in urban areas. We were shocked to find that out, but it is true.

So apparently the advantages of mobility that are there for rural residents are in some cases outweighing the advantages of the fixed wireline service. So in that case I would not consider them complements at all but absolute substitutes.

Mr. WILLIAMS. I would just like to comment on what he said about the criteria being the same for the wireline and the wireless.

One of the prices I pay for being able to draw from that fund is I am regulated, and the regulator requires me to do certain things to continue to draw that fund. I am reviewed yearly by the Missouri Public Service Commission. Also, while those requirements in the act are spelled out, we do not think, or I do not think personally that they are stringent enough, and I think that there needs to be some more accountability out there. But having said that I think what has happened is the state commissions, as in the des-

ignation process, have in some cases just said, as Mr. Brown said, this is competition, competition is good, and by the way, the feds are paying the bill. The states have no skin in the game.

And when they designate an ETC carrier in a lot of places states think we are bringing money into our state from the federal government, or from the federal fund. It is not—you know, we can argue all day whether it is a tax or whether it is a surcharge. But in the end they look at it as it is free money coming into our state, and that is just a comment that I would make on that.

Chairman GRAVES. Mr. Attar.

Mr. ATTAR. A couple of comments on that.

First, as it relates to regulation, our state, the State of West Virginia, both the public service commission and the consumer advocate division has been very proactive in making sure that the monies are going to consumers in rural areas where there is a lack of coverage.

The state legislature is reviewing coverage within the state, and there is a huge push within the state to have more coverage, so that body is going to be making sure that the monies that come in go out to the people who do not currently have service.

Another comment as it relates to cutting the cord so to speak, you know, we are finding people in the larger towns where we do not have access to universal service, that they are doing that. We are offering an unlimited rate plan that encourages that. We are not able to offer that product to the folks that live in the very rural areas.

So the incentive for us to go out there and build that coverage is we have got competition, and expanding our network into those areas and building a high-quality network allows us to more effectively compete with the other four or five carriers in our market.

So as it relates to regulation, again, I think the force we have regulating our behavior is the competition we face. I think some of the other folks do not have that same force against them, so there is a little bit difference in circumstance.

Chairman GRAVES. We keep hearing about competition, but, you know, we do seem to have this differentiation when it comes to regulation or differences in regulation.

Mr. BROWN. And it differs between states, Mr. Chairman. I am sorry my friend Billy Jack Gregg cannot be here, because I respect him greatly, and I know he has done a lot to ensure that the money is used wisely, and managed, I think somebody else on the panel said a scarce national resource.

I can tell you though my business takes me all over the country, and I wish other states were as rigorous as West Virginia has been. I can tell you many are not.

Chairman GRAVES. Mr. Ballance.

Mr. BALLANCE. Thank you.

Mr. Brown, I want to just follow up a bit. How does it happen? You say that less than thorough consideration of the public interest impact, and in many cases carriers are receiving scarce high-cost dollars for primarily serving low-cost customers. How is that occurring if we have regulators who the application is being made to, and it is being reviewed?

Mr. BROWN. Right. First of all, Mr. Ballance, I would say that I think the regulators have tried to do their job well. I think they have been focusing on the wrong issue. They are saying the issue is competition. There is competition throughout rural America. What they are not looking at is a balancing—in my opinion—is a balancing of the public benefits that come from supporting multiple competitors against the public costs.

I am aware of a number of states where commissions for the same service area have approved ETCs for two, three, four, and in some cases even more competitors in the same area without putting any requirements that they also build into the areas that currently aren't served.

If you think of a rural community, the town where people are clustered, that is inexpensive to serve, and there is probably competition there today. Where there is not competition is between towns and areas that are not on interstate highways, and there is nothing—what we ought to be doing is encouraging people to build into those areas. The current system is not set up to do that. Under the current system, in many cases, companies only serve the low-cost areas, but receive funding as though they were.

So that is why I came up with my four recommendations.

Mr. BALLANCE. We heard from Kathleen Abernathy. What is the FCC's response going to be to your recommendation number four, that we broaden the base? How is that going to be received, in your opinion?

Mr. BROWN. Well, I think it will be received favorably. A letter was sent by the joint board members, three of whom are FCC commissioners, to the—I forget what, oh, I believe it went to Senator Burns, endorsing the concept of broadening the base.

There is debate though. I know that Commissioner Martin, for example, has been advocating a telephone numbers-based approach. So I guess I had better not say what they would think. I would recommend it.

Mr. BALLANCE. Does anybody else on the panel feel that there is adequate room to broaden the base so that we can build the fund or keep the fund sustained?

Mr. WILLIAMS. I would comment, and to take a step further, I think Commissioner Abernathy, before she left, said that she did support broadening the base. I think broadening the base is important. I think it can help sustain the fund.

Again, I do not think we want the fund to explode or to continue to grow exponentially because I think that is a recipe for disaster, and the train wreck that Mr. Brown referred to.

Mr. BALLANCE. Mr. Attar.

Mr. ATTAR. Yes, sir.

Mr. BALLANCE. Do you think wireless companies are paying their fair share?

Mr. ATTAR. You know, I am not well versed in the methodology per se, but I look at what we bill each customer, and I believe it is on a per line basis. It is over a dollar, I believe. I have not checked that number recently. So, you know, I do not know how that compares with other, the amount paid for line for other telecom services, but that seems a reasonable amount when you

look at the entire wireless industry with 140 million customers. That would be over $150 million a month.

So I do not know if that is fair or not, but that seems like a pretty tidy amount of money.

Mr. BALLANCE. All right.

Mr. BALHOFF. Mr. Ballance, my understanding of what occurs for virtually all these carriers is that they are not exactly accessed based upon their revenues, but they are told in the case of wireless that they pay 28.5 percent related to their revenues, because most of them have the flat rated plans, and you do not know what is long distance and what is local, and so they say 28.5 percent.

And then that amount goes on the bill, and is simply a pass-through from the consumer to the Universal Service Fund, so it is not as if it comes out of the wireless carrier nearly as much as the wireless carrier is told how much they have got to come up with, and then they bill the consumer for that.

Mr. BALLANCE. Brian.

Mr. STAIHR. If I could, first off, every carry, it is just a pass-through. I mean, carriers only get money from customers for two reasons. I mean, we do not get money from anybody else except investors. So a local company, a long distance company, a wireless company, it is a pass-through on the bill for everyone.

If you are a local customer, you do not have any long distance, right now you pay on average somewhere between 50 and 60 cents.

Mr. BALLANCE. Okay.

Mr. STAIHR. That is because there is a little part of your local bill called the SLIC, subscriber line charge, and they call that interstate charges. And because the current fund is just based on interstate charges, that is what you get assessed on, and it is somewhere between 50 and 60 cents.

Chairman GRAVES. Fifty or 60 cents per month?

Mr. STAIHR. Per month.

Chairman GRAVES. Per month.

Mr. BALLANCE. Per month.

Mr. STAIHR. So if an average wireless customer is paying over a dollar, and I am talking just a person with just local is paying 50 to 60 cents, we could probably say wireless is probably contributing their share.

The long distance companies, because all of their reviews are interstate, you pay a lot more based on your long distance bill. And because all these companies are merging, local companies are now offering long distance, long distance companies are offering local, et cetera, it is getting harder and harder to tell what is an interstate revenue. That is why we need to broaden the base and do it in a way to where you do not have to make these distinctions.

That is why Sprint likes the numbers-based plan because you have got a telephone number on your wireless phone, you pay. You have got a telephone number on your local phone, you pay, and you pay about a buck.

So broadening the base, absolutely. But in terms of burdening the share of the burden, it is shifting, but what we need to do is spread it evenly.

Mr. BALLANCE. Yes, sir.

Mr. WILLIAMS. I would just like to comment on the wireless piece because I also manage or I am chairman of a wireless company partnership that we work on.

I think when we talk about broadening the base and we talk about is wireless paying their fair share, the trouble, one of the problems we have with wireless is trying to get our hands around is what is interstate and what is intrastate. Like they said, they have the flat rate plans.

By broadening the base to include both inter and intrastate revenues, we exacerbate that—we take care of that problem because we no longer have to decide what is interstate and what is intrastate.

So I think that is, from a wireless point of view, and I am speaking as an ILEC, but I got my wireless hat on for a minute, I am saying broadening the base, including both revenues, takes that away, because today we have a hard time distinguishing what is interstate.

Mr. BALLANCE. I see my light is on. I just want to ask one more question.

Dr. Staihr, in rural eastern North Carolina, District 1, we have a lot of Sprint customers. What is it that causes you to penetrate in this rural area? What motivates your penetration?

Mr. STAIHR. With regard to local service where the incumbent were obligated to serve, okay, with regard to Sprint's wireless service——.

Mr. BALLANCE. Yes, more wireless because we need more towers.

Mr. STAIHR. Right. Oh, I understand.

To the extent that the federal Universal Service Fund continues to be available to wireless carriers, when we apply to be an ETC, we have to sign an affidavit, and it is my affidavit, and I say we have guaranteed that the funds we receive will go back to enhancing our network in North Carolina, or whichever state it happens to be. I have to testify to that.

So this fund is one of the key drivers on whether or not we will be able to enhance our network in a place like eastern North Carolina and Warrenton, wherever.

Mr. BALLANCE. Thank you.

Mr. BALHOFF. I would like to answer a question that has not been asked, and that is, as I listen to this discussion, I am struck that the constituencies that I represent would probably sell their stocks immediately, and try to get out of the way of what they consider to be a very dangerous situation, and the reason is because we are dealing with a bunch of the trees and we are not really dealing with the forest, and the trees are competitive, neutrality, and whether or not there are going to be more towers that are going to be built, and exactly who is the carrier of last resort, and all that kind of thing.

The real issue, I think, out there is, is there real stability for businesses in high-cost region? Is there a goal, a set of goals that we have carefully defined? Glenn Brown has already pointed out the fact that we need to understand where it is that we are going.

The amount of money that we are talking about for 3.5 wireless carriers in rural regions plus the incumbent is an astronomically large amount of money, and that is unsustainable as far as I am concerned.

The real issue is are we going to have a sustainable plan for supporting telecommunication services of whatever type that is out there so that we know where it is going and whether or not in fact it can be funded. And as I hear this discussion going on, my fear is that the political football is going to prove to be we are going to give a little bit to you, and we will give a little bit to you, and we will screw up the whole system, and that really is the fear of the financial community.

The system becomes unpredictable and unsustainable and a mess like some of the stuff that we have come to experience in some of the other markets that are out there. We cannot make this just about political football. We have got to figure out what our goals are for rural regions in this particular case, or small businesses, and we have got to figure out whether or not the dollars, once we begin to extrapolate, whether it is going to work or not. And I think that sometimes when we fight over the individual issues we miss that longer term set of issues.

Chairman GRAVES. I will kind of use that to dovetail into another question, which is a little bit of a shifting of gears.

When the money comes in, when you access money from the Universal Service Fund, I mean, obviously originally in the original communications act it was to make sure that we had service in rural areas, that every American had communication service. So obviously they tapped into those funds. The incumbent or whoever became the incumbent uses that money to improve infrastructure, bring infrastructure out to those areas.

Well, now, when you have got competition, you have got other companies applying and getting status, you know, where does that money go? Is there any requirement out there that says they have to improve their network, improve their infrastructure, or does that just go to the bottom line in their company? Is it just injected into their revenue stream? I mean, I am curious as to that.

And anybody can answer.

Mr. BROWN. The act has a fairly simple requirement, that companies must attest annually, and that is what Dr. Staihr was talking about, that the money is used for the purposes for which it is intended.

But this is where, you know, it stops. There is no definition. We want to assure that there is coverage throughout the territory. It needs to be invested in infrastructure, we know that. But where? Invested where, you know, it is low cost or where it is high cost?

And I think the goal is to get ubiquity, but I do not think the current system is going to get us there.

Chairman GRAVES. Go ahead.

Mr. WILLIAMS. The incumbent, and I am speaking as the incumbent now, we are required to file a Part 69, Part 32 cost study every year that shows that our calculation of what we received from a Universal Service Fund or what we received out of the pools is based on what our costs are as an incumbent exchange carrier, and that changes from year to year.

I will not draw the same amount of dollars from USF next year as I drew this year, the year after that. That is a moving target because, you know, the fact that by being a regulated company I am required to file cost data.

And I think what we are saying is, is if there are going to be CETCs, they need to file some type of cost data to receive based on their costs. I think in some states they are required to make a showing where they are spending the money and where it is going, and in some states I do not think they are.

So I will let me good friend Tom.

Mr. ATTAR. As it relates to us, as noted earlier, we have just started receiving these funds, and in our receipt of ETC status in West Virginia it was very clear with both the public service commission and the consumer advocate division that they were going to be looking at that.

The CAD has just recently initiated a general investigation into what carriers need to do in order to become an ETC, and what they need to file annually, similar to what the IBOCs and the ILECs file annually to show how they spend those dollars.

So I think in our case the system is clearly working where the state regulatory body is managing and ensuring that the funds are spent properly.

Mr. STAIHR. And actually, I was just going to say something along the same lines. I think the state commissions are doing a much better job than you may have been led to believe with regard to making sure this money is targeted to where it is supposed to go.

Recently in South Carolina's principal local provider in South Carolina, Nextel had a hearing about being an ETC, a wireless ETC, and they were pummelled with questions: what are you going to do with this money, where are you going to put your towers, how much are you getting, how will we know that we have benefitted from this process. It is not just the rubber stamp.

So in my experience, in Sprint's experience, the state commissions are much more diligent that some might believe in terms of making sure this money goes to where it is needed.

Chairman GRAVES. Given my experience at least in state government in the past too, it concerns me a little bit when you do have a state regulating, you know, those federal dollars coming in, because there tends to not be nearly as much oversight when they are not writing the check.

But the problem is, again, we have got 50 states and 50 different criteria. And Michael, you pointed out to us some interesting things. You are looking at it from an investor's standpoint. I am, obviously, looking at it a little bit differently too from the rural aspect.

What concerns me is this, you know, this train wreck as Mr. Brown alluded to, you know, where we are headed with this thing, and getting to a point where we no longer have investment in the rural areas, and small business able to access, you know, high-quality communications. And we have already got problems in many of the rural areas now, you know, just with Internet service and trying to bring high-speed Internet in.

You know, I understand this is a very complex issue. We are trying to find out more and make sure that the small business has the ability to compete, particularly in the rural areas, and that is our area of jurisdiction, you know, rural enterprise and technology, and it is a big concern of mine as we dilute this thing out.

And it is also a concern of mine of how far we go, when is it going to end if we continue to draw down, you know, or add ETCs to this equation, and also, you know, looking at specifically those small businesses that operate phone companies out there such as the Oregon Mutual Company, and being able to compete because those are viable businesses in our rural areas.

I appreciate everybody being here today and helping shed some light on this issue. We obviously have a long ways to go trying to sort this out, and there has obviously been a lot of work done in the last decade trying to sort this thing out, and I do not know if we will ever come to a conclusion.

But I do know the Universal Service Fund provided a very important service and we just have to figure out now what the direction is, and where we are going to go and what the—you know, what we are trying to shoot for, just as Mr. Balhoff pointed out.

But I want to thank everybody for being here today. The hearing is adjourned. Thank you.

[Whereupon, at 12:07 p.m., the Subcommittee was adjourned.]

Chairman Sam Graves
September 25, 2003

Good Afternoon and welcome to the Rural Enterprise, Agriculture and Technology Subcommittee. Our purpose today is to examine the Universal Service Fund and its administration, and to analyze the designation of Eligible Telecommunications Carrier. The stated goal of the universal service policy is to provide every American, regardless of location, affordable, high-quality access to telecommunications and information services. Today we bring together a variety of telecommunication providers to discuss the effectiveness and efficiency of the Universal Service Fund, and the designation of Eligible Telecommunications Carrier (ETC).

As first outlined in the *Communications Act of 1934*, all Americans both urban and rural, should have access to quality telecommunications services at affordable rates. The goal is to increase the value of the network for Americans by ensuring a continual increase in its use.

The Universal Service Fund provides financial support to designated carriers. This cost-recovery mechanism promotes infrastructure investment in underserved and high-cost areas. Today we will be discussing the way state commissions and the Federal Communications Commission designate Eligible Telecommunications Carriers.

I look forward to today's expert testimony and hope that this hearing serves as a forum to explore and challenge the future of the Universal Service Fund. The Universal Service Fund is a very complex issue. By concentrating on ETC designation I hope to focus our efforts and become better educated on this issue. I would now like to recognize the Ranking Member of the Subcommittee, Mr. Balance for his Opening Remarks.

Madeleine Z. Bordallo Statement
Subcommittee on Rural Enterprises, Agriculture and Technology

September 25, 2003 – "The Future of Rural Telecommunications: Is the Universal Service Fund Sustainable

I would like to take this time to thank our distinguished panel members for testifying before the Subcommittee today. I look forward to hearing your testimony, and I hope this hearing will lead to increased cooperation between Congress and the FCC in addressing equity in rural and high cost areas with respect to telecommunications.

First, I would like to take the time to complement the FCC in its efforts to bridge the telecommunications gap in rural and high cost areas. Pursuant to the Telecommunications Act of 1996, the FCC has implemented programs designed to assist residents in rural and high cost areas in obtaining equitable technology and reasonable prices. Hailing from a designated rural and high cost area, I can attest to the virtues of this program that has helped small businesses to compete in the telecommunications market and offer technology comparable to that in urban areas in the States.

I have recently learned from one small business wireless provider on Guam that they have been approved as an Eligible Telecommunications Carrier, have received Universal Service Fund reimbursements and have used those funds to build 3 new cell sites. In addition, this small provider plans to build 10 new cell sites that would give better access to the entire island of Guam. Furthermore, the provider is now offering special low-cost rates through the Lifeline Program. Needless to say, the USF has been critical to helping telecommunications providers to increase competition and provide equitable technology in rural and high cost areas. Congress and the FCC should continue to support this highly successful program.

Many of my distinguished colleagues will be addressing the issue of declining revenues for the USF. You will hear a number of ideas for how to rectify this situation. At this time, I would like to point out another issue related to equitable rates for telecommunications usage. This is a major issue for customers on Guam.

Section 254 of the Telecommunications Act of 1996 clearly stipulates that the FCC should "adopt rules to require that the rates charged by providers of interexchange telecommunications services to subscribers in rural and high cost areas shall be no higher than the rates charged by each such provider to its subscribers in urban areas." Furthermore, Section 254 states, "Such rules shall also require that a provider of interstate interexchange telecommunications services shall provide such services to its subscribers in each State at rates no higher than the rates charged to its subscribers in any other State."

It appears clear that the congressional intent of this statute was to create equitable rates for calls originating from any point in the United States to any point in the United States. Furthermore, under the Telecommunications Act of 1996, the term "State" is generally defined to include "the District of Columbia and the Territories and Possessions." In fact, the FCC ruled that these provisions in Section 254 should apply to Commercial Mobile Radio Services (CMRS), which includes cellular and PCS wireless service.

Unfortunately, the FCC decision was successfully challenged in the United States Court of Appeals for the District of Columbia Circuit on the basis that wireless communication does not meet the definition of a "telephone exchange service." Thus, it is still not clear whether these important consumer protections in Section 254 apply to wireless customers. There have already been repercussions for customers on Guam.

Two major service providers to Guam have proposed increasing rates between Gaum and the States and other possessions to reflect rates generally associated with an international call. Under intense public pressure, one provider has rescinded its decision and restored rates equitable to those charged in other States. However, the apparent ambiguity of the definition of "telephone exchange service" has allowed for a loophole to exist, which could impose unreasonable costs on rural and high cost territories such as Guam.

It is important that we review these provisions in the Telecommunications Act of 1996 to ensure that customers in rural and high cost areas have access to the same technology at the same prices as their urban counterparts. It is seems clear to me that Congress had intended for the consumer price protection measures imbedded in Section 254 to apply to wireless, and it is clear that the FCC has interpreted as such. However, this issue should be examined by Congress to ensure that congressional intent is followed by the FCC.

Thank you very much for allowing me to testify.

WRITTEN STATEMENT

of

KATHLEEN Q. ABERNATHY

Commissioner,
Federal Communications Commission

on

The Future of Rural Telecommunications:
Is the Universal Service Fund Sustainable?

Before the
United States House of Representatives
Committee on Small Business
Subcommittee on Rural Enterprise, Agriculture and Technology

Thursday, September 25, 2003

SUMMARY OF STATEMENT OF KATHLEEN Q. ABERNATHY

The goal of providing high-quality telecommunications services to all Americans at affordable rates is a cherished principle in U.S. telecommunications policy and one of the cornerstones of the Telecommunications Act of 1996. Shortly after Congress's enactment of the 1996 Act, the FCC adopted rules implementing section 254 to provide for the collection of explicit universal service support and its distribution through the high-cost funds and the mechanisms supporting schools, libraries, rural health clinics, and low-income consumers. Now, with several years of experience under its belt, the FCC is engaged in a reexamination of many aspects of the program to ensure that each component is administered as efficiently and effectively as possible. In my opinion, to ensure the sustainability of universal service, the FCC will soon need to revise its rules regarding the collection of funds and their distribution through the various support mechanisms.

Contribution Methodology. Service providers contribute to universal service based on their revenues from end-user interstate telecommunications services. In December 2002, the Commission adopted a number of measures to stabilize the universal service contribution system and mitigate the growing funding burden on consumers. However, I believe that more fundamental reform will be necessary to ensure the sustainability of universal service funding in the long term, because of the declining trend in interstate revenues and the impact of bundled service offerings, which increase the difficulty of identifying interstate revenues and also give carriers the opportunity and incentive to understate the portion of their revenues that are subject to assessment. Congress accordingly may wish to consider giving the FCC authority to assess intrastate revenues — which would reduce incentives to game the system — and the Commission is independently considering alternatives to its revenue-based contribution methodology to ensure a stable supply of funding.

Distribution of Support. The Commission and the Federal-State Joint Board also are actively engaged in a review of the rules that govern the distribution of support to telecommunications carriers. Just as an insufficient supply of funds could undermine universal service, so too could runaway demand jeopardize the sustainability of the program. The most significant demand-side proceeding concerns the intersection of competition and universal service in areas served by rural telephone companies. In particular, this rulemaking is focused on the manner in which competitive providers are designated as eligible telecommunications carriers and receive funding, and the impact of designating new ETCs on the growth of the Universal Service Fund. The Commission also is reconsidering its rules regarding the support mechanism for "non-rural" carriers in response to a remand by the Court of Appeals for the Tenth Circuit. This proceeding aims to ensure that support is sufficient to keep rates affordable and reasonably comparable in areas served by non-rural carriers.

Taken together, the reforms being considered by the Commission should ensure the continued vitality of the federal universal service support mechanisms. The Commission has no higher priority than delivering on the promise of ubiquitous, high-quality, and affordable services.

STATEMENT OF COMMISSIONER KATHLEEN Q. ABERNATHY

Good afternoon, Chairman Graves and distinguished members of the Subcommittee. I appreciate the opportunity to appear before you to discuss the challenges confronting universal service and the FCC's efforts to preserve and advance this critical policy objective.

The goal of providing high-quality telecommunications services to all Americans at affordable rates is a cherished principle in U.S. telecommunications policy and one of the cornerstones of the Telecommunications Act of 1996. As Chair of the Federal-State Board on Universal Service, I make it a top priority to ensure that the federal support mechanisms fulfill their objectives.

The 1996 Act directed the FCC to promote two key goals that at times appear to be in tension with one another: opening local markets to competition and preserving universal service. The prior monopoly environment enabled regulators to promote universal service by building implicit subsidies into local and long distance rate structures. In a competitive environment, however, these implicit subsidies cannot be sustained, since the rates that provided surplus funds — such as business rates in urban areas — are undercut by new entrants and eventually driven down to a cost-based level. Congress accordingly directed the FCC to adopt explicit support mechanisms that would be sufficient to ensure that rates remain affordable and reasonably comparable throughout the nation. In response, the FCC developed several explicit support mechanisms for carriers that provide service in high-cost areas. High-cost support will total approximately $3.3 billion in 2003.

The 1996 Act also expanded the scope of universal service by directing the Commission to establish support mechanisms for schools and libraries and for rural health care facilities. The schools and libraries program (often called the E-Rate program) provides up to $2.25 billion in annual support and has enabled millions of school children and library patrons to gain access to advanced telecommunications and Internet services. While the rural health program generally has been underutilized, the FCC is considering a variety of measures to strengthen it, as discussed below.

In addition to the high-cost support mechanisms and the programs supporting schools, libraries, and rural health clinics, the FCC's Lifeline and LinkUp programs provide discounts off monthly service charges and connection fees to ensure that low-income consumers have access to basic telephone service. This year, these programs will provide approximately $691 million in support.

All of these programs promote the universal service goals set forth in section 254(b) of the Act, including the availability of quality services at affordable rates; access to advanced services in all regions of the Nation; comparable access to telecommunications services for all consumers, including low-income consumers and those living in rural, insular, and other high-cost areas; and access to advanced services for schools, libraries, and rural health care facilities. Shortly after Congress's enactment of the 1996 Act, the FCC adopted rules regarding the collection and distribution of universal service support. Now, with several years of experience under our belts, we are engaged in a reexamination of many aspects of the program to ensure that each component is administered as efficiently and effectively as possible and that the overall program remains sustainable. A host of marketplace and technological developments

have already prompted some course corrections, and may ultimately cause us to reassess certain fundamental policy choices made in the initial implementation period. As we engage in this review, our commitment to preserving and advancing universal service remains unwavering.

I describe below the key challenges confronting universal service and the efforts the FCC has underway to ensure that the universal service program remains faithful to the principles set forth in section 254 of the Act. In my opinion, the FCC will soon need to revise its rules regarding the collection of funds and their distribution through the various support mechanisms. I will begin with the contribution methodology and then discuss issues pertaining to the distribution of support.

Contribution Methodology

The Commission collects funds for the various universal service support programs pursuant to section 254(d) of the Communications Act. Service providers must pay a percentage of their revenues from interstate end-user telecommunications services to the Universal Service Fund. This percentage fee, called the contribution factor, changes on a quarterly basis depending on the demand for funding and the base of reported revenues. The current contribution factor is 9.5 percent.

Several trends have combined to put upward pressure on the contribution factor, which in turn has increased the funding burden on consumers. While long distance revenues grew between 1984 and 1997, they have since been flat or in decline as a result of price competition and substitution of wireless services, e-mail, and, more recently, Voice Over Internet Protocol (VOIP) services. Because federal universal service contributions under existing rules are assessed only on *interstate* revenues from end-user

telecommunications services, this shrinking of the applicable revenue base has contributed to a steady rise in the contribution factor over time — it has increased by more than six percentage points over the last six years. While the contribution factor for the fourth quarter of this year will be 9.2 percent, the slight reduction from the current factor likely represents a one-time reprieve resulting from an earlier over-collection, considering that the reported revenue base remains in decline.

Another important trend has been the increasing prevalence of bundled service plans. For years, wireless carriers have offered buckets of any-distance minutes at flat rates, and now wireline carriers are offering packages including local and long distance for a single price. In addition, many carriers offer business customers bundles that include local and long distance voice services, Internet access, and customer premises equipment. Such bundling has been a boon for consumers but has made it difficult to isolate revenues from interstate telecommunications services. And the problem is likely to get worse as bundling becomes more and more popular.

In December 2002, the Commission adopted a number of measures to stabilize the universal service contribution factor in an effort to mitigate the growing funding burden on consumers. For example, the Commission increased from 15% to 28.5% the safe harbor that wireless carriers may use to determine the interstate percentage of their revenues. The Commission also eliminated the lag between the reporting of revenues and the recovery of contribution costs, which lessened the competitive disadvantages facing long distance carriers with sharply declining revenues. And the Commission prohibited mark-ups of contribution costs on customers' bills to ensure that carriers cannot profit from inflated line charges.

While these were important steps, I believe that more fundamental reform will be necessary to ensure the sustainability of universal service funding in the long term. Bundling together interstate and intrastate services — and telecommunications and information services — gives carriers the opportunity and incentive to understate the portion of their revenues that are subject to assessment and increases the difficulty of identifying interstate revenues. Contribution factors therefore are likely to continue their ascent under a contribution methodology based on interstate telecommunications service revenues.

For this reason, the Federal-State Joint Board has recommended that Congress amend section 254 to provide the FCC with authority to assess intrastate revenues, in addition to interstate revenues. A total revenue assessment would be far lower and more stable than one based solely on interstate revenues, and, just as importantly, it would prevent carriers from avoiding their contribution obligations by allocating revenues to the intrastate jurisdiction.

In addition, the Commission has been considering whether to make substantial changes under its existing statutory authority. The Commission has sought comment on alternative methodologies based (in whole or in part) on end-user connections or assigned telephone numbers, because such approaches arguably would create a more sustainable model for funding universal service in the future. The number of end-user connections has been more stable than the pool of interstate revenues, and connection-based charges can be adjusted based on the capacity of each connection to ensure an equitable distribution of the funding burden among business and residential customers. Moreover, proponents of a contribution methodology based on telephone numbers (with connection-

based charges for high-capacity business lines) argue that it would not only be more stable but also promote number conservation. Critics of these proposals — including carriers that would face increased assessments based on connections or telephone numbers — argue that reducing the contributions of long-distance carriers (which have very few assigned telephone numbers or end-user connections) would violate the statutory requirement that all carriers contribute on an equitable and nondiscriminatory basis.

Finally, the Commission also has sought comment, in the Wireline Broadband NPRM, on whether all facilities-based providers of broadband services should be subject to the same contribution obligations. While a total-revenue methodology or one based on end-user connections or telephone numbers would address problems arising from the blurring of the line between interstate and intrastate telecommunications services, such changes would *not* necessarily broaden the contribution base to include all broadband transmission services and new services such as VOIP. The Commission accordingly sought comment on whether or not to change the contribution pool to include new services that currently are not assessed. Regardless of whether such services are classified as telecommunications services or information services, section 254 gives the FCC permissive authority to assess contributions on "telecommunications," which underlies both types of services.

Distribution of Support to Carriers Serving High-Cost Areas

The steady increases in the contribution factor have resulted not only from the shrinking of the interstate revenue base, but also from the significant increases in the demand for funding. Much of the increased demand has resulted from the FCC's reform

of interstate access charges: Many incumbent LECs now recover from the Universal Service Fund costs that previously were recovered from long distance carriers. In addition, the increasing entry of wireless carriers and other competitors as eligible telecommunications carriers (ETCs) has raised questions about the long-term sustainability of the high-cost support mechanisms.

1. ETC/Portability Issues

Before enactment of the 1996 Act, only incumbent LECs received universal service support. In recent years, however, wireless carriers and competitive LECs have been designated as ETCs. While competitive ETCs receive a very small percentage of high-cost funds overall, their share has been increasing dramatically in recent months along with a surge in the number of ETC applications. Competitive ETCs receive support under the "identical support" rule (also called "portable support"), which provides per-line support based on the incumbent ETC's costs. Incumbents do not lose support when a competitive ETC captures lines; rather, both carriers receive universal service funding. Rural LECs have argued that this regime creates uneconomic arbitrage opportunities and threatens the viability of universal service, while competitive ETCs generally contend that providing identical support — whether based on the incumbent LEC's embedded costs or based on forward-looking economic costs — is essential to competitive neutrality.

In November 2002, the Commission asked the Federal-State Joint Board to consider the intersection of competition and universal service in rural areas. The Joint Board subsequently sought comment on several key issues, including the manner in which competitive ETCs receive support and the impact of providing support to

competitive ETCs on the growth of the universal service fund. The Joint Board also sought comment on the process for designating ETCs and whether the FCC should establish guidelines for consideration by the state commissions that make these determinations under section 214(e)(2). In July, the Joint Board held a public forum on these issues, and a wide range of industry representatives, consumer advocates, and state commissioners provided valuable insights.

Parties advanced a variety of proposals in their comments and at the public forum. Several groups of incumbent LECs argue that competitive ETCs should receive support based on their own embedded costs. Some competitive ETCs argue that incumbents and competitors should receive support based on forward-looking economic costs. To control growth, some parties advocate capping support upon entry of a competitor and dividing the funds pro-rata based on the percentage of lines each carrier serves; other parties advocate supporting only a single connection per household (current rules do not limit the number of wireline or wireless connections that are funded). Incumbent LECs generally oppose these proposals, arguing that reforming the ETC-designation process — in particular, making the public interest analysis more exacting — would suffice to keep the Universal Service Fund from growing too large.

The Joint Board is now considering the record and plans to provide a recommended decision to the FCC as expeditiously as possible.

2. Support for Non-Rural Carriers

While the rural high-cost support mechanism provides the lion's share of the funding — and correspondingly has received most of the attention — "non-rural" carriers (the Bell operating companies and other relatively large LECs) also receive high-cost

support. Whereas rural carriers receive support based on their embedded costs, non-rural funding is determined based on forward-looking economic costs. Non-rural carriers receive support in a particular state if the statewide average cost per line, as determined by a computer cost model, exceeds the national average cost by a certain margin. Currently, non-rural carriers receive support in eight states (Alabama, Kentucky, Maine, Mississippi, Montana, Vermont, West Virginia, and Wyoming). While non-rural carriers in other states serve many high-cost wire centers, their *statewide average* costs are not sufficiently high to receive support. Moreover, rural carriers receive substantial support in each of the states for which non-rural support is unavailable.

The Commission is nearing completion of a review of this support mechanism in response to a remand by the Tenth Circuit Court of Appeals. The court ruled that the Commission did not adequately explain how the non-rural support mechanism is sufficient to enable states to set affordable rates that are reasonably comparable in both rural and urban areas. In addition, the court directed the Commission to consider how to induce states to develop their own support mechanisms to fund high-cost areas within their borders, since the federal mechanism aims primarily to mitigate cost differentials *among* the states. The Joint Board issued its recommendations last October, and the Commission will complete its consideration of these issues next month.

* * *

Taken together, the reforms being considered by the Commission should ensure the continued vitality of the federal universal service support mechanisms. The Commission has no higher priority than delivering on the promise of ubiquitous, high-quality, and affordable services. I would like to thank you, Mr. Chairman, for calling this

hearing, and I look forward to working with you and other members of the Subcommittee on these challenging and critical issues.

Statement by Mr. Robert Williams

President, Oregon Farmers Mutual Telephone Company,

on behalf of the

National Telecommunications Cooperative Association
and the
Organization for the Promotion and Advancement of Small Telecommunications Companies

Before the

United States House of Representatives
Committee on Small Business
Subcommittee on Rural Enterprises, Agriculture and Technology Policy

In the Matter of
"The Future of Rural Telecommunications: Is the Universal Service Fund Sustainable?"

September 25, 2003

Introduction

Chairman Graves, Ranking Member Ballance, members of the subcommittee, my name is Bob Williams, and I am the President of Oregon Farmers Mutual Telephone Company, which is a family-owned, directed, and managed rural local exchange carrier located in St. Joseph, Missouri. Oregon Farmers Mutual is a true "small company", serving approximately 165 square miles of territory and 1,000 customers.

Mr. Chairman, I deeply appreciate this opportunity to discuss the future of rural telecommunications, and more specifically, the future of the federal Universal Service Fund (USF). On behalf of my fellow small businesses and consumers in Missouri, thank you for using your position to help small business owners like myself communicate our views about regulatory decisions that threaten the sustainability of the Universal Service Fund and the ability of rural consumers to remain connected to the network.

I am very pleased to testify today on behalf of the National Telecommunications Cooperative Association (NTCA) and the Organization for the Promotion and Advancement of Small Telecommunications Companies (OPASTCO). Collectively, these national trade associations represent hundreds of locally owned small, rural telecommunications companies and cooperatives nationwide. Importantly, small, rural carriers represented today share a commitment to universal service and to providing telecommunications service at affordable prices.

My message to this subcommittee is very simple:

- The high-cost universal service program has been put at great risk largely due to ill-advised decisions made by federal and state regulators governing eligibility for high-cost support.
- Congress must exercise vigilant oversight of the process for designating Eligible Telecommunications Carriers (ETCs) in areas served by rural telephone companies. Greater oversight of this process is critical to ensuring the long-term sustainability of the Universal Service Fund.
- The perfunctory designating of ETC status by various state commissions and the FCC do not take into consideration the potential costs of such decisions to rural consumers and to consumers nationwide who are the ultimate contributors to the USF.

My concerns go to the heart of the 1996 Act's twin goals of universal service and competition. Thus, a brief overview of the success of the high-cost universal service program and discussion about the presence of competition in rural America would be a good way to introduce my concerns about the ETC designation process.

Universal Service: A Success Story

For more than 100 years, small independent local exchange carriers (LECs) have provided local telecommunications service throughout rural America. These carriers are the embodiment of the universal service concept, having built the infrastructure that provides ubiquitous, high-quality local exchange service and exchange access (as well as

a variety of other services) to some of the country's most remote and difficult to serve areas. This would not have been possible were it not for the nation's policy of universal service.

In my view, section 254 of the Telecommunications Act of 1996 is the most important section of this law for every consumer, particularly those residing in rural America. This section codified our nation's universal service policy, which has as its ultimate goal to ensure that every citizen, regardless of location, has affordable high-quality access to the public switched telecommunications network and thereby benefits from the myriad of telecommunications and information services. Public policy that seeks to maximize the level of subscribership to the network also maximizes the utility of the network to all who are connected to it.

Universal Service Support Equals Infrastructure Investment

Mr. Chairman, I urge this subcommittee and your colleagues on the House Small Business Committee to recognize that the high-cost universal service support is not a subsidy program. Rather, it is a cost recovery program designed to encourage investment in infrastructure. High-cost support should never be confused with a program to simply reduce the rates for telecommunications service charged to an individual end user. Without adequate high-cost support, investment will not continue to occur, and rural subscribers will no longer have access to the affordable and reasonably comparable services and rates that are called for in the Act.

Competition Exists in Rural America

Mr. Chairman, as a consumer myself, I expect that almost every member of the House of Representatives supports the Act's goal of promoting competition. However, I hope that this hearing will help to remind your colleagues that there already is robust intermodal competition in the areas served by rural telephone companies. Today, most of this competition is coming from Commercial Mobile Radio Service (CMRS) providers. Many rural telephone companies have at least one unaffiliated CMRS provider serving in their territory. And the FCC's Seventh CMRS Competition Report states that rural markets, on average, have slightly more than three CMRS providers. In my service territory, NW Cellular (our wireless partnership), Sprint, Nextel, T Mobile, and Dobson/AT&T are all competing against my Incumbent Local Exchange Carrier (ILEC).

Moreover, many consumers are using their mobile wireless service as a substitute for their traditional wireline toll service. This is due to the fact that many of the calling plans offered by the nationwide CMRS providers include "free" nationwide long distance. AT&T has attributed the decline in its long distance calling volumes and revenues in part to mobile wireless substitution. In addition, many rural telephone companies have indicated that some customers are not choosing presubscribed interexchange carriers (PICs) and are using CMRS for all of their long distance calling. Without question, the use of e-mail, instant messaging, the World Wide Web and certain types of IP telephony often substitute for calls that would have otherwise been made on the wireline network.

Lastly, a study cited in the FCC's Seventh CMRS Competition Report demonstrates that CMRS providers were able to provide service in rural markets, at rates reasonably comparable to those charged in urban markets, before virtually any mobile wireless providers had even received ETC status. The October 2001 study conducted by Econ One compared the CMRS pricing plans in 25 rural markets with the CMRS pricing plans in the top 25 U.S. cities. The study found that "there was virtually no difference in the average monthly charge for wireless service between the two groups." In fact, the charge for rural markets was 2.9 percent less than it was in the top 25 markets. If CMRS providers are able to provide "reasonably comparable" services and rates in rural areas without high-cost support, it becomes questionable whether subsidizing these carriers is the most judicious use of limited federal resources.

The Current State of the Universal Service Fund

Mr. Chairman, I share your concerns about the impact excessive growth in the USF could have upon rural telecommunications providers and consumers—our friends and neighbors back in Missouri. I believe three main changes to universal service policy have contributed to a dramatic increase in the size of the USF. First, as mentioned earlier, Congress in the 1996 Act expanded the purposes of universal service beyond its historical purpose of cost recovery for high-cost carriers (and assistance for low-income subscribers) to include discounted services for schools, libraries and health care facilities. Second, the 1996 Act also allowed for more than one carrier in a local service area to be eligible to receive universal service support and empowered the states (and in come cases the FCC) to make these eligibility determinations. Lastly, further reform of the access charge regime since passage of the Act has shifted an even greater portion of a LEC's costs from interstate access charges to the USF for recovery.

Without question, these changes in universal service policy have had a dramatic impact upon the size of the USF. Since 1996, total universal service funding has increased from $1.7 billion to more than $6.4 billion in 2003. Equally alarming, the number of Competitive Eligible Telecommunications Carrier (CETC) study areas and the support received by CETCs has skyrocketed over the past several years. For example, the total amount of support going to CETCs has increased from $3.1 million in 2000 to more than $250 million by the end of this year. During the course of this hearing you will hear me say the following repeatedly: changes to the CETC designation process are desperately needed to ensure the long-term sustainability of the Universal Service Fund.

Problems with the CETC Designation Process

Mr. Chairman, I would like to explain what many rural telephone companies believe to be the core problem with the ETC designation process. Under the 1996 Act, in order to be eligible to receive high-cost universal service support, a carrier must first be designated as an ETC by a state commission or, in limited circumstances, by the FCC. In areas served by a non-rural ILEC (*ex.*, Verizon, SBC, BellSouth, Qwest), the Act requires

state commissions and the FCC to designate additional ETCs, so long as the applying carrier meets certain prerequisites.

However, in areas served by a rural telephone company, the Act provides state commissions and the FCC with the discretion to determine whether or not providing more than one carrier with universal service support would be in the best interest of those communities. More specifically, it requires state commissions and the FCC to find that the designation of an additional ETC in a rural service area is *in the public interest* before such a designation is made. I firmly believe that this additional requirement demonstrates Congress's recognition that supported competition would not always serve the public interest in the areas served by rural telephone companies. Unfortunately, in many instances, state commissions and the FCC have not been following the intent of Congress and have been quick to designate additional ETCs in rural telephone company service areas without thoughtfully and thoroughly considering all of the factors that determine the public interest.

Mr. Chairman, in my view, a substantial number of the decisions on ETC applications for rural service areas that have been made thus far have placed an over-emphasis on the perceived benefits of competition, and have equated the introduction of financially supported competition to serving the public interest. On the other hand, less attention has been paid to ensuring that all consumers in the area will retain, and gain, access to affordable, high-quality services, including advanced services, that are reasonably comparable to the services and rates offered in urban areas. These decisions have overlooked or ignored the often-significant costs and detriment to rural consumers that Congress recognized could result from financially supporting competition in rural service areas. My concerns are reflected in comments made recently by Commissioners Kevin Martin.

Commissioner Martin explained how supporting competition in rural areas may not always be in the public interest when he stated:

> I have some concerns with the Commission's policy....of using universal service support as a means of creating "competition" in high cost areas. I am hesitant to subsidize multiple competitors to serve areas in which 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.

In case after case, state authorities and the FCC have granted ETC status to competitive carriers based on extremely loose public interest tests or tests that are inconsistent with the language and intent of the law. Notably, however, just last year, the Utah Supreme Court upheld a decision of the Utah Public Service Commission that denied ETC status for Western Wireless Corp. In upholding the PSC decision, the Court found that:

> ...the [Utah Commission] is not against competition per se, but rather, merely recognizes that in some instances competition in rural

> areas by multiple ETCs receiving state universal service support may not be in the public interest.

Additionally, I was interested to learn that a leading consumer organization, the National Association of State Consumer Advocates (NASUCA), has expressed similar concerns about the ETC designation process.

NASUCA recently stated in comments to the FCC:

> "ETC eligibility should entail specific public interest obligations in exchange for public support. ILECs typically provide high quality, highly reliable service ubiquitously throughout their service territory and are providers of last resort for that territory. Moreover, customers of ILECs have the substantial benefit of state regulation, which enforces service quality rules, billing and collection rules, and ensures just and reasonable rates. By contrast, wireless carriers are generally unregulated entities that provide highly variable service quality, varying levels of customer service, unilaterally determined billing and collection policies, unilaterally determined rates and have no requirement to provide facilities in specific areas. Federal ETC designation guidelines would ensure that all states receive federal support in a consistent manner."

Federal Guidelines Would Not Infringe Upon States Rights

The legislative history leading to the creation of the section of the statute that provides the states with the responsibility of making ETC determinations shows that the Congress believed state authorities would be in a better position to make ETC determinations than the FCC. State policymakers, after all, would have the best information with regard to the needs of their respective rural markets and would have a vested interest in ensuring such markets were efficiently and well served. Unfortunately, to a large extent state policymakers have simply followed the direction and directives of the FCC, without a great deal of thought being given to their individual, unique circumstances.

The FCC first tried to prevent states from adopting any additional requirements for carriers seeking to qualify for support. The 5th Circuit decided that the law did not permit this prohibition. The FCC has, since then, issued an unnecessary declaratory ruling threatening to preempt state requirements the FCC perceives as obstacles to the publicly-supported "competition" it wants to foster.

Possible Solutions to the CETC Designation Process

Mr. Chairman, many witnesses come before your committee without solutions. However, I am very pleased that both NTCA and OPASTCO have each developed their own principles to strengthen the public interest standard governing the CETC designation process.

This past July, my industry colleague, John Metts, CEO of Penasco Valley Telephone Cooperative located in Artesia, New Mexico and president of the National Telecommunications Cooperative Association testified before the Federal-State Joint Board on Universal Service to urge adoption of NTCA's proposed seven-point public interest test for evaluation of ETC designation in rural telco service areas. NTCA's seven-point public interest test is as follows:

1. Is the additional ETC designation of the requesting carrier required to ensure that consumers living in the rural ILEC service territory have access to the nine support services listed in the definition of universal service at rates that are comparable to similar services and rates received by consumers living in urban areas?

2. Would the requesting ETC designation be able to provide service to the entire rural ILEC service territory, as required by FCC rules?

3. Do the potential benefits to the rural service area of granting the ETC designation outweigh the ultimate burdens on consumers that will occur through the added growth in state/federal universal service funds?

4. Is the carrier requesting designation willing to demonstrate its cost to provide universal service to consumers living in the rural ILEC service territory?

5. Would the ETC designation result in excessive support to the requesting carrier based on the amount of support distributed under the identical support rule?

6. If the carrier seeking ETC designation is offering rural consumers universal service at a rate that is at, below or slightly above the comparable rate for supported services, why is the requesting carrier seeking universal service support?

7. Is the carrier requesting ETC designation willing to adhere to quality-of-service guidelines or other state-specific requirements?

Additionally, to complement these efforts, I played an integral role within OPASTCO in developing an industry white paper, titled, "Universal Service: A Congressional Mandate At Risk." This paper elaborates upon how misinterpretations of the public interest standard by state and federal regulators when designating multiple ETCs has placed the USF in serious jeopardy. In developing this paper, my colleagues and I developed the following principles, guidelines and requirements to guide state regulators and the FCC.

More specifically, the OPASTCO white paper recommends that State commissions and the FCC should adopt the following universal service public interest principles to guide them in their consideration of ETC applications for rural telephone company service areas:

1. Rural consumers should receive access to affordable, high-quality telecommunications and information services, including advanced services, that are reasonably comparable to those services provided in urban areas and at reasonably comparable rates.

2. The high-cost support mechanisms should not be used to incent uneconomic competition in the areas served by rural telephone companies.

3. The USF is a scarce national resource that must be carefully managed to serve the public interest.

4. Rural universal service support reflects the difference between the cost of serving high-cost rural areas and the rate levels mandated by policymakers.

5. The public interest is served only when the benefits from supporting multiple carriers exceed the costs of supporting multiple networks.

6. In areas where the costs of supporting multiple networks exceed the public benefits from supporting multiple carriers, the public interest dictates providing support to a single carrier that provides critical telecommunications infrastructure.

7. The cost of market failure in high-cost rural America could be severe.

Along with the adoption of public interest principles, the OPASTCO white paper further recommends that in order to be considered for ETC status in a rural telephone company service area, a carrier should be required to demonstrate to the state commission or FCC that it meets, and will abide by, all of the following qualifications and requirements:

1. A carrier must demonstrate its ability and willingness to provide all of the services supported by the federal High-Cost program throughout the service area.

2. In fulfilling the requirement to advertise its services and rates, an ETC must emphasize its universal service obligation to offer service to all consumers in the service area.

3. A carrier must have formal arrangements in place to serve customers where facilities have yet to be built out.

4. A carrier must have a plan for building out its network once it receives ETC designation and must make demonstrative progress toward achieving its build-out plan in order to retain ETC designation.

5. A carrier must demonstrate that it is financially stable.

Lastly, State commissions and the FCC should also adopt the following policies regarding ETC designations in rural telephone company service areas:

1. ETC designations in rural telephone company service areas should be made at the study area level (an ILEC's entire service territory within one state).

2. State commissions and the FCC should ensure that competitive ETCs will be capable of providing high-quality service to all of the customers in the service area should the rural ILEC find it necessary to relinquish its own ETC designation.

3. Any service quality standards, reporting requirements and customer billing requirements established by the state commission should be applied equally to all ETCs in the state.

4. State commissions have the authority to decertify any ETC that is not meeting any of the qualifications or requirements enumerated above.

Conclusion

I strongly believe that the long-term sustainability of the federal USF has been greatly threatened by federal and state regulator decisions about whether to designate multiple ETCs in an area served by a rural telephone company. The number of competing carriers seeking designation as eligible to receive universal service support is growing at an ever-increasing pace. If the size of the USF reaches a point where further growth is prohibited, yet the number of carriers receiving support continues to grow, then no carrier will have the funding necessary to provide affordable, high-quality telecommunications services and rural consumers will be denied the benefits promised by the Act. It is imperative that Congress become more engaged in this very important aspect of universal service policy by paying close attention to the ETC certification recommendations that are ultimately presented by the Joint Board to the FCC for the Commission's adoption.

Written Statement of Tom Attar of Highland Cellular, Inc.
on behalf of the Rural Cellular Association

before the

Subcommittee on Rural Enterprises, Agriculture and Technology

Committee on Small Business

House of Representatives

September 25, 2003

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Statement of Tom Attar
Highland Cellular, Inc.
on behalf of the Rural Cellular Association
before the
Subcommittee on Rural Enterprise, Agriculture & Technology
Committee on Small Business, House of Representatives
September 25, 2003

Mr. Chairman and Members of the Subcommittee:

Thank you for this opportunity to testify on behalf of the Rural Cellular Association ("RCA"). I am the Vice President – Corporate Development of Highland Cellular, Inc. ("Highland Cellular" or "Highland"). We are one of RCA's nearly 100 members who provide wireless service in more than 135 rural and small metropolitan markets where approximately 14.6 million people reside in the United States. Highland and other RCA members face many of the same challenges as rural landline carriers in their efforts to deliver high quality telecommunications services in rural areas.

Like all of you, RCA members are committed to the long-term sustainability of the universal service support system. We have seen first hand how it helps the lives of those living in rural and underserved communities. As one of the wireless companies that has recently started receiving USF support we hope to provide you with our perspective on how high-cost funds are improving and will continue to improve the rural communities that Highland serves in West Virginia. Our experience in these communities tells us that there is a critical need for coverage within small towns, a need which will not be met by national providers focused on metropolitan areas. We furthermore believe that investment in these communities is one of the best ways to differentiate ourselves from the large national wireless carriers that we compete with.

The people of West Virginia and Highland are facing an immediate challenge with this program. Lawmakers are reviewing this program and the landline telephone companies are lobbying against wireless telephone company participation in this program. The landline industry has reaped the benefits of the Universal Service Fund ("USF") for decades. At the same time the wireless industry have been contributing to the fund for over 6 years and has only started receiving money out of the fund in the past couple years. In Highland's case, we have only been receiving USF funds for roughly six months.

For ease of reference, my testimony is divided into three sections. Section I describes our company and our experience in West Virginia as a competitive ETC ("ETC" or "CETC"). Section II outlines specific policy positions that RCA supports. Section III provides responses to some of the more popular arguments advanced by ILECs in presentations made to the FCC and members of this Committee.

I. A DESCRIPTION OF HIGHLAND CELLULAR AND OUR EXPERIENCE AS A COMPETITIVE ETC.

A. Our Company

Highland Cellular is a locally owned and operated cellular telephone company operating in the southern West Virginia counties of Raleigh, Fayette, Mercer, Greenbrier, Summers and Monroe and the Virginia counties of Bland and Tazewell. Those counties make up markets identified by the Federal Communications Commission ("FCC") as Rural Service Areas ("RSAs") West Virginia 7 and Virginia 2A. Highland has committed itself to bringing advanced wireless communications to the local and rural populations of its licensed service areas.

Highland launched the areas first wireless network in 1991, introducing wireless technology four years before its national competitor. Highland launched digital service in 1999, 2 years before its national competitor. Most recently, Highland committed $17 million to the addition of GSM digital technology, which enables high speed data connections to cellular telephones and other wireless devices. This network upgrade is in line with the upgrades which AT&T and Cingular are making to their networks, nationwide. Our customer quality surveys, our churn rate, and our interaction with customers tell us that we have developed a first rate wireless system serving the areas where we hold licenses.

Because Verizon and other landline carriers in West Virginia are recipients of high-cost support from the USF in much of rural West Virginia, it was very difficult for any carrier using any technology to achieve network and service quality at price points low enough to be competitive. In the 1996 Telecom Act, Congress directed the FCC to designate additional ETCs throughout the country. Since 1997, the FCC has released a series of rulemaking orders implementing the 1996 Act and designating competitive ETCs.

Highland applied for and received a grant of ETC status from the West Virginia Public Service Commission ("PSC") for the area in the West Virginia 7 RSA served by Verizon, which comprises over three quarters of the area in this RSA and includes some of the most rural portions of West Virginia. In early 2003, we began receiving high cost support from the federal USF. Today, we receive an average of approximately $9.25 per month per line in support in Verizon's service areas where Verizon receives support.

Just two weeks ago, an administrative law judge of the West Virginia PSC issued a decision that grants Highland competitive ETC status in the portion of West Virginia RSA 7 served by landline companies other than Verizon. That decision is subject to the appeal process and it may be late next year before Highland begins to receive high cost support for its service in the non-Verizon areas.

B. Our Experience

Federal law requires eligible carriers to use high-cost support solely to construct, improve, and maintain facilities and services in designated ETC areas. We have done just that and the results have been remarkable for West Virginia's rural residents.

1. Network Improvements Provide Important Service Quality Benefits To Small Businesses and Consumers

Highland has built roughly 50 cell sites across its service area over the past twelve years. Prior to accessing the USF, Highland was focused on expanding coverage in the larger towns and interstate roads. The rural populations and state routes were not on the priority list, as a result.

High-cost support has and will enable Highland Cellular to significantly accelerate the construction of cell sites in some of the most rural areas of the state. This commitment was reached as part of an informal agreement with the state PSC and Consumer Advocate Division in which Highland committed all USF dollars to be used for the expansion of coverage.

Funding from the USF is a crucial element in overcoming the challenges of a rural expansion. The first challenge in building in rural areas is the lack of tower infrastructure available to wireless companies. The tower industry has done a good job lowering the capital requirements for wireless companies, however, the tower industry business requirement is based upon renting tower space to 3-5 wireless company tenants. This type of opportunity does not and will never exist in the highly rural areas. As a result, Highland must construct its own towers as it expands into these rural areas. This tower construction more than doubles the cost of building a single cell site.

The second challenge is the low population and low density of these highly rural areas. Wireless competition within our markets is focused on the large towns. Specifically, consumers within towns like Beckley, Bluefield and Princeton can choose to purchase wireless service from five different wireless companies. These towns have population densities of over five hundred people per square mile, making such customers the "low hanging fruit" for wireless service providers. Many of the rural areas where Highland is in the process of expanding service have population densities of between twenty to sixty people per square mile. These are challenging, mountainous and highly rural areas where large wireless companies will almost certainly never serve. USF provides the means by which a locally owned, operated and focused company can serve areas which would otherwise remain unserved.

Crucial wireless services such as public access to 911 and police and fire department use of wireless become available with the availability of USF support for these areas. These improvements make the rural communities we serve more attractive to small businesses and promote economic development that otherwise might flow to urbanized areas.

2. High Cost Support Has Improved Business and Consumer Choices

Without high cost support, attempting to compete with long established incumbent wireline carriers in the local exchange market would be extremely difficult, if not out of the question.

With high-cost support, a competitor such as Highland Cellular has an opportunity to deploy network facilities that enable service quality improvements. These improvements enable customers to see wireless as a viable alternative to local exchange telephony, while at the same time extending the benefits of universal service. Although it is too early to measure our progress with any precision, we believe that our GSM overlay and deployment of new cell sites is having a significant impact on the competitive landscape in West Virginia, to the benefit of small businesses and citizens of our state. In addition, we believe that the deployment of approximately 10 new sites in 2004 will accelerate our ability to compete in rural areas.

For example, our upgraded GSM network permits us to offer customers a larger local calling area and a lower price. Larger local calling areas are a critical competitive factor – because most basic calling plans offered by wireline carriers offer very small local calling areas that provide toll free calling to only a few thousand, or sometimes only a few hundred, numbers. All other calls incur toll charges. Customers in many rural areas across the country pay much higher rates for in-state toll calls and most interexchange carriers do not offer their discounted interexchange toll service rate plans in many rural areas.

In contrast, we are able to offer customers the ability to make unlimited calls throughout our licensed service area for as little as $39.95 per month. For Highland Cellular to make these competitive service offerings available in rural areas, we need to deliver a robust and high quality network with both coverage and capacity. It is the provision of high-cost support that is enabling us to deliver competitive choices to small businesses and rural consumers.

ETC status has also enabled us to commence offering federal Lifeline and Link-Up benefits to eligible consumers. Lifeline and Link Up provide discounts on service and connection charges to consumers who participate in federal low-income programs. We have advertised the availability of Lifeline and engaged in specific outreach efforts at local health, welfare, and employment offices, to inform consumers of the availability of these benefits. We have instituted specific training for all of our sales representatives and hired an additional administrative person so prospective customers can be made aware of the Lifeline and Link-Up benefits and that orders will be processed efficiently.

West Virginia consumers trail the nation in participating in the Lifeline and Linkup programs. According to a recent report by the USF administrator, less than 3.71% of the eligible subscribers utilize this federal benefit. Highland is working with state and local officials to bring wireless service to eligible subscribers for $1.00 per month. Highland believes there is a substantial business opportunity in targeting a niche which has clearly been overlooked by the

incumbent LECs. Furthermore, this type of community outreach is just one of the many ways by which Highland demonstrates the philosophy of caring for the communities it serves.

With Highland's entry into the Lifeline market, even low income consumers in rural areas will now have a choice of service provider. Eligible customers can currently obtain telephone service from us for as little as $10.00 per month and in the coming months Highland will launch a revised plan for $1.00 per month. This essential benefit advances universal service and competitive choices to those most in need.

II. POLICY POSITIONS

A. High-Cost Support Advances Universal Service and Drives Critical Infrastructure Development in Rural Areas.

In urban areas, it is taken for granted that in most areas you can complete a wireless call in an emergency. In a very short time, consumer expectations for wireless have risen enormously, to the point where the failure to complete an important health or safety call is newsworthy. In many rural areas served by RCA members, expectations are often very different. Consumers understand that wireless phones work in larger towns and on major roads, and not much beyond that. Unlike urban dwellers, many rural West Virginians have traditionally seen mobile phones more as ancillary communications tools, rather than one that can be counted on to provide primary telephone service.

The FCC's rules require all support to be used for the construction, provision and maintenance of facilities and services within the designated ETC support area. For us, there is no more important goal than to improve coverage within our existing service area. High-cost support has provided us with an opportunity to achieve that goal. Since obtaining ETC status, we have committed to an infrastructure development plan that significantly exceeds the amount we are receiving from the fund.

With respect to universal service, we can think of few achievable goals more important than driving investment into rural areas that will improve critical infrastructure. At Highland Cellular, our new cell site construction is rapidly filling in service gaps and extending our reach in rural areas that we would not have reached for many years, if ever. In addition, it is self-evident that the number of important health and safety calls, such as those made by doctors, volunteer firemen, police, and first responders, is increasing with every new cell site that we construct in rural areas.

For all of these reasons, we urge Congress to ensure that high-cost funds continue to be available to wireless carriers.

B. High-Cost Support Will Bring Economic Development to Rural Areas.

As a rule, our nation's rural areas have long trailed cities in terms of economic development. Use of high-cost support to improve infrastructure has significant economic impact

on small communities and is a key to closing that gap. Today, many companies and people consider rural areas as more attractive places to locate and to live. One of the major factors involved in selecting a community is the quality of its telecommunications infrastructure.

Wireless service is a very important factor in the equation. In our experience, more and more companies and people today rely on wireless phones to improve efficiencies and manage their businesses, especially in rural areas where the distances between job sites can be large, and in the case of farms and ranches, the job site itself can be quite large.

At Highland Cellular, we believe that a number of small communities where we have constructed new cell sites are now better positioned to attract and keep business. We urge the Congress and the FCC to recognize the substantial economic benefits that can accrue to rural America as a result of the provision of high-cost support to wireless carriers.

C. Wireless Carriers Pay Into the Fund And Are Entitled To Draw From It.

For years now, wireless subscribers have been required to contribute to the universal service fund, to support wireline service. Yet incumbent local exchange carriers ("ILECs") have generally and vigorously opposed wireless companies' efforts to gain ETC status in rural areas, even though under the current system they are not harmed as a result of a competitor's designation.

Just this year, the FCC nearly doubled the amount that wireless subscribers must pay into the universal service fund. It is completely unfair for wireless subscribers to contribute to a fund without having a fair opportunity to receive the benefits that both the Congress and the FCC have long ago determined are to be made available to competitors.

Over the past seven years, the FCC has implemented a comprehensive plan to carry out Congress' mandate to provide high-cost support to competitors in rural areas. Virtually every state has followed suit, adopting rules and deciding cases to designate new competitors. Still, long after being discredited at the FCC and in the courts, many ILECs view the high-cost fund as theirs alone. They see landline telephone service as the only "true" universal service, which in areas where wireless service is available, is no longer the case.

We, like other RCA members, have played by the rules to apply for and obtain support, often enduring a process that is far more protracted and expensive than is necessary, opposed by well financed incumbents backed by national organizations. Wireless carriers are capable of advancing Congress' twin goals of promoting universal service and competition in rural areas, if given the opportunity. In all fairness, if wireless subscribers are required to pay into the fund and support wireline networks, they must be permitted to obtain the benefits that the universal service system was designed to provide.

D. Congress Should Ensure That The FCC Continues To Enforce The 1996 Act And Administer All Federal ETC Rules In A Competitively Neutral Manner.

Following Congressional direction contained in Section 254(h)(2) of the Act, the FCC adopted competitive neutrality as a core principle for its universal service program, stating, "competitive neutrality means that universal service support mechanisms and rules neither unfairly advantage nor disadvantage one provider over another, and neither unfairly favor nor disfavor one technology over another." Federal-State Joint Board On Universal Service (Report and Order), 12 FCC Rcd 8776 (1997) at paras. 47-49.

In spite of this principle, ILECs have steadfastly urged states to adopt eligibility criteria and rules for CETCs that are not competitively neutral. In many cases, they have succeeded in turning the ETC designation process into an extended litigation that is far more arduous than even obtaining a certificate to become an ILEC. Seven years after the 1996 Act, only a relatively small number of CETC designations have been made. ILEC opposition at the state level has greatly contributed to this long delay.

The standard set forth by Congress and the FCC is relatively simple. In rural areas, a state is required to examine whether a petitioner will advertise and provide the nine supported services and that a grant will serve the public interest. Some ILECs now urge that the public interest bar be raised, suggesting a long list of eligibility requirements that were never imposed on ILECs.

We believe that Congress gave clear direction here and if it wanted a lengthy list of eligibility criteria, it would have specified them in the Act or directed the FCC to do so. It is not competitively neutral to make ETC designations easy for ILECs and difficult for others.

With respect to ongoing regulation of CETCs, Congress preserved the state preemption of rates and entry for CMRS carriers, even when a CMRS carrier seeks ETC designation. States are free to regulate "other terms and conditions" of service. Most states have properly understood this, however a few have attempted to impose tariffs and otherwise regulate rates that violate the preemption. Some CETCs have assented to such regulation as a condition of obtaining ETC status simply because it is expensive to litigate and delays in receiving funding mean delays in bringing competition to the marketplace.

Some ILECs have taken the position that it is competitively neutral to cause CETCs to be subject to the same regulatory structures as ILECs. Not true. Such ILECs ignore the fact that the purpose of ILEC regulatory structures is to protect consumers from monopoly abuse, which is simply not possible in a competitive market.

Asymmetrical regulation of a monopoly and its competitors is not only appropriate in the current case, it has been implemented before with success. For example, when AT&T was broken up in 1984, monopoly regulation continued to be applied to AT&T until such time as its monopoly grip was broken, after which such regulations were dismantled.

Highland Cellular is a prime example of why such regulations are unnecessary. Like all carriers in a competitive market, Highland Cellular cannot afford to act like a monopoly because its customers have a choice of service provider. If a customer does not like our service, they may choose another wireless carrier, or the ILEC's service. Most ILEC customers in rural America do not have the same choice and therefore regulation must take the place of a competitor.

E. Portability of Support is Essential to Promoting Competition and Universal Service

When a CETC gets a customer, it receives the same amount of "per line" support as the ILEC receives for serving that customer. This is called portability of support. Portability is the lynchpin that levels the playing field among competitors. It is the ability to compete for customers on a level playing field that drives infrastructure investment and improves services for consumers in areas where monopoly service would otherwise be the norm for the foreseeable future.

Portability was a cornerstone of the FCC's policy for providing high-cost support to CETCs and the concept was specifically affirmed by the 5th Circuit in the Alenco case:

> The purpose of universal service is to benefit the customer, not the carrier. "Sufficient" funding of the customer's right to adequate telephone service can be achieved regardless of which carrier ultimately receives the subsidy....What petitioners seek is not merely predictable funding mechanisms, but predictable market outcomes. Indeed, what they wish is protection from competition, the very antithesis of the Act.

The court also stated:

> The Act does *not* guarantee all local telephone service providers a sufficient return on investment; quite 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. The Act only promises universal service, and that is a goal that requires sufficient funding of *customers*, not *providers*. 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.

Alenco v. FCC, 201 F.3d 608 (5th Cir. 2000).

Put simply, portability of support is a core element of the FCC's universal service high-cost support mechanism. Without portability of support, there is no hope of advancing universal service and bringing the benefits of competition to high-cost areas.

F. The High-Cost Fund is Not "Exploding" As a Result of CETC Designations.

For months ILEC lobbyists have proclaimed that the size of the high-cost fund is exploding as a result of ETC designations to competitive carriers. This is untrue. According to the Cellular Telecommunications and Internet Association ("CTIA"), over the past three years, high-cost support to CETCs increased by approximately $175 million. During that same period, high-cost support to rural ILECs increased by approximately $2.1 ***billion***. It is my understanding that, in 2001, rural ILECs successfully lobbied the FCC to provide them with a major increase in high-cost funding through 2006. Prior to that, they sued the FCC in federal court to remove caps on their funding and have consistently argued that the size of the fund must not be considered when determining whether funding (to them) is sufficient.

In short, rural ILEC lobbyists now for the first time argue that a $100 million increase in the size of the fund to competitors threatens the fund's viability. There can be no doubt but that the increase in high-cost funds paid to carriers has increased almost exclusively as a result of increases to rural ILECs.

The fund is also increasing because the FCC has properly implemented its Congressional mandate to make all universal service support explicit – that is – to remove support from ILEC rates so that rates are cost-based and support is in plain view. As the FCC has removed support from rates and placed it in new high-cost programs, such as for example, Interstate Access Support, customers see on their bills exactly what they pay for service and what they pay for universal service support.

To be clear, as more support is moved out of ILEC rates and into explicit funding mechanisms, the fund will continue to grow and rates will decline. This has been expected and is a good thing. It permits all participants to compete for customers and support on a more level playing field.

Finally, we note that most of the growth in the high-cost fund generally is within the Schools and Libraries Program, which is a subset of the high-cost support program. We agree with suggestions that the Schools and Libraries Program should be separated from the high-cost fund, at least for the practical purpose of grouping together only those programs that have similar purposes. But make no mistake – in response to claims that the viability of the fund is threatened, CETCs are not the responsible party.

G. Fund Growth Must be Managed in a Competitively Neutral Fashion

It is self-evident that, as more CETCs are designated, the high-cost fund is going to grow. RCA supports careful management of the high-cost fund, provided that it is done in a competitively neutral fashion. An increase is only appropriate if consumers receive appropriate levels of support and if carriers are using support for the intended purposes. The high-cost fund is not a set aside program for incumbents, nor is it the duty of regulators to ensure a market outcome in favor of ILECs. Quite to the contrary, if the fund is to be preserved and universal

service advanced, then state and federal governments should support efficient technologies and promote competition for support so that private industry has an incentive to drive infrastructure investment out to rural areas.

Competition for customers and support will drive costs down, and likewise, reduce the overall level of support required nationwide. In the meantime, an increase in the size of the fund is not necessarily a negative if the increase is used to improve critical wireless infrastructure in rural areas that currently have substandard networks and lack reliable 911 service.

Managing the growth of the fund is a complicated task that is not subject to a quick fix. As the expert agency, the FCC must work within the statutory framework of the Communications Act to ensure that wireless companies, which pay into the fund and currently receive less than 4% of the total high-cost support, have the same opportunity to obtain support in rural areas as do ILECs.

III. RCA RESPONSES TO COMMON ILEC ARGUMENTS

From the RCA perspective, Congress and the FCC set forth laws and rules implementing a system for encouraging competitors to obtain ETC status. I am advised that rural ILEC lobbyists have asked the FCC to reverse policies that have encouraged competition in rural areas. Thus far, they have succeeded in getting the FCC to initiate a proceeding to reexamine its policies for designating and distributing high-cost support to CETCs, without examining how the overall system for providing support to all carriers can be improved.

Here are our positions in response to a few of the commonly expressed criticisms by ILECs:

A. On Whether the Universal Service System Should Support More Than One Network in Rural Areas:

Many ILECs state, without any supporting economic evidence of which we are aware, that most rural areas will not support competition and therefore the government should not be supporting duplicative networks, risking stranded plant and endangering universal service. The common argument is that competitive carriers are going to construct five or six wireless networks in remote areas that will not today support even two competitors.

This argument directly contradicts Congress' express goal set forth in Section 254(b) of the Act that

> 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.

The current system provides exactly the proper incentive for CETCs to enter rural areas. We are not aware of any evidence that any significant number of rural customers are going to abandon wireline service any time soon. We suggest that competitive market forces supply a very good discipline on market participants. The long-term economic benefits of competition represent the greatest potential gain for consumers in rural areas and for rural economic development. Those benefits cannot be realized if one carrier is funded to the exclusion of all others.

Reserving support for ILECs harms consumers in rural areas by relegating them to second class status indefinitely by locking out improvements in service and new services (such as mobile service) that can be introduced by competitors. We urge Congress and the FCC to reject these and other ILEC arguments that seek market outcomes in their favor, especially when such companies are asking the FCC to set aside spectrum for the second time in 15 years, and to adopt eligibility rules favoring rural ILECs.

B. On Whether High-Cost Support to CETCs Stimulates "Artificial" Competition:

We believe exactly the opposite is true – that denying high-cost support to CETCs cements artificial monopolies into place. If no high-cost support were available to any carrier, most of the wireline infrastructure that is today in use in high-cost areas would not have been constructed. Unfortunately, that infrastructure has been constructed at a very high price. A system that only supports one carrier artificially keeps a monopoly in place and denies consumers the benefits that a competitive system inevitably and surely brings.

We believe that most every rural area in America can support competition, especially if competitors only receive support to the extent that they have a customer. Throughout the country, in over 30 cases, we are not aware that ILECs have been able to demonstrate any consumer harms that will arise as a result of competitive entry.

In northeast Arizona and northwest New Mexico, one of the most remote and sparsely populated areas of the country, it is my understanding that a CETC has signed up over 33,000 new customers on Native American lands in just over two years since becoming a CETC. I am also advised that in rural northeastern Colorado, a new CETC has signed up over 500 new subscribers that have "cut the cord" with their ILEC in just one year, while using high-cost support to provide improved service and more choices to consumers.

As a general rule, we believe that consumers throughout this country should enjoy the benefits of competition.

C. On Whether Competitive ETCs Should Continue to Receive Support Based Upon ILEC Costs:

The FCC properly determined that high-cost support must be made available to all eligible carriers, no matter what technology is used. ILECs and CETCs receive high-cost support in completely different ways. ILECs use cost studies to obtain "explicit" support from the high-cost fund, and receive additional implicit high-cost support within their rate structure. A wireless CETC receives no implicit support and can only receive the "per line" support available to an ILEC when it gets a customer.

In order for a CETC to gain support, it must get and maintain customers. Therefore, it is misleading to say that a competitor is getting paid on ILEC costs.

Moreover, it is not by any means clear that a wireline carrier's "per line" costs in remote areas are lower than those of wireless carriers. In fact, the opposite may be true because in most rural areas, wireless carriers have fewer customers. Their networks are relatively young and require much more in capital expenditures to extend new service than do wireline networks, which are mature and not growing rapidly. From all we have observed, allegations that the current system provides excess support to wireless carriers are unfounded.

The current system, which forces market participants to compete for customers and support is the right approach. RCA believes that the size of the fund must be managed in a competitively neutral fashion so that all carriers can compete for customers and for support on a relatively level playing field.

D. On Whether the High-Cost Support Mechanism Appropriately Funds All Lines:

From the outset, the high-cost fund has supported all lines because the cost of providing all services are spread across an ILEC's entire network, including primary lines, second lines, fax lines, lines in vacation homes, and lines dedicated to internet access. Spreading costs across the entire network is appropriate because it enables an accurate determination of whether the costs of providing that network are above the level that triggers high-cost support.

Some have posited that the fund should support only one line per household. Others advocate only one line per household per competitor. A few theorists believe that only the primary line in a household should receive support and that the customer should designate its primary line for purposes of high-cost support.

We view all of these approaches as band-aids that provide no comprehensive answer to the issue of fund growth. I am advised that we may agree with ILECs that these solutions will be arbitrary and unlikely to result in appropriate support levels being achieved. Moreover, a system where customers designate a primary line will undoubtedly lead to a new class of "slamming" caused by carriers competing over the "primary" designation. In the end, consumers are likely to be harmed.

All lines are properly funded under the current system, and if change is to be made, it should be done thoughtfully and carefully.

E. On Whether the USF Support System is "Broken" and Will Run Out of Money:

As long distance rates continue to fall, interexchange carrier contributions are dropping and therefore a rational means of ensuring that sufficient funds are generated to sustain the system must be developed. While some have argued that the problem can be solved by simply cutting off funds to competitive ETCs, the facts make clear that the answer lies elsewhere. ILECs continue to receive over 95% of available high-cost support and rural ILECs received a $1.26 billion increase in support in 2001.

In order to sustain the system Congress must implement a mechanism that will provide consumers with sufficient funds to permit the twin goals of advancing universal service and introducing competition to be realized. RCA takes no position on whether an end user fee or other mechanism should be introduced. RCA's primary concern is that opponents of fair competition not be permitted to derail the substantial progress that the FCC has made in developing a universal service system that is today accomplishing the goals that Congress set forth seven years ago.

F. On Whether the "Public Interest" Standard for CETC Designations Should be Changed to Make it More Difficult for Wireless Carriers to Obtain CETC Status and High Cost Support:

Rural ILEC advocates sometimes argue that Congress granted the states too much discretion in determining whether or not a CETC designation in rural ILEC areas will serve the "public interest." In essence they suggest that Congress take action to enact legislation that directs the states on how to apply the public interest standard.

In West Virginia, the state PSC and its Consumer Advocate Division ("CAD") have been proactive in ensuring that the "public interest" standard is met by CETCs. In our case the state PSC conducted a full hearing in which all parties called expert witnesses for testimony. The CAD was especially active in our case. Subsequently the PSC and its CAD instituted a general investigation regarding appropriate conditions to be placed on CETC designations to assure that uniform standards for on-going compliance by CETCs are in place. The PSC and the CAD clearly have an interest in insuring that universal service funds that flow to the state are put to use for the benefit of the consumers within the state. This is just one example of a state that takes seriously its responsibilities in evaluating the public interest, as mandated by Congress.

RCA believes that Congress should not interfere with state review of the public interest aspects of a CETC application. In any event, states have made the right decision when they have found that the public is better served by having a choice of service providers. State regulators have available to them, or can obtain, all necessary data about the ILECs they regulate in order to

analyze whether or not continuation of service to any customer would be jeopardized by a CETC designation.

CONCLUDING REMARKS

RCA members and other wireless carriers have played by the rules in obtaining ETC status and are now beginning to deliver on the promise that Congress made to rural America. Certain rural ILECs seek to cut short the process by urging quick changes that favor only them in a regulatory area that is more complex than almost any other in telecommunications. The Federal-State Joint Board is currently requesting comment on well over 100 issues relating to the universal service system.

We urge thoughtful consideration by regulators, industry leaders and other experts. RCA believes that another process similar to that conducted by the Rural Task Force should be instituted to achieve useful and productive recommendations that encompass both CETCs and ILECs, so that comprehensive and competitively neutral solutions are reached. Piecemeal decisions advocated by some ILECs will be disruptive to rural subscribers, or worse yet, deny them the benefits of competition that they deserve.

We do not come here today with all the answers. What we do know is that making it harder for competitive ETCs to be designated, imposing onerous monopoly-era regulations, and reducing support to competitors but not incumbents, all appear to be on the shopping list of certain ILECs. All are bad for rural consumers and we believe are contrary to Congressional and FCC directives that consumers be the focus of universal service policy decisions.

In our CETC service area, Verizon has both a monopoly on wireline facilities and in some neighboring areas, a 50% interest in a formidable wireless network, operating under the Verizon Wireless brand name. They have enormous capital resources, the highest credit rating, a national advertising budget, Section 271 authority to provide long distance services, and the ability to bundle wireline and wireless services to their existing and potential customers. In addition, we must compete with rural ILECs in our CETC area. Their monopoly wireline advantages are enormous. It is only the provision of high-cost support which begins to level the playing field, providing Highland Cellular an opportunity to construct a network that can challenge their lock on the market and more important, give rural West Virginia consumers the advantages of quality competitive wireless services enjoyed by their urban cousins. If they believe that we are capturing any significant market share, they can respond in the marketplace and I'm sure they will.

We request the understanding of this Subcommittee that high cost support to wireless carriers allows improvements to infrastructure. Better infrastructure is a key component to attracting small business and capital investment in rural communities. Business development provides jobs. Jobs promote economic stability. And economic growth provides quality of life for rural residents and helps keep young people interested in remaining in their communities. We urge the members of this Subcommittee to support the continuation of the current USF system

that allows wireless carriers to qualify for and draw high-cost support in a competitively neutral fashion and in a pro-competitive manner.

Testimony of Dr. Brian K. Staihr
Senior Regulatory Economist
Sprint Corporation

Hearing before the Subcommittee on Rural Enterprise, Agriculture, and Technology:

The Future of Rural Telecommunications: Is the Universal Service Fund Sustainable?

September 25, 2003

Sprint Corporation holds a unique position in the telecommunications industry. Sprint is both a wireless carrier and a wire-line carrier. It is both a long-distance carrier and a local carrier. And it is both a competitive carrier and an incumbent carrier. In addition to serving customers in cities and suburbs, Sprint is the incumbent local telephone company in some of the most rural regions in the United States: the plains of West Texas, the Florida Everglades, the farmlands of Western Nebraska, the coastal areas of Western North Carolina and many locations in between. As a result, Sprint remits approximately ½ billion dollars to the Federal Universal Service Fund annually *and* receives support from the fund in certain markets. Accordingly, Sprint, perhaps more so than any other telecom company operating today, understands what it means to balance competing interests when it comes to telecommunications policy, particularly with regard to universal service.

When Sprint examines its competing interests with regard to universal service, it arrives at the following conclusions regarding the sustainability of the federal universal service fund:

- Conclusion #1: Sustainability of the fund is most directly affected by who pays into the fund, and what those payments are based on; and by a determination of who can draw out of the fund, and what those payments support.
- Conclusion #2: The current mechanism for paying into the fund is broken and must be fixed.
- Conclusion #3: The federal universal service fund was designed to co-exist with competition. As the U.S. Court of Appeals for the 5th Circuit stated: *The FCC must see to it that both universal service and local competition are realized. One cannot be sacrificed in favor of the other.*
- Conclusion #4: Competitive neutrality is a necessary component of any proposed "fix" to the contribution mechanism of the federal universal service fund. Similarly, competitive neutrality must shape any proposed changes regarding who can draw out of the fund and for what services.

Contributions to the fund are currently based on end-user, interstate revenues. The problem with this approach is two-fold: First, interstate revenues in total are declining while the fund size is growing. A growing fund that is based on declining revenues translates to larger and larger assessments on end-users. Second, as technologies merge and lines are blurred between different types of carriers and services, it becomes more difficult to determine what revenues are truly "interstate" in nature.

One proposed solution is to expand the set of revenues on which contributions are based to include intrastate end-user revenues as well as interstate revenues. While this

approach has the desired effect of broadening the contribution base, it is a sub-optimal solution for several reasons:

— Revenues continue to be affected by price reductions. They do not provide stability in terms of a base for calculating contributions.

— Differences in revenues often simply reflect pricing differences. Two users who pay different per-minute prices pay different amounts in universal service support even if they consume the same number of minutes.

— Revenues are a poor proxy for usage.

— And revenues do not address preferential treatment for information service providers that currently benefit from the existence of the public switched telephone network but do not contribute to universal service.

A more optimal solution in terms of expanding the contribution base for the federal universal service fund would be to adopt a proposal currently before the FCC to base contributions on telephone numbers. Simply put, all customers contribute equally to the universal service fund based on their telephone numbers. This proposal is attractive on many different levels:

— It is administratively simple and easily understood by end-users.

— Telephone numbers create a broad, stable-but-growing base for contributions.

— Telephone numbers are technology-agnostic. Any service—wire-line, wireless, cable-based, Internet-protocol-based—that utilizes a number would have a basis upon which to calculate a contribution to the universal service fund.

— Adoption of a numbers-based methodology does not require additional legislation. The FCC currently has jurisdiction over telephone numbers.

— Most importantly, it is *competitively neutral* for the end-user. Consumers will see no difference in their universal service assessment between carriers, or between types of carriers, or between services or bundles of services. Essentially, it removes the universal service assessment from the customer's decision process and, in doing so, eliminates distortion from the market.

There have been certain criticisms leveled against using telephone numbers as a base for USF contributions. Claims have been made that it shifts much of the funding burden from one industry segment—long-distance carriers—to another industry segment, local exchange carriers. But this claim is without merit because the distinction between local and long-distance carriers is quickly dissolving: The nation's largest local exchange carriers offer long-distance service, and the nation's largest long-distance companies offer competitive local service.

Claims also have been made that a contribution mechanism based on telephone numbers unduly burdens low-income or low-usage customers. These claims are also inaccurate: Under the existing telephone-number proposal low-income customers are *exempt* from paying into the federal universal service fund.

In summary, in order to broaden the base of support for the federal universal service fund, contributions to the fund must be based on some measure other than end-user interstate revenues. A contribution mechanism based on telephone numbers is technologically neutral, administratively workable, end-user comprehensible and, most

importantly, competitively neutral. A contribution mechanism based on telephone numbers is an important first step in maintaining the sustainability of the federal universal service fund.

The second step to ensuring sustainability of the fund is to address the receiving side of the equation: Which carriers may receive dollars from the fund, and for which services? The issue is controversial—even contentious—because it lies at the heart of a difficult problem: How to encourage competition and support ubiquitous service simultaneously but keep the fund at a manageable size. The issue becomes particularly difficult when we consider the role of *wireless* carriers in rural regions, and their access to universal service.

Currently, wireless carriers receive support from the federal universal service fund when they meet the criteria for becoming an eligible telecommunications carrier, or ETC. If they provide service in high-cost areas, using their own networks, they receive support just as an incumbent wireline company does, and just as a competitive wireline company would. The FCC has, historically, been extremely clear that wireless carriers should be eligible for support. In fact, when the FCC established the serving areas that competitive ETCs must serve in order to receive federal support, the FCC specifically did so with wireless carriers in mind.

But because the size of the federal fund is growing, and because the contribution base is shrinking (as discussed above), there are parties who would prefer to limit the size of the fund and limit it in such a way that the result would in effect deny wireless carriers access to federal universal service support. For example:

The suggestion has been made to limit support to "primary" lines, in an attempt to control the overall size of the fund. (Currently, all lines provided by carriers that have been designated as ETCs – wireless as well as wireline – are supported by the fund.) While imposing a "primary line" limitation might indeed achieve the objective of controlling the size of the fund, it raises significant and troubling questions regarding administrative feasibility, technological impartiality, and most importantly, competitive neutrality:

- There is tremendous difficulty involved in determining exactly what constitutes a "primary" line. The 2000 Census identified more than 6.1 million non-family, two-or-more person households and an additional 5.1 million unmarried partner households in the U.S. If two co-habitants reside in a single home, and each has wire-line service, which line is the "primary" line? The question becomes even more difficult to answer when residents at a single address purchase service from multiple carriers, including wireless as well as wireline.
- It is highly debatable whether limiting support for primary lines is consistent with the intent of the 1996 Telecom Act. Section 254 (b) (3) of the Act refers to "consumers" having access to affordable service at comparable rates. To the extent that two consumers reside at a single location and have separate lines, if support is available only for a single (primary) line, one consumer would be forced to pay an unsupported rate.
- If support were limited to primary lines, incumbent and competitive providers currently receiving support for non-primary lines would suffer an immediate

revenue shortfall, and would (by necessity) require higher rates for non-primary lines.

- Most customers tend to think of their wireline service as their "primary" line, simply because it existed first. But the 1996 Act prohibits measures that effectively impose barriers to entry, including regulations that provide preference to a carrier just because it was there "first." If customers are required to designate which service is "primary" (their wireline or wireless service) it is likely that wireless providers will lose much needed support, in violation of the principle of competitive neutrality.

As an alternative approach to limiting the size of the fund, the suggestion has been made that support should only be distributed to incumbent, wireline providers. Again, while such a plan may limit the growth of the federal fund, the implications of such a plan for customer choices and competitive neutrality in rural areas are extremely troubling.

- No provider—including existing incumbent providers—is (or has been) expected to serve certain high-cost areas without explicit support. To limit support to only the incumbent essentially relegates rural residents to a monopoly environment forever.
- The FCC has stated explicitly that denying support to competitive carriers constitutes an unlawful barrier to entry.
- Furthermore, it would have the undesired effect of discouraging the efficiency and technological innovation that comes from a competitive marketplace. While such

a measure might protect the financial viability of incumbent wireline carriers, such assurance would come at the expense of the very customers they serve. Universal service support is intended to benefit rural *consumers,* not a particular group of carriers.

- In terms of competitive neutrality, such a proposal raises the question: If the incumbent wireline provider is not expected to serve the high-cost area without support, how could it be competitively neutral to expect other providers—including wireless providers—to serve the same high-cost area without support?

In summary, maintaining the fund at a manageable size, and limiting the growth of the fund, are reasonable objectives. But mechanisms must be implemented that achieve these objectives without compromising competitive neutrality and, most importantly, without denying rural residents the same benefits of competition and choice that their urban counterparts enjoy.

There <u>are</u> alternatives available to controlling the growth of the fund, alternatives that do not hinder competition, alternatives that do not deny rural residents the choices and technological advances that urban residents take for granted. But as of today these alternatives have not been investigated sufficiently. Instead of excluding entire portions of the industry from receiving support, as some would propose, we should investigate options such as capping federal support at study area levels, or state levels. Capping support is both competitively neutral and pro-competitive. It encourages firms to operate efficiently, and rewards the more-efficient provider in a market in exactly the same way

that competition does. It is administratively workable and technologically impartial. It is consistent with the intent of the 1996 Telecom Act and the FCC's history of technology-neutrality. It is a superior choice.

In conclusion, competition is not a threat to the sustainability of the federal universal service fund, nor is it a threat to service in rural areas. And competition—along with the choices it brings and the efficiencies it rewards—is no less desirable for rural residents than for urban residents. As stated above, the sustainability of the federal universal service fund is a two-part problem (the contributing side, the receiving side) that requires a two-part solution. The contribution side can be addressed by broadening the contribution base in the correct way, the competitively neutral way, by basing contributions on telephone numbers. The receiving side can be addressed by limiting fund growth in a competitively neutral manner such as capping study area totals. This approach is the superior approach because it does not eliminate customers' choices, it does not preclude entire classes of carriers, and it does not punish the rural consumer by removing the benefits of competition. In short, these competitively neutral solutions place the rural customer on a level playing field with urban and suburban residents. The people who live and work in rural America deserve no less.

Statement by Michael J. Balhoff, CFA
Legg Mason Wood Walker, Inc.

Before the

United States House of Representatives
Committee on Small Business
Subcommittee on Rural Enterprises, Agriculture and Technology Policy

In the Matter of
"The Future of Rural Telecommunications: Is the Universal Service Fund Sustainable?"

September 25, 2003

All relevant disclosures and certifications appear on page 10 of this report.

Chairman Graves, Ranking Member Ballance, members of the subcommittee, good afternoon, and thank you for the opportunity to address you concerning rural telephone issues and universal service funding concerns.

Curriculum vitae

I am Michael J. Balhoff of 1213 Shady Creek Road, Marriottsville, MD 21104. I head the Telecommunications Equity Research Group at Legg Mason, a Baltimore-based full-service investment firm. I cover equities in the incumbent local exchange carrier industry, including the regional Bell companies and rural telephone carriers. Our practice is most widely recognized for a focused coverage of rural telephone companies, and, to this point, we have sponsored the only annual investor conference dedicated to investments in rural telephone companies. We provide investment advice to a wide range of prominent institutional and private equity investors in addition to company managements, both across North America and Europe.

Besides publications on the regional Bell companies, I have authored major rural telephone reports, including *Harvesting New Values: Rural Local Exchange Industry* (Spring 1999); *Rural Local Exchange Carriers: New CLEC Initiatives* (Fall 1999); *Reshaping Rural Telephone Markets: Financial Perspectives on Integrating Acquired Access Lines* (Fall 2002); and *The RLEC Monitor.* I speak regularly on telecommunications issues, including rural telecom matters, at conferences sponsored by The United States Telecommunications Association, OPASTCO (Organization for the Promotion and Support of Small Telecommunications Companies), NTCA (the National Telecommunications Cooperative Association), and NARUC (the National Association of Regulatory Utility Commissioners.) I have also made presentations several times to state commissioners of the Regional Oversight Committee, comprised of the 13 state public utility commissions overseeing the long-distance relief process for Qwest, as well as at this year's Annual Regulatory Policy Conference on "Fiscal Fitness: The Financial Condition of the Utility Industries and the Role of Regulation," which is a forum for federal and state regulators and industry leaders. Most recently, I presented at a special three hour seminar session of House and Senate staffers related to rural issues and intercarrier compensation.

I have a doctorate and four master's degrees, including an M.B.A. from the University of Maryland, am a CFA charterholder and am a member of the Baltimore Security Analysts Society. I have been named on four occasions as a *Wall Street Journal* All-Star Analyst for my recommendations in the telecommunications industry.

Focus of Testimony on Problems in the Universal Service System

My understanding is that you wish to define the problems in today's Universal Service Fund (USF) system so that you can work toward constructive solutions. The investment community agrees with you that there are problems with today's systems, and I will attempt to outline those issues further. At the same time, I want to parse my commentary by saying that I can provide insight as an informed member of the financial community, but I do not have the background or the information to provide sufficient insight from the

vantage point of policymakers or engineers or regulatory experts. I see my charge today as offering a narrowed perspective on *how the investment community perceives the problems with a view to arriving at certain principles that might help in improving the solution set.*

The Investment Community

You might ask about which are the members of the financial community with whom we interact. We publish on telecommunications issues and visit frequently with large mutual funds, insurance companies, pension funds and banks. We therefore believe that we have an understanding of the concerns of equity and debt investors such as Fidelity Funds, Alliance, Putnam, CalPERS (California Public Employees' Retirement System), Capital Research, American Express, US Bancorp, Bank of America, Rural Telephone Finance Cooperative, and CoBank, among others. Organizations such as these generally account for about 60%–70% of the capitalization of the major rural telephone companies. We are also in regular dialogue with and provide insight to a broad range of more specialized professional investors or venture capital firms, including Welsh Carson Anderson & Stowe, The Carlyle Group, Fox Paine, The Quadrangle Group, and The Texas Pacific Group, among others. As a company, Legg Mason also interacts directly with individual investors through our retail brokers who are part of the Legg Mason retail system.

The Problems as Viewed by the Investment Community

In my view, the investment community perceives three problems related to universal service and telecommunications. The first problem is that the current contribution system appears to be overextended precariously. The second problem arises from the introduction of USF payments, beginning in 2001, to carriers other than the incumbent local telephone company. And the final issue is possibly the most complex and important from a financial point of view, and that is how the current system of intercarrier compensation—access charges and reciprocal compensation—might be reformed to better accommodate technology changes.

I will go through each of these issues briefly and then offer several financial principles that might help as you and other policymakers attempt to effect reforms.

Problem 1: The Current USF Contribution System is Increasingly Overextended

I believe that the problems with the current USF contribution system are reasonably well known. In summary, USF monies are collected from carriers such as long-distance companies and wireless service providers that generate interstate telecommunications revenues, consistent with the mandate in the Telecom Act's section 254. Those monies are then redistributed for the most part to other carriers or other parties (schools, libraries, health care institutions) that are deemed appropriate recipients because they operate in high cost regions.

The difficulty today is that quarterly interstate revenues that were once expanding year-over-year are now contracting over the year-ago periods. So, for example, the revenues against which the fund is drawn have gone from $20.5 billion in the first quarter of 2001

to $18.8 billion in the third quarter of 2003. At the same time, the size of the universal service fund has grown and is expanding for various reasons. In the current quarter, the contribution rate (calculated as the dollars needed to support USF demands divided by eligible interstate revenues) is now 9.5% compared with 5.9% in the first quarter of 2000. To be fair, the reforms of USF in 2001 caused the majority of that increase, but the effective contribution rate has risen from 8.8% in the third quarter of 2002 to its current level of 9.5% in the post-reform period, providing a better illustration of the organic growth in the fund requirements.

The major reform proposals involve broadening the contribution base from *interstate only* to include *intrastate and interstate* telecommunications revenues (which I believe would require Congressional action) or possibly to include some of the data revenues that are generated by cable television companies but are not part of the current assessment process. The political issue is whether to engage in a so-called "tax" of the Internet in this latter proposal. For the most part, I believe the fund contribution mechanisms can be reformed without jeopardizing the monies paid out to rural carriers, possibly depending on how some of the issues regarding the portability of USF are resolved, with the result that there is negligible financial harm to the small rural companies that currently receive USF payments. In my view, then, the key issues that must be resolved by policymakers are with respect to the contributors and not the recipients. If there is some concern on the part of the financial investor, it is about how policymakers resolve any perceived competitive disadvantage arising from a world in which some carriers are exempted from paying some or all USF monies, while the traditional payors continue to be obligated to make USF contributions.

Problem 2: Portable USF Needs More Attention

The second issue affecting USF today relates to non-incumbent carriers that are eligible for the first time to receive USF payments. This change was implemented in the USF reform included in the "Rural Task Force" Order of May 2001. The reform introduced "portable" USF payments based on (1) a state public utility commission determining that it was in the public interest that a non-incumbent carrier should be designated as an "eligible telecommunications carrier" (ETC), also known as a competitive ETC (CETC), (2) the payment of USF monies that mirrored the per-line payments made to the incumbent carrier in the interest of "competitive neutrality" and (3) a reduced set of obligations for the CETC compared with those imposed on the incumbent, with the reduced obligations based on the belief that "competition" is a valued outcome even if the obligations and financial characteristics are dissimilar.

Notably, the new practice has involved USF payments to many wireless carriers that are represented as being "competitors" to the incumbent carriers. I have seen some commentary even from the former members of the Rural Task Force, indicating that wireless carriers are not truly offering a "competitive" service since there is a different value proposition in wireless. This dispute is not for me to resolve, but I must note the apparent inconsistency in urban markets where regulators insist that there is insufficient residential competition since wireless services (nearly 150 million U.S. subscribers in

total) are not included as "competitors" and UNE-P is therefore justified by state and federal regulators. By contrast, wireless is deemed to be a competitive service eligible for USF payments in rural regions. I believe that there are regulatory consistencies that beg for reconciliation.

Turning back to the universal service problem, it is my view that the new CETC policy could be construed as a decoupling from financial reality, with the potential for troubling consequences. By way of background, my understanding is that the legacy universal service policy was established so that rural or other high-cost consumers should benefit from having services and rates comparable to those in urban regions. In high cost areas, the policy has been to provide support payments from other lower cost regions to moderate the difference in costs in rural and insular geographies. To paraphrase, the government has said that there is no business case for providing telecommunications services in certain regions at certain rates, but, through federal and state intervention, the government will provide for the difference to ensure ubiquitous telecommunications services.

Against the legacy backdrop, the new post-2001 policy implements payments to CETCs, effectively declaring that it is in the public interest to create multiple business cases in a way that some have named "synthetic competition." The criticism is that there is possibly not even a single business case (the original motive for the payment of USF), and new funding is being raised to support additional carriers, further burdening the payor into the USF. I may not fully appreciate the complexity of the public policy issues, but it seems that there was financial sense in the former system that tied USF to underlying costs (i.e., universal service as a cost-recovery mechanism), and that the separation of USF from costs by paying multiple carriers is an attempt to soar across a wide chasm and refashion what was a cost-recovery system into a system far-removed from costs.

There appear to be other issues for policymakers in resolving the CETC issues, including standardization of ETC approval processes across multiple states and the need for comparable obligations for recipients of USF, but these issues do not seem to have the same financial import as the issues I raised above and are therefore beyond my area of focus.

Problem 3: Intercarrier Compensation is the Most Complex Pending Reform

The third problem, in my opinion, arises from technology changes and how they affect the legacy access charges paid by long-distance companies to local companies for originating or terminating calls. I believe that this is the most important long-term problem from a financial point of view for various carriers, including rural telephone companies. At first, access charges do not appear to be related to universal service payments, but I believe that USF is one of the linchpins in resolving the intercarrier compensation question.

We can best explain the crisis by beginning with the Regional Bell operating companies (RBOCs) that have expressed an urgent need to change the intercarrier compensation system for access charges and, to a lesser extent, for reciprocal compensation. The

RBOCs are notably concerned about the traffic bypass that is increasingly occurring through IP services that are exempt from access charges. Their view, simply stated, is that competitive neutrality requires that the intercarrier regime be simplified, possibly through a "bill-and-keep" scheme whereby the consumer is billed for all of the services it receives and intercarrier charges are eliminated. The RBOCs do not want to be disadvantaged by an access regime that leaves them with a cost structure—because of regulation—that is higher than the costs of their competitors.

One of the problems in resolving intercarrier compensation is that bill-and-keep works poorly for the 1,300 U.S. rural carriers. The difficult issue for rural carriers (defined here as NECA pool rate-of-return carriers) is that their per-minute long-distance charges that are paid by the long-distance carriers to the local companies are approximately 2.2 cents compared with 0.55 cents per minute paid to the RBOCs by the long-distance carriers and 0.95 cents per minute paid to rural price cap LECs. And intrastate rates per minute often are even higher in rural regions. If additional access payments are shifted from the long-distance carriers to the consumer under a bill-and-keep approach, urban bills are likely to remain close to the current levels, but monthly rural rates are estimated to rise by $40 on average or as much $170 in certain extreme circumstances. Such increases in a bill-and-keep environment would prove untenable to the rural customer. Some industry players have therefore suggested that the policy dictum "comparable rates and comparable services" is the basis for shifting such excessive rates from the consumer to an increased USF fund.

This is the rub. We believe that, if regulators wrestle with the rapidly changing IP world and how it affects the legacy intercarrier compensation system, USF could very possibly again increase, possibly by 30%. Further, such a change in intercarrier compensation to increased USF would exacerbate the first two problems outlined above. First, the USF contribution method must be carefully and securely crafted to cope with potential increases, not simply to the current rate of increase, but also to a more dramatic change in intercarrier compensation. Second, the portable USF arrangement as currently construed could result in higher revenues in USF payments to CETCs that at the same time could benefit from lowered terminating obligations, making today's arbitrage even more extreme.

Financial Principles for the Reform of USF

I do not have good solutions for these problems, but I note that I am aware of industry players—RBOCs, long-distance carriers and rural telephone companies—that have begun to discuss resolutions of these complex and thorny problems. I think that these efforts probably are most constructive since the companies themselves understand subtleties that likely escape the financial community, the regulators and the legislators. Still, I will suggest some simple views from the vantage point of a financial institution—Legg Mason—that has been active in issues related to universal service. I have three principles that I consider important.

Financial sense is key to investment

I think that financial input is key, since capital flows at attractive prices are necessary in capital-intensive industries such as telecom. Parenthetically, I might note that policymakers occasionally dismiss the investment community or corporations in the reform process. In the extreme, some people view investors as self-serving, greedy, oppressive, willing to engage in fraud and opposed to public policy goals. In fact, good corporations, banks, financial analysts, venture capitalists and mutual funds are interested in serving the same public that you serve and want to do so in a constructive, honest and productive manner. And we believe we have something to add to the discussion since capital is critical in advancing the public interest today and in the future.

The problem we have in the financial community is that our job is to make money and we cannot commit capital if the rules are unpredictable or the system is in some ways biased. Further, if the regulatory system is distorted, the price of investment capital rises for companies, undercutting your goals. Our mutual funds, banks and pension plans are bound by laws as immutable as gravity—the value of stocks or bonds go up or they go down. Simply stated, investment realities need to be considered in reforms so that unreasonable arbitrage or disintermediation of funds is limited.

The message for you in the reform process is that the financial community should be considered as part of the process that involves long-term investment. If you set the wrong rules, we cannot participate or we will be compelled to charge higher rates. If you set good rules, we will dedicate capital.

Engage in as little regulation as possible

Investors generally assign a valuation discount to industries that are heavily regulated. This is the case for monopolies where investors perceive that the upside potential is capped or for utilities in which competition is being "artificially" introduced.

During the 1990s, for example, in spite of the monopoly status of the RBOCs, the equity values of the companies generally traded at a 10%–25% discount relative to the average valuation on the overall market. For the most part, the discount reflected limited upside compared with that generated by other investments.

In the wake of the Telecom Act, the discount on the RBOCs' securities has become pronounced for a multitude of reasons, including weak fundamentals, a shifting set of technologies, confusion over the strategic direction of the companies, and, I believe, the problems associated with regulatory policies that set deep discounting of RBOC plant. The best illustration of the valuation adjustments—rightly or wrongly—made by investors was the sharp drop (approximately 6%) in RBOC stock prices on February 20 when the FCC's Triennial Review Order was announced, but there are other examples.

Our opinion is that investors once attempted to choose the winners and the losers in light of shifting regulatory decisions. Not long ago, investors committed large amounts of capital to CLECs that benefited from reciprocal compensation revenues in the late 1990s (a regime that changed subsequently), to DSL standalone services based on favorable

collocation rules (that have evolved), and to long-distance companies that benefited from UNE-P discounts (that are in the process of changing). More recently, I believe that a fundamental investor shift has occurred in the wake of the collapse in the capital markets and notably in telecom securities, in 2000, 2001 and 2002. Investors have become more wary of business plans that are premised on, or affected by, regulatory artifices, believing now that much of regulation is ephemeral and less worthy of serious capital commitments. As a result, the vast majority of telecommunications stocks remains under pressure, including the stocks of those carriers that have benefited from some regulatory favor, *because investors are more inclined today to commit to real business plans and do not want to risk capital in an artificial environment.* Investors want reduced regulation that is rational and predictable.

Establish reforms on actual costs of the businesses
Investors do not believe that all regulation is onerous. In fact, most investors recognize the value of policy commitments, for example, in the case of rural telephone companies. I suggest that the rural and/or independent carriers such as Alltel, CenturyTel, Citizens, TDS, Commonwealth Telephone, SureWest, CT Communications and a host of small public and private carriers have performed relatively well in the capital markets since the beginning of 2000.

The reasons are several. First, investors see that the regions the rural carriers serve are high-cost and that policymakers have a well-proven system for evaluating costs and providing support payments. In this case, the artificial aspects are understandable and predictable. A second reason is that the regulatory environment is judged to be constructive as state and federal public utility commissions have worked with the rural carriers to find solutions rather than attempt to destabilize their operating environments. Third, the theory of a high-cost region in the minds of investors translates into a more predictable environment from a competitive point of view.

The concerns about CETCs and about intercarrier compensation, however, are growing to be more important. Investors are increasingly asking about whether the regulators have wrestled with the underlying realities about universal service and competition. In 2001, the National Regulatory Research Institute (NRRI), which serves as the research arm of the National Association of Regulatory Utility Commissioners (NARUC), published a document titled *Balancing Competition and Universal Service: The Role of the Regulator Five Years After the Telecommunications Act.* That document suggested that there is an inherent contradiction between the Telecom Act's goals of competition and universal service in high-cost regions. The document proposes an alternating or phased approach between "the conflicting goals of the Act" so that universal services are constrained to essential programs and there are curbs on expanding the definition of universal service (see pages 42-44) while incenting competition in other services. While we may dispute various insights in that paper, we can agree with key premises, including (1) universal service has been remarkably effective to this point, and (2) expansion of the definitions of universal service can bring complex and unintended consequences.

Our strong opinion is that the capital markets will commit to support of businesses where the costs are understood and the policy is clear. If there is a decoupling of the cost analysis or if there are arbitrages introduced into the marketplace, the capital markets will require a higher return (higher-cost of capital) to participate. We suggest that regulators and legislators should well understand their goals for universal service and the risks associated with altering the system. We believe, in short, that it is dangerous to create systems that are not well founded on costs and that create distortions in the fundamental business case and the incentives for capital deployment.

Conclusion

I thank you for the opportunity to make this presentation to your subcommittee. My summary observations are that there are three key problems arising from the universal service system: (1) the mechanisms for collecting USF monies must be reformed, (2) the CETC question must be carefully examined and founded on more defensible cost analyses, and (3) the intercarrier compensation system is in need of an industry reform. My suggestion is that the financial dynamics be carefully considered so that the reforms allow for appropriate incentives to invest in a stable set of businesses that are minimally based on regulatory interventions. Thank you for your time.

Important Disclosures and Certifications

I, Michael J. Balhoff, CFA certify that the views expressed in this research report accurately reflect my personal views about the subject securities or issuers; and I, Michael J. Balhoff, CFA, certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation or views contained in this research report.

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Testimony of Glenn H. Brown before the
United States House of Representatives
Committee on Small Business
Subcommittee on Rural Enterprise, Agriculture and Technology
September 25, 2003

Introduction

Chairman Graves, Ranking Member Ballance and Members of the Subcommittee, my name is Glenn Brown, and I am President of McLean & Brown, a telecommunications research and consulting firm specializing in universal service and rural telephony issues. I want to commend you for convening this hearing on this critically important topic, and I greatly appreciate your invitation to testify today.

The title of this hearing is *The Future of Rural Telecommunications: Is the Universal Service Fund Sustainable?* As I will detail in the remainder of my testimony, I believe that unless fundamental changes are made in the way the Universal Service Fund is administered, the fund as we currently know it will not be sustainable, and the ultimate losers will be the consumers and small businesses in rural America.

In January of 2002, McLean & Brown published a white paper titled *The Coming Train Wreck in Universal Service Funding: Why is it coming – and how do we avoid it?*[1] In this paper we outlined several disturbing trends that were occurring with universal service, including significant growth in the size of the fund at the same time that the ability to collect the necessary funding was under stress. Since then, the problems identified in the paper, and in particular the way in which competitive carriers have been granted Eligible Telecommunications Carrier (ETC) status for receipt of high-cost funding, have combined to bring the situation to a point where immediate action is necessary. In too many cases ETC status is being granted by state and federal regulators with a less-than-thorough consideration of the public interest impact, and in many cases, carriers are receiving scarce high-cost dollars for serving primarily low-cost customers. The public interest test must be more carefully focused to include a clearer definition of the public goals and objectives that are to be achieved through universal service funding, and a reasonable evaluation of the public costs and public benefits that will result from such funding. The current regime results in significant waste of scarce public resources, and threatens the viability of affordable and advancing service in the most remote and high-cost regions of the nation. Immediate action to address these problems is needed.

Most of the actions necessary to address these problems ultimately need to be carried out by regulators at the state and federal level. Proceedings are currently underway before the Federal-State Joint Board on Universal Service that have the potential to significantly improve the management of the universal service process. As the architects of the Telecommunications Act of 1996, it is important that Congress clearly reaffirm its intent regarding the goals and objectives of the universal service funding program, and in at

[1] Copies of this and other McLean & Brown white papers on Universal Service can be found on the M&B web site at www.mcleanbrown.com.

least one instance, clarify the intent of the Act to assure continued and sustainable funding for affordable and advancing service in the most remote, high-cost regions of the nation. In this testimony I recommend four specific actions:

1. The public interest test for ETC designation must entail clearly defined public goals and objectives, and include a reasonable balancing of public benefits and public costs.
2. Recipients of public funds must have public accountability for how that money is spent.
3. Support for ETCs should be based on their reasonable cost for achieving the defined public goals.
4. Congress must act to broaden the base of universal service funding to include both state and interstate revenues, as well as all services that benefit from the ubiquitous telecom network, including broadband and Voice over Internet Protocol (VoIP) services.

Background

In the early days of the telephone, the Bell System built its networks in the more heavily populated urban and suburban areas of the country, but bypassed remote rural areas where subscriber density was low and costs were high. Rural telephone companies evolved to meet the needs of consumers in these higher-cost areas. Many of these companies were cooperatives, started and owned by their customers. Later, REA financing, support from nationwide long distance revenue pooling, and the investment of private capital allowed customers in rural areas to enjoy affordable and advancing telecommunications services from rural telephone companies. Following the Bell System divestiture in 1984, the toll pools were replaced with access charges and a system of explicit Universal Service Funds (USF). Today, rural telephone companies rely on USF to cover their costs for serving the remote, high-cost areas at affordable rates. Significantly, rural telephone companies only receive high-cost funding *after* they have made the investment to serve high-cost rural customers.

In introducing competition into local telecom markets, Congress was mindful that a total reliance on competitive forces would harm consumers in the most remote and high-cost areas of the nation. The Telecommunications Act thus struck a fine balance between the twin goals of Competition and Universal Service. Perhaps nowhere has that balance been tested more than in the current debate over the provision of Universal Service support to competitive telecommunications providers.

The language governing the provision of universal service support to competing carriers is found in Section 214(e) of the Act. Section 214(e)(1) states that, to be eligible for ETC status, a carrier must offer the defined universal service elements (the FCC rules currently define nine elements) throughout the service area for which the designation is received, and advertise the availability of such services in media of general distribution. Section 214(e)(2) states that the Commission *may*, for rural telephone companies, and *shall* for non-rural companies, designate more than one ETC (emphasis added). It further states that, "before designating an additional [ETC] for an area served by a rural telephone

company, the State commission shall find that the designation is in the public interest." If congress had intended that multiple ETCs be funded in all rural areas, then this additional language and public interest test surely would not have been necessary. Yet today we find regulators at the federal and state levels routinely approving competitive ETC requests in even the most rural areas. Usually this is done in the name of advancing competition.

The "Competition" Issue

The debate over providing universal service funding to multiple ETCs often gets miscast as a question of "Whether there should be *competition* in rural telephone company areas?" Stating the question this way confuses the issue because there already *is* significant telecommunications competition throughout rural America today. Rural consumers have a choice of wireline, wireless, and often cable service providers of telecom services. Wireless providers, in particular, have built networks in cities and towns and along major highways throughout rural America without universal service support. Indeed, in its recently released 8th Annual Report on CMRS Competition, the FCC concludes that there is effective competition in rural areas, that rural counties on average have 3.3 mobile competitors, and that the average price for mobile service in rural areas appears to be very similar to that in urban areas.[2]

Wireless carriers have built their networks in towns and along major highways because those are the areas where customer concentration is high, and their costs are low. Where mobile service is not always available is in the "hinterlands" between population clusters and away from heavily traveled thoroughfares. In these remote areas customer density is low and cost are high, both for wireline and wireless network providers. An efficient universal service regime would support the development and construction of new facilities and services in unserved and under-served areas, if and when such expenditure of public funds would serve the public interest. Unfortunately, as I will discuss in the next section, one of the problems with the current system is that competing ETCs are receiving "high-cost" support even if they do nothing more than continue to serve only the lower-cost areas they currently serve. This does little to advance the cause of competition, and represents a significant drain on a critically important national resource.

There is also a reasonable question whether wireline and wireless services are indeed competitive services or if the are more likely complimentary services. In testimony before the United States Senate earlier this year, Dr. William R. Gillis, Director of the Center to Bridge the Digital Divide at Washington State University, and former Chairman of the Rural Task Force stated:

> [I] would observe mobile wireless and traditional telecommunications are not for the most part competing services and have been inappropriately characterized as such. With the exception of those cases where mobile wireless has resulted in the ability of customers to eliminate their traditional telecommunications connection,

[2] Eighth Report in WT Docket No. 02-379, Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993, Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services, Released July 14, 2003 at paragraphs 13, 113, and 118.

> we are discussing complementary services, both desired by consumers for different reasons.

In addition to often serving different consumer needs, wireline and wireless service differ in other significant ways. Wireless service provides the advantage of mobility, and generally offers a larger toll-free calling area.[3] Wireline service has the advantages of high-speed data applications, is available over wider service areas, and may be better able to survive disaster situations. The two services also use different technology, and have significantly different cost drivers.

Problems With the Current System

The "Public Interest" Test

While the Act is specific that funding a second ETC in the service area of a rural telephone company requires a public interest finding, it is not clear on how that public interest test should be applied. In many regulatory decisions at both the state and federal level, the logic for granting an ETC application has gone something like this – 1) Competition is in the public interest, 2) Approval of ETC status will advance competition, therefore 3) ETC status is in the public interest. Missing in most of the decisions made thus far is any analysis of the public benefits that a specific ETC designation will bring (beyond the most generic platitudes regarding the benefits of "competition"), or any consideration of the often considerable costs that will be created through increased public assessments. Many ETC decisions have approved wireless ETCs for a service area smaller than the incumbent's study area, and there is generally no requirement to build out to serve the entire service area for which ETC status has been granted. Earlier I mentioned that wireline incumbents must first incur the cost of building into the remote areas before they qualify for high-cost support. Under the current liberal service area rules and the fact that competitive ETCs receive the same per-line support as the incumbent (see next section), they receive high-cost support *as if* they were serving these high-cost areas even if they never venture beyond their current lower-cost areas.

In a speech earlier this year, FCC Commissioner Jonathan Adelstein summed up the need for a more rigorous public interest standard rather well:

> I'm encouraging state commissioners to carefully consider the public interest when making their eligibility determinations, as is required by the Act. Specifically, states must make sure that the new market entrants receiving universal service meet all the obligations required by the Act. These include providing service throughout the service area and advertising its availability. They also need to consider whether the new service proposed is an enhancement or an upgrade to already existing or currently available service. Another consideration is the effect it will have on the cost of providing service. As the fund grows, so does the level of contribution. We must ensure that the benefits

[3] The ability of wireless carriers to offer wider toll-free calling areas is more a result of legacy regulatory constraints on incumbent wireline carriers than on any technical advantage of wireless technology.

> that come from increasing the number of carriers we fund outweigh the burden of increasing contributions for consumers.[4]

As it has become apparent that the "competition is in the public interest" argument is working, the body of wireless carriers requesting ETC status and USF funding has grown from a handful of small regional carriers to now include larger providers such as Alltel Nextel and Sprint. In their recent filing with the FCC for approval for ETC status in rural areas of the state of New York Nextel explained why approving this request was in the public interest by stating:

> [d]esignation of competitive ETCs promotes competition and benefits consumers in rural and high-cost areas by ...provid[ing] a valuable alternative to the existing telecommunications regime in these areas. In addition, designation...will provide an incentive to the incumbent LECs in designated areas to improve their existing networks in order to remain competitive, resulting in improved service to consumers.[5]

We are also beginning to see that when one carrier receives ETC status in an area, other wireless competitors in that market come in with similar "me too" applications for ETC status and funding. I am personally aware of a number of managers of small telephone companies with both wireline and wireless operations who believe that liberal wireless ETC funding is wrong, but have reluctantly come to the conclusion that with their wireless competitors applying for and receiving ETC status, that they too must apply. A wireless carrier would be failing in its fiduciary responsibilities to its owners if it fails to apply for federal funding that appears to be so readily available. If all wireless carriers nationwide were to receive ETC status, then the demands on the current universal service fund would increase by over $2 billion per year.[6] This would push the current funding mechanisms over the brink, and would harm rather than enhance the public interest.

Support Based on Wireline Incumbent's Cost

Under current FCC rules, when a competitive provider receives ETC status they receive the same per-line support as the wireline incumbent. This can make for some odd situations that often provide windfall support, particularly when the competitive ETC uses a different technology, or doesn't have the same service obligations as the wireline incumbent. Among other differences, the ILEC has Carrier of Last Resort (COLR) responsibility, and is required to provide equal access to all long distance carriers. Wireless carriers have no COLR responsibilities, and have actively fought requirements to provide equal access. Wireline networks can usually carry much faster data speeds, and are usually designed to be more resilient in disaster situations. All of this adds cost to the wireline provider that wireless networks may not have.

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[4] Remarks of Commissioner Jonathan Adelstein before the National Telephone Cooperative Association February 3, 2003.

[5] Petition of NPCR, Inc. d/b/a Nextel Partners for Designation as an Eligible Telecommunications Carrier in the State of New York (filed April 3, 2003), p. 6-7

[6] This estimate was first reported in the M&B white paper *One Year Later, One Year Closer – The Coming Train Wreck in Universal Service Funding, released January 18, 2003. Updating this estimate with data from the 8th Report on CMRS Competition and 4Q03 funding levels the current number would be $2.4B.*

Rural wireline carriers often have high costs both because of the nature of the territory that they serve, as well as smaller scale of their operations. Wireless carriers usually serve throughout the state, and often throughout the region or the nation, and thus their scale of operations is generally much larger. An example of the kind of anomaly that this can cause is found in the application of the Local Switching Support (LSS) mechanism. LSS is available to ILECs with 50,000 lines or less, to account for the higher cost of maintaining smaller switches in remote rural areas. Wireless carriers do not deploy switches into the remote areas and generally switch calls through large, centrally located switches. Thus it makes no sense for them to receive LSS support, yet under the current equal-per-line support rules they do.

Another anomaly under the current support rules comes from the fact that support is provided on a "per-line" basis. In a wireline network a "line" from the central office to the customer's premise is a readily identifiable commodity, and a large portion of a rural ILEC's cost is represented by these lines. There is no direct equivalent of a "line" in the wireless network. Most of the costs of a wireless network are in its towers and related equipment. For purposes of USF funding, however, wireless carriers report the number of wireless handsets with billing addresses in each wireline carrier's serving area. One possible way in which the fund could be "gamed" would be to seek out areas where the per-line support is high ($50 to $100 per line per month or higher is not unusual in the more rural parts of the country) and provide each subscriber with multiple handsets to use with their contracted "bucket" of minutes. This would not significantly increase the wireless carriers costs, however it could significantly increase its draw from the fund as each handset would qualify for additional "per-line" support.

Another problem with the equal-per-line support rules, particularly when the competing carrier employs a different technology, is the impact that is has had on carrier decisions regarding disaggregation of support. The Joint Board recommended and the FCC approved plans that would allow ILECs to disaggregate their support into up to two support zones per wire center based upon the relative cost of serving the different zones. The problem is that what might be a high-cost customer for a wireline carrier might be a low-cost customer for a wireless carrier. I am aware of a number of situations where an ILEC had customers located at long distances from their switching location (making them high-cost for the ILEC) but in close proximity to an interstate highway (and therefore wireless towers, making them low-cost for the wireless carrier). This disparity would have provided an unwarranted windfall to the wireless provider which made no sense. As a result, many ILECs decided not to disaggregate their support, at least until more rational portability rules were developed.

Finally, perhaps the most serious problem with equal per-line support is that it eliminates much of the incentive for carriers to invest to expand their networks into sparsely populated, high-cost areas. Unlike the incumbent wireline carrier that has to actually invest to get its high-cost support, a wireless ETC gets "high-cost" support from day-one for all of its existing lower-cost customers.

Some Areas may not be Able to Support Multiple Funded Competitors
Perhaps the best commentary on the problems with funding multiple carriers in a sparsely populated area was made by Commissioner Kevin Martin:

> "I also note that I have some concerns with the Commission's policy – adopted long before this Order – of using universal service support as a means of creating "competition" in high cost areas. I am hesitant to subsidize multiple competitors to serve areas in which 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."[7]

The economic phenomenon identified by Commissioner Martin applies to both wireline and wireless networks, as both have a high concentration of fixed costs, costs that are incurred regardless of the number of customers in a given area, in their networks. In a wireline network the fixed costs are the poles, trenches, and switches. In the wireless network the major fixed costs are in the towers and associated radio and transmission equipment. While the cost of installing and equipping the tower is largely fixed, the cost per-customer is determined by the number of subscribers within the radio "footprint" of that tower. In sparsely populated areas the cost per customer is high, and in more densely populated areas the cost per customer is lower. When two or more wireless carriers compete in the same area, the number of subscribers each carrier serves within their respective footprints is necessarily smaller, and thus their effective cost per subscriber is larger. In densely populated areas this phenomenon is not a problem, as there are sufficient numbers of potential customers so that multiple carriers can each have an economically viable business. In sparsely populated areas, however, there may not be sufficient customer density to allow multiple carriers to be economically viable without dramatically increasing the amount of support provided to each competitor. This leads to the situation described by Commissioner Martin of inefficient investment and a ballooning USF. A similar phenomenon exists for wireline networks, with per-subscriber costs increasing dramatically as subscriber density decreases in the more sparsely populated areas.[8]

Stress on Funding Resources
Under current rules, the funds necessary to pay USF recipients are collected through an assessment on interstate end-user revenues. Currently, this assessment level is over 9%, and is growing, as demands on the fund increase while the level of interstate end-user revenues is actually decreasing.[9] This is a trend that cannot continue too much longer.

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[7] 2nd R&O and FNPRM in CC Docket No. 00-256, 15th R&O in CC Docket No. 96-45, and R&O in CC Docket Nos. 98-77 and 98-166, Released November 8, 2001, *Separate Statement of Commissioner Kevin J. Martin.*

[8] For a more complete discussion of the impacts of supporting multiple ETCs in sparsely populated areas please see the M&B white paper *Universal Service Portability – Getting it Right, released June 25, 2002.*

[9] Much of the recent growth in the high-cost fund has been due to shifting costs that were previously recovered through access charges to long distance carries to the universal service fund. This does not

The current universal service fund totals $6.2 billion, made up of High-Cost ($3,258 million), Schools and Libraries ($2,168 million), Low Income ($728 million) and Rural Health Care ($26 million). If the demands on the fund grow to the point where the current funding sources are not sustainable, then it is likely that funding to all USF recipients would need to be scaled back. This could be particularly harmful to rural telephone companies serving the most remote high cost areas, and to their customers.

Several potential solutions are currently being considered, including broadening the assessment base to include both state and interstate revenues, and changing the collection methodology to assess a flat fee for each connection to the network. As difficult as solving the Universal Service problem is, it will be far easier if there are sufficient resources to pay for USF programs that serve the public interest. It is important that all users who benefit from the ubiquitous telecommunications infrastructure contribute to funding its support. This includes broadband and VoIP services. While it is true that VoIP providers do not use the public switched network to originate calls, their services would be worthless were it not for the ability to terminate calls to all telephones nationwide. Those who benefit from this ubiquitous infrastructure have a duty to contribute to its preservation.

What Should be Done?

Following are four specific recommendations of changes that could greatly improve the current Universal Service process.

1. Focus the Public Interest Standard

The public interest test, necessary before funding for multiple ETCs in a rural area, should be more precisely defined to include a clearer definition of the public goals that are to be achieved through such funding, and a reasonable evaluation of the public costs and public benefits that will result from such funding.

Much of the problem in the current system comes from placing emphasis on an amorphous concept of "competition", rather than focusing on more concrete public goals and objectives that could be furthered by funding multiple network providers. The current universal service system had its genesis in a desire to develop a ubiquitous, high-quality wireline infrastructure, and in this regard it has been largely successful. It may well be that an equally valid public goal is to develop a ubiquitous wireless infrastructure. If this is the case, then policy makers could evaluate alternative ways to achieve wireless ubiquity, and determine the most cost-effective way to achieve this goal.

It is highly likely that, in this context, the most effective way to achieve wireless ubiquity will not be to provide an average of 3.3 wireless carriers with identical per-line funding to the wireline incumbent for all of their existing customers, and hope that this will encourage them to construct new facilities in sparsely populated areas that currently lack adequate wireless coverage. The competitive marketplace should deliver service as far as is economically reasonable without support. Policy makers can then identify areas that

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change the revenue flow of the wireline incumbent, but does increase the amount of funding potentially portable to competitive ETCs.

lack coverage and develop plans and programs to encourage wireless carriers to serve these areas. Wireless carriers would then apply for ETC status, and the right to receive public funding to accomplish the defined objectives.

2. Increase Accountability

When a carrier accepts public money to construct their network, it takes on a responsibility to the public to account for how that money is spent, and the services that it provides to the public. The Organization for the Promotion and Advancement of Small Telephone Companies (OPASTCO) has prepared a white paper titled *Universal Service in Rural America: A Congressional Mandate at Risk*, that contains a number of specific recommendations that will assure that recipients of public funding are accountable for its use. I was a member of the team that prepared this paper, and would recommend that the principles contained in that paper form the basis for the universal service administration process.

3. Support Based on Cost

Universal Service support for any carrier should be based on its reasonable cost for accomplishing the defined policy objectives. Incumbent wireline carriers have a choice from among two methodologies for the receipt of their support. They can either use an "average schedule" support methodology where a pre-approved formula is applied to the characteristics and metrics of their network, or they can submit their actual cost for use in computing their support requirements. Wireless carriers could be offered a similar choice. An "average schedule" could be developed based upon factors that influence the cost of a wireless network, such as population density. Carriers could also have the option of submitting their actual costs for accomplishing the defined policy goals.

4. Broaden the Funding Base

As difficult as solving the universal service problems will be, it will be far easier if policy makers have adequate funding resources to meet the defined policy goals. Congress should take actions to clarify that universal service funding should be obtained on an equitable and non-discriminatory basis from both state and interstate end user revenues. States should also be given the opportunity to utilize both state and interstate revenues as a funding base for any additional universal service programs that they may develop. The funding base should include all service providers who benefit from the ubiquitous telecommunications infrastructure, including broadband and VoIP providers.

Thank you again, Mr. Chairman, for the opportunity to provide this testimony, and I look forward to questions from the Committee.

Testimony of Glenn H. Brown
September 25, 2003

Curriculum Vitae
Glenn H. Brown

Education

BS – Engineering, Lehigh University, Bethlehem, PA
MBA – University of Colorado, Boulder, CO

Professional Experience

1998 – Present	President, McLean & Brown, Chandler AZ
1993 – 1998	Executive Director – Public Policy, US West, Washington, DC
1987 – 1993	Executive Director – Regulatory Operations, US West, Denver, CO
1985 – 1987	Assistant Vice President – Marketing, US West, Denver, CO
1971 – 1985	Mountain Bell, Denver, CO (various management positions)

Major Publications

The Intercarrier Compensation Debate: Bill & Keep – Bad for Universal Service and Rural America, July, 2003

One Year Later – One Year Closer – The Coming Train Wreck in Universal Service, January, 2003

USF Portability – Getting it Right, June, 2002

The Coming Train Wreck in Universal Service Funding – Why is it coming, and how do we avoid it?, January, 2002

America's Digital Divide – Not Available in All Locations, February, 1999

Rule XI, clause 2(g)(4) Disclosure

McLean & Brown has not received any federal grant, contract or subcontract in the current year or in the two proceeding years.

Testimony of
Billy Jack Gregg
Director, Consumer Advocate Division
Public Service Commission of West Virginia

Before the
Rural Enterprise, Agriculture and Technology Subcommittee
House Committee on Small Business
September 25, 2003

"The Future of Rural Telecommunications: Is the Universal Service Fund Sustainable?"

My name is Billy Jack Gregg and I am the Director of the West Virginia Consumer Advocate Division. My office is charged with the responsibility of representing West Virginia utility ratepayers in state and federal proceedings which may affect rates for electricity, gas, telephone and water service. My office is also a member of the National Association of State Utility Consumer Advocates (NASUCA), an organization of 43 state utility consumer advocate offices from 41 states and the District of Columbia, charged by their respective state statutes with representing utility consumers before state and federal utility commissions and before state and federal courts.[1] I am a former member of the Board of Directors of the Universal Service Administrative Company (USAC) and currently serve on the Federal-State Joint Board on Universal Service. I greatly appreciate the opportunity to testify at this

[1] In most respects, my testimony reflects the positions taken by NASUCA, although there are some areas where NASUCA has not yet reached a consensus position.

legislative hearing on the sustainability of the Federal Universal Service Fund (USF).

I. Background

The most important issue facing the Federal Universal Service Fund is its long-term sustainability. We must ensure that the USF is sufficient, predictable and affordable for all parties involved: fund recipients, telecommunications providers and consumers. Before I address the current problems facing the USF, I believe it is appropriate to review the achievements of the USF since the passage of the Telecommunications Act of 1996 (the Act).

Section 254 of the Act enshrined and expanded universal service principles which had been followed by the Federal Communications Commission for decades. Based upon the requirements of Section 254, the FCC, after consultation with the Federal-State Joint Board on Universal Service, created a new Universal Service Fund in 1997 containing several distinct support mechanisms. As a result, total USF funding has grown from $1.8 billion in 1997 to $6.2 billion during 2003. While these support amounts are large, they must be kept in perspective. Total telecommunications revenues in the United States last year were in excess of $230 billion. By annually collecting and redistributing less than 3% of these total revenues, we are able to make phone service affordable in all high-cost areas of the nation; support low-income customers; assist rural health care providers; and connect all classrooms to the internet. Moreover, all states and territories benefit

from the USF as shown on **Attachments 1 and 2.**[2] That's quite an accomplishment, and one that everyone involved in the USF should be proud of as we move forward to ensure the long-term sustainability of the fund.

II. The Funding Base

As I mentioned earlier, total funding for the USF has grown from $1.8 billion to $6.2 billion. Unfortunately, the funding base for the USF has not kept pace with the growth in the fund, resulting in higher and higher USF assessments on carriers and their customers.

The contribution base problem stems in large part from the wording of the Act itself. Section 254(b)(4) states that: "All providers of telecommunications services should make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service." However, Section 254(d) states: "Every telecommunications carrier that provides interstate telecommunications services shall contribute on an equitable and non-discriminatory basis, to the specific, predictable, and sufficient mechanisms established by the Commission to preserve and advance universal service." In other words, even though the principle set forth in the Act is that all telecommunications providers should contribute to the fund, and even though the fund benefits all areas of the country, Section 254(d) limits the obligation to

[2] Attachments 1 and 2 show actual disbursements to states during 2002 under each of the federal USF support mechanisms. Attachment 1 ranks the states based on total support received. Attachment 2 considers the number of access lines in each state, and ranks the

support the fund to a subset of telecommunications carriers - providers of interstate telecommunications services.[3]

In 1997 the FCC decided to base the funding for the high-cost and low-income support mechanisms on each carrier's interstate and international revenue, while the funding for schools and libraries and rural health support mechanisms were supported by assessments on all revenues, interstate and intrastate. The use of intrastate revenues for USF assessment purposes was struck down by the Fifth Circuit Court of Appeals in 1999.[4] Since that time the contribution base for the USF has been limited to only interstate and international revenues. As the USF has grown in order to meet the Act's direction that support be sufficient and explicit, and as the interstate revenue base has leveled off, the assessment rate has increased rapidly.

Attachment 3 shows the change in USF funding since 1997, along with changes in the interstate revenue contribution base for the USF.[5] As you can see, the introduction of the schools and libraries fund and increases in the high-cost fund have driven the overall size of the fund. As a result, the fund has tripled, rising from approximately $1.8 billion in 1997 to approximately $6.2 billion this

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states based on monthly support received per line.

[3] As a practical matter, virtually all telecommunications carriers provide some sort of interstate service.

[4] Texas Office of Public Utility Counsel v. FCC, 183 F.3d 393 (5th Cir. 1999) at 448.

[5] Through 2002 the interstate revenue base for a particular year represents revenues reported from the previous year. The USF assessment rate shown on Attachment 3 is not the actual rate used in any quarter, but is derived by dividing annual funding by the annual interstate revenue base. The interstate revenue base for years 1998 - 2003 comes from USAC reports. The interstate revenue base for 1997 is estimated. Beginning in the second quarter of 2003, assessments are based on projected collected revenues.

year. So long as interstate revenues grew at a reasonable rate, the ultimate impact of fund growth on the USF assessment rate and customers' bills was fairly moderate. However, beginning in 2000 interstate revenue growth began to flatten out, and during 2002 started to decline. The result has been a steep escalation in the assessment rate, from 5.7% in the fourth quarter of 2000 to 9.5% in the third quarter of 2003.[6] A universal service fund which cannot depend on the stability of its funding base is not predictable, is not sufficient, and is clearly not sustainable.

III. Alternatives for the Contribution Base

There are several alternatives available in order to stabilize the USF contribution base. One alternative would be to retain the current system, but remove restrictions in current rules which artificially depress the existing interstate revenue contribution base. One such restriction is the so-called "safe harbors" which limit the contribution responsibility of certain classes of carriers. Beginning in the second quarter of 2003, the FCC raised the safe harbor for wireless carriers from 15% to 28.5%.[7] However, in spite of these changes the interstate revenue base continues to decline.

Another restriction limits the contributions from broadband providers, one of the fastest growing areas of telecommunications. Under current rules,

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[6] These increases have been flowed through to most customers by means of line items. Beginning in the second quarter of 2003, carriers can no longer mark up these assessments, but can only flow through the assessment rate approved by the Commission.

[7] Under the "safe harbor" provisions, a wireless carrier can claim that 28.5% of its total revenues are interstate without further documentation. A wireless carrier claiming a smaller percentage of interstate revenues must have adequate documentation to back up such a claim.

providers of broadband by means of digital subscriber line (DSL) service must contribute to the fund, while cable modem service providers are exempt. It is obvious that such an inequitable and artificial system of assessment on similar services cannot be maintained. However, proposals to eliminate the inequity by eliminating contributions from DSL providers would only further shrink the interstate contribution base.

A second alternative would be to grant the FCC the authority to base contributions to the fund on total telecommunications revenues. While growth in the interstate revenue base has flattened out and begun to decline, total telecommunications revenues from end-users have continued to grow at a healthy pace. Shown on **Attachment 4** is a comparison of changes in the universal service fund, the interstate revenue base, and total telecommunications revenues from 1997 to 2003.[8] As you can see, total telecommunications revenues would provide an adequate funding base for the USF. In fact, if total telecommunications revenues had been used as the funding base from the start, we would not be discussing this issue today. The growth in the fund could have been accommodated while keeping the assessment rate below 3%.

Use of total revenues would also eliminate disputes about whether revenues are intrastate or interstate, and would equitably spread the obligation to support universal service to all providers and to all customers based on their use of the

[8]On Attachment 4 USF Funding and the Interstate Revenue Base are taken from USAC reports. The Total Revenue Base is taken from the FCC's Telecommunications Industry Revenues reports. The funding base for 1997 is estimated. Beginning in the second quarter of 2003, the USF funding base has been based on carriers' projected revenue collections.

network. However, basing federal universal service on total revenues would require a statutory change to clarify that the FCC has the authority to base contributions on all revenues, intrastate as well as interstate.[9] In addition, a total revenues base could be susceptible to erosion in the future as more and more traffic, including voice traffic, migrates to the internet and is classified as "information services," currently exempt from USF assessment.[10] Finally, the impact of the use of total revenues on state universal service programs is unclear.

A third alternative would be to base assessments on connections to the public switched telephone network, or on assigned telephone numbers. The FCC is currently considering several such proposals. While these connection-based or numbers-based proposals do enlarge the base of the USF, and minimize problems with classification of services or revenues as information services, they do have several flaws: (1) each proposal radically shifts the funding of the USF among industry groups; (2) each proposal appears to exempt pure providers of interstate long distance from making any contribution to the fund in contravention of the plain wording of Section 254(d); (3) each proposal requires capacity-based connection equivalents for high-capacity customers; and (4) each proposal shifts

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[9] On May 19, 2003, the members of the Federal-State Joint Board on Universal Service sent a letter to Senator Conrad Burns of Montana suggesting legislative changes to enable the FCC to use a total revenue base for universal service contributions.

[10] It should be noted that the FCC already has the discretionary power under 254(d) to require contributions from any other provider of interstate telecommunications "if the public interest so requires."

responsibility for payment of USF charges from high-use to low-use customers.

A final alternative, which my office has proposed to the FCC, would be a hybrid of the proposals described above. For example, the Commission could continue to base 50% of the universal service assessment on interstate revenues, and assess the remaining 50% on end-user connections to the public switched network. Such a hybrid would not require a statutory change and would ensure that all providers of interstate services, even those that did not provide end-use connections, would continue to contribute to support universal service. In addition, this 50/50 hybrid approach would mitigate impacts on low-usage customers, and result in contributions from various industry sectors that are very close to those produced by use of total telecommunications revenues.

In finding a solution to the contribution base problem, I agree with Senator Stevens of Alaska who said last spring: "All companies that use the network, in my judgment, should contribute to universal service, regardless of the type of service they provide."[11] I believe we must expand contribution responsibility to encompass all revenues and all services that connect to the telecommunications network. Since all benefit, all should contribute.

IV. ISSUES RELATED TO PARTICULAR SUPPORT MECHANISMS

In looking at the long-term sustainability of the fund, we need to focus not only on broadening the contribution base, but also on controlling and focusing the

[11] TR Daily, March 26, 2003.

funds paid out for the individual support mechanisms which make up the overall USF. Each of these support mechanisms presents unique issues which will have to be resolved. Even though many have argued that we must stabilize the fund - which implies that we should limit funding - we must be mindful that the Act requires the fund to be sufficient to carry out each of the universal service principles. For some mechanisms this may require a limitation in funding, while for others an expansion will be needed.

A. HIGH-COST SUPPORT

The high-cost support mechanism is the oldest portion of the fund, and is still the biggest, amounting to $3.3 billion this year. Of this amount, approximately $800 million goes to non-rural companies, while $2.5 billion goes to rural carriers.[12]

As shown on **Attachment 3**, total high-cost support has grown by over $1 billion since 2000. Most of this increase is the result of three new mechanisms which have been added to the fund: high-cost model support, interstate access support, and interstate common line support. These new funds have helped adapt the USF to the introduction of competition by making support explicit and portable. However, the continued growth in the high-cost fund has added to the unrelenting pressure on the assessment rate which must be paid by all consumers.

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[12] The term "rural carrier" is defined at 47 U.S.C. 153(47). Generally, rural carriers are small carriers serving rural and high-cost areas, while non-rural carriers tend to be larger carriers, such as the regional Bell operating companies. There are approximately 80 non-rural carriers which serve 90% of the access lines in the nation, while the 1400 rural carriers serve

Earlier this year, the FCC referred to the Joint Board a number of issues related to the growth of the high-cost fund. These issues include determination of how many lines to support, the cost basis of per line support, and whether guidelines should be adopted for state eligible telecommunications carrier (ETC) determinations.

1. Limitation of Support to a Single Line Per Household

There is one issue common to all parts of the high-cost fund which threatens to enlarge the fund to an unsupportable size. Under current rules, all lines provided by ETCs in high-cost areas receive support. The support in any particular wire center is the same for all carriers, and is based on the costs of the incumbent carrier. However, rather than competing for universal service support, all ETCs that provide service receive support in equal per line amounts for all lines that they provide to a home or small business. For example, a single family in a high-cost wire center could be provided two landlines by an incumbent ETC and three cellular lines by a wireless ETC. Each of these carriers would receive equal support for each of the lines provided.[13] As a result, the potential exists for a large increase in the high-cost fund as more and more carriers - especially wireless carriers - attain ETC status.

It is estimated that during 2002, support for secondary lines amounted to

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the remaining 10%.

[13] Under the example provided above, if the per line support in the wire center was $10 per line per month, the incumbent ETC would receive $20 (2 X $10) per month in support. Once the wireless ETC began providing the three wireless "lines," the wireless carrier would receive $30 (3 X $10) per month for providing service to the same household. However, the incumbent's support would not be reduced. Thus, the USF would be obligated to pay out $50

$336 million, or 11.5% of the entire high-cost fund. Moreover, support paid to wireless carriers represents the fastest growing component of secondary line support. As shown on **Attachment 5**, high-cost support for wireless carriers has grown from $500,000 in 1999 to approximately $120 million in 2003.

If the high-cost fund is going to continue to provide affordable access in all parts of the country, then it cannot continue to subsidize the unlimited desires of each individual. I believe that federal USF support should be limited to a single line for each household,[14] and that the choice of which carrier receives USF support should be left to each customer. This would mean that carriers would have to compete for the USF subsidy. This will increase customer benefits and stabilize the federal high-cost fund. Individual states should be free to subsidize additional lines if they so choose.

2. Determination of the Cost Basis of Per Line Support

As I previously mentioned, the current high-cost system bases per line support on the costs of the incumbent carrier, and offers this support to all ETCs serving the same area. This is true even when competitive carriers – such as wireless carriers - may have costs that are substantially less than the wireline incumbent. Another means of limiting the growth of the high-cost fund would be to use each carrier's own costs as the basis for per line support. In order to

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per month in total support for this household, even though per line support for the wire center is only $10 per month.

[14] In order to mitigate the impact of this change on rural carriers, per line support should be redetermined based only on single lines. However, once an additional ETC enters the rural incumbent's service territory, per line support should be frozen. This will prevent an unwarranted spiraling of per line support which is possible under current rules.

ensure that no carrier receives an unwarranted windfall from USF support, support to competitors should be capped at the per line support received by the incumbent.

3. Guidelines for ETC Public Interest Determinations

Under Section 214(e) of the Act, two different standards were adopted for designation of ETCs, depending on whether an area is served by a rural or non-rural incumbent carrier. For areas served by non-rural carriers, the Act mandates that states must designate additional carriers as ETCs if they can provide all of the supported services[15] and advertise the availability of those services throughout the service area. However, for areas served by rural carriers, states may designate additional ETCs, and must first find that it is in the public interest to do so.[16]

Unfortunately, there are currently no standards to guide states' determination of the "public interest" under Section 214(e) of the Act. As a result, state ETC determinations in rural study areas have varied widely in terms of conditions which must be met by carriers prior to and after ETC designation. In many states the obligations on competitive ETCs are less than those imposed on incumbent ETCs.

Almost every party agrees that one of the purposes behind Section 214(e) was to allow states to identify those areas where it was so costly to serve, that it made no sense to have more than one subsidized carrier. However, since states

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[15] The complete list of supported services is found at 47 C.F.R. §54.101(a).

[16] Section 214(e)(5) of the Act also requires any additional ETCs in a study served by a rural carrier serve the rural carrier's entire study area, unless the state and FCC concur that an area less than the entire study area is appropriate.

have no responsibility for funding the federal USF, and under current rules additional ETCs mean more federal USF money coming into the state, it is very difficult for states to find that it is not in the public interest to designate additional ETCs in rural areas. This is true regardless of the cost to serve any particular area.

I believe the FCC should establish guidelines for the public interest determination. The guidelines should allow states to level the playing field among ETCs by requiring all ETCs to offer an unlimited local calling plan, equal access to long distance carriers, and a comparable monthly price for local service. ETCs should also be required to follow the same consumer protection rules, including billing and collection rules, that apply to incumbents.

In order to provide guidance to the states in identifying those areas where there should be a limit on the number of subsidized carriers, I believe the FCC should also establish ETC guidelines based on the amount of per line support received by each study area. Under this approach, in rural study areas receiving an average of $30 or more per line in monthly support the guideline would state that it is presumed that it is not in the public interest to designate more than one subsidized carrier, i.e., more than one ETC. In areas receiving more than $20 per line in monthly support, but less than $30 per line, it would be presumed that no more than one additional subsidized carrier should be designated. There would be no limitation on the number of ETCs in study areas receiving less than $20 per line in support. States would be able to overcome these presumptions by specific

evidence about particular carriers or particular areas.

Establishing such presumptive benchmarks based on the amount of monthly per line support for each study area would be easy to administer, and would encompass the truly small study areas where it is especially costly to serve. Of the 1400 rural study areas, those study areas receiving over $20 per line in monthly high-cost support serve only 1.7% of the total access lines in the United States, but receive almost 45% of total high-cost support. In other words, these study areas represent the small, high-cost areas where presumably it makes no sense to have more than a limited number of subsidized carriers. Placing limitations on the number of ETCs in these truly high-cost areas will help ensure the long-term sustainability of the fund, and will help ensure that consumers in those areas continue to have high-quality access at affordable rates.

B. LOW-INCOME SUPPORT

The FCC greatly expanded the eligibility criteria and the size of the low-income support mechanism in 1997. Nevertheless, participation in the Lifeline and Link-Up programs varies widely among the states. As shown on **Attachment 1**, of the $673 million paid out for low-income support in 2002, almost half went to one state, California. This is not to disparage California's low-income program, but to point out that low-income support funds are distributed very unevenly throughout the nation. There are also overall fund size implications from this skewed distribution. If every state's program was as successful as California's, the size of the low-income support fund would more than double to $1.5 billion.

The FCC currently has a proceeding open to review the operation of the low-income support mechanism. A Recommended Decision from the Joint Board was issued in April 2003 which endorsed expanding Lifeline and Link-Up eligibility to include customers with incomes at or below 135% of the federal poverty guidelines. NASUCA has supported the use of a benchmark based on 150% of the federal poverty guidelines, and has encouraged the use of automatic enrollment and self-certification to ensure that as many eligible customers as possible receive Lifeline benefits.

C. SCHOOLS AND LIBRARIES SUPPORT

The schools and libraries fund has been capped since its inception at $2.25 billion. Demand for schools and libraries funds have always far exceeded the cap. As noted by the FCC in its Order of June 13, 2002, annual demand for e-rate funding is almost double the funds available. As more and more schools have become connected to the internet through the e-rate, the demand for recurring or priority one funds has increased. The result has been that the money available for internal connections in the schools yet to be wired has been declining. The FCC's decision to allow unused schools and libraries funds to be rolled forward to increase future funding may help resolve this problem, but pressure on the cap is likely to continue. The FCC is also currently considering comments on reforms to the schools and libraries fund to address allegations of fraud and abuse, and inefficiency in the administration of the program.

D. RURAL HEALTH CARE SUPPORT

Unlike the other support mechanisms, the rural health fund has had difficulty generating sufficient demand. The FCC originally anticipated a rural health fund sized at $400 million per year. However, in spite of repeated attempts to remake the fund, disbursements have remained low, only $16.4 million in 2002. Like the low-income program, benefits under the rural health care program are distributed unevenly. During 2002 Alaska received 72% of total USF rural health care funding.

Although the FCC is currently examining the operation of the rural health fund, it is clear that the root cause of the problems with the fund lie in the wording of Section 254. Unlike the schools and libraries support mechanism which provides discounts from regular prices on all telecommunications services, and pays for internal connections, Section 254(h) limits the rural health fund to the difference between rates available to health care providers in rural and urban areas of a state. Since many states have rural rates which are lower than urban rates, or have "postage stamp" rates for data services, the rural support mechanism has been of limited utility in meeting the needs of rural health providers. A statutory change should be considered which would make the rural health section of the Act parallel with the schools and libraries by providing services "at rates less than the amounts charged for similar services to other parties."

V. CONCLUSION

In order to be stable and sustainable in the long-term, the USF must be configured like a pyramid: it must have a broad and stable base of contributions at the bottom, and a narrow but sufficient focus of support at the top. The current universal service fund requires work on both ends of this structure. Issues related to the contribution base must be resolved. Since all benefit, all should contribute. In addition, the limited resources of the fund must be properly targeted to carry out the purposes of the Act. In order to continue the public policy success of the universal service fund, we must support access, not excess.

Attachment 1

FEDERAL UNIVERSAL SERVICE SUPPORT
RANKED BY SUPPORT IN EACH STATE
2002 DISBURSEMENTS IN MILLIONS

	State	High Cost Support	Low Income Support	Rural Health Support	Schools & Libraries Support	Total Support
1	California	$65.4	$313.6	$0.1	$266.6	$645.7
2	Texas	$187.8	$45.6	$0.1	$171.8	$405.3
3	New York	$49.0	$53.2	$0.0	$300.5	$402.7
4	Mississippi	$199.7	$2.4	$0.0	$24.8	$226.9
5	Florida	$79.2	$15.5	$0.0	$45.0	$139.7
6	Georgia	$81.7	$7.4	$0.0	$49.1	$138.2
7	Oklahoma	$89.5	$12.9	$0.1	$26.6	$129.1
8	Pennsylvania	$45.9	$10.4	$0.0	$70.1	$126.4
9	Alabama	$100.2	$2.7	$0.0	$17.9	$120.8
10	Arizona	$67.0	$11.6	$0.3	$39.5	$118.4
11	Arkansas	$101.5	$1.0	$0.1	$12.4	$115.0
12	Ohio	$34.7	$26.3	$0.0	$53.3	$114.3
13	Puerto Rico	$97.7	$6.6	$0.0	$4.9	$109.2
14	Alaska	$81.2	$2.5	$11.8	$10.8	$106.3
15	South Carolina	$69.5	$2.4	$0.0	$34.2	$106.1
16	Washington	$79.2	$10.1	$0.1	$15.6	$105.0
17	Louisiana	$75.6	$1.9	$0.0	$24.3	$101.8
18	North Carolina	$60.1	$10.9	$0.1	$29.8	$100.9
19	Kansas	$90.9	$1.5	$0.2	$7.8	$100.4
20	Missouri	$70.7	$3.2	$0.1	$25.6	$99.6
21	Kentucky	$76.4	$5.5	$0.1	$16.9	$98.9
22	Wisconsin	$70.6	$6.8	$0.0	$20.7	$98.1
23	Illinois	$38.0	$8.7	$0.1	$50.0	$96.8
24	Virginia	$71.5	$2.1	$0.1	$20.2	$93.9
25	Michigan	$26.5	$12.0	$0.4	$53.0	$91.9
26	Tennessee	$48.9	$5.3	$0.0	$33.2	$87.4
27	West Virginia	$81.5	$0.5	$0.0	$5.0	$87.0
28	Colorado	$68.6	$3.3	$0.1	$12.7	$84.7
29	Oregon	$67.7	$4.1	$0.0	$9.8	$81.6
30	Indiana	$54.5	$4.1	$0.0	$15.0	$73.6
31	Minnesota	$49.9	$3.9	$0.4	$19.0	$73.2
32	New Mexico	$29.3	$5.3	$0.1	$38.3	$73.0
33	Montana	$64.7	$1.7	$0.5	$3.4	$70.3
34	Maine	$40.7	$9.8	$0.0	$4.8	$55.3
35	Massachusetts	$1.3	$17.6	$0.0	$30.1	$49.0
36	Idaho	$40.2	$3.1	$0.1	$3.1	$46.5
37	New Jersey	$9.2	$4.7	$0.0	$31.2	$45.1
38	Nebraska	$36.2	$1.7	$0.6	$6.0	$44.5
39	Wyoming	$42.1	$0.3	$0.1	$1.2	$43.7
40	South Dakota	$33.9	$3.9	$0.2	$5.5	$43.5
41	Connecticut	$19.3	$5.5	$0.0	$18.4	$43.2
42	Guam	$39.3	$0.3	$0.0	$2.3	$41.9
43	Nevada	$33.9	$3.5	$0.0	$3.1	$40.5
44	North Dakota	$34.9	$2.0	$0.2	$2.7	$39.8
45	Iowa	$32.0	$1.6	$0.1	$5.8	$39.5
46	Virgin Islands	$31.8	$0.0	$0.1	$5.3	$37.2
47	Maryland	$20.0	$0.4	$0.0	$10.0	$30.4
48	Vermont	$25.8	$3.2	$0.0	$1.3	$30.3
49	Utah	$18.6	$2.1	$0.0	$4.6	$25.3
50	N. Mariana Is.	$21.7	$0.0	$0.0	$2.0	$23.7
51	New Hampshire	$13.5	$0.6	$0.0	$1.0	$15.1
52	Hawaii	$6.7	$1.4	$0.2	$1.7	$10.0
53	D.C.	$0.0	$1.2	$0.0	$8.5	$9.7
54	Rhode Island	$0.1	$4.9	$0.0	$3.6	$8.6
55	Delaware	$1.5	$0.2	$0.0	$1.1	$2.8
56	American Samoa	$0.7	$0.1	$0.0	$1.6	$2.4
	TOTAL	$2,978.0	$673.1	$16.4	$1,682.7	$5,350.2

Note: Numbers may not add due to rounding. Annual support amounts less than $50,000 show as $0 due to rounding. Support amounts shown are actual amounts disbursed. Amounts assessed and collected may be higher.

Source: USAC 2002 Annual Report

Attachment 2

2002 FEDERAL UNIVERSAL SERVICE DISBURSEMENTS
RANKED BY PER LINE SUPPORT IN EACH STATE

	State	High Cost Support	Low Income Support	Rural Health Support	Schools & Libraries Support	Total Support	Total Lines	Monthly Support Per Line
		$ Millions						
1	N. Mariana Is.	$21.7	$0.0	$0.0	$2.0	$23.7	21,521	$91.77
2	Guam	$39.3	$0.3	$0.0	$2.3	$41.9	74,006	$47.18
3	Virgin Islands	$31.8	$0.0	$0.1	$5.3	$37.2	69,073	$44.88
4	American Samoa	$0.7	$0.1	$0.0	$1.6	$2.4	10,325	$19.37
5	Alaska	$81.2	$2.5	$11.8	$10.8	$106.3	461,194	$19.21
6	Mississippi	$199.7	$2.4	$0.0	$24.8	$226.9	1,443,215	$13.10
7	Wyoming	$42.1	$0.3	$0.1	$1.2	$43.7	312,778	$11.64
8	Montana	$64.7	$1.7	$0.5	$3.4	$70.3	553,795	$10.58
9	South Dakota	$33.9	$3.9	$0.2	$5.5	$43.5	410,229	$8.84
10	North Dakota	$34.9	$2.0	$0.2	$2.7	$39.8	392,284	$8.45
11	West Virginia	$81.5	$0.5	$0.0	$5.0	$87.0	1,035,865	$7.00
12	Puerto Rico	$97.7	$6.6	$0.0	$4.9	$109.2	1,333,656	$6.82
13	Arkansas	$101.5	$1.0	$0.1	$12.4	$115.0	1,509,333	$6.35
14	New Mexico	$29.3	$5.3	$0.1	$38.3	$73.0	1,003,993	$6.06
15	Vermont	$25.8	$3.2	$0.0	$1.3	$30.3	426,028	$5.93
16	Oklahoma	$89.5	$12.9	$0.1	$26.6	$129.1	2,035,796	$5.28
17	Maine	$40.7	$9.8	$0.0	$4.8	$55.3	883,970	$5.21
18	Idaho	$40.2	$3.1	$0.1	$3.1	$46.5	762,986	$5.08
19	Kansas	$90.9	$1.5	$0.2	$7.8	$100.4	1,666,630	$5.02
20	Alabama	$100.2	$2.7	$0.0	$17.9	$120.8	2,497,624	$4.03
21	Nebraska	$36.2	$1.7	$0.6	$6.0	$44.5	955,957	$3.88
22	South Carolina	$69.5	$2.4	$0.0	$34.2	$106.1	2,366,512	$3.74
23	Kentucky	$76.4	$5.5	$0.1	$16.9	$98.9	2,206,741	$3.73
24	Louisiana	$75.6	$1.9	$0.0	$24.3	$101.8	2,575,040	$3.29
25	Arizona	$67.0	$11.6	$0.3	$39.5	$118.4	3,095,149	$3.19
26	Oregon	$67.7	$4.1	$0.0	$9.8	$81.6	2,171,014	$3.13
27	New York	$49.0	$53.2	$0.0	$300.5	$402.7	13,076,558	$2.57
28	Texas	$187.8	$45.6	$0.1	$171.8	$405.3	13,192,061	$2.56
29	Nevada	$33.9	$3.5	$0.0	$3.1	$40.5	1,349,473	$2.50
30	Colorado	$68.6	$3.3	$0.1	$12.7	$84.7	2,948,466	$2.39
31	Washington	$79.2	$10.1	$0.1	$15.6	$105.0	3,743,055	$2.34
32	Wisconsin	$70.6	$6.8	$0.0	$20.7	$98.1	3,525,444	$2.32
33	California	$65.4	$313.6	$0.1	$266.6	$645.7	23,385,691	$2.30
34	Missouri	$70.7	$3.2	$0.1	$25.6	$99.6	3,630,138	$2.29
35	Georgia	$81.7	$7.4	$0.0	$49.1	$138.2	5,148,317	$2.24
36	Tennessee	$48.9	$5.3	$0.0	$33.2	$87.4	3,385,953	$2.15
37	Minnesota	$49.9	$3.9	$0.4	$19.0	$73.2	3,136,277	$1.94
38	Iowa	$32.0	$1.6	$0.1	$5.8	$39.5	1,704,785	$1.93
39	Utah	$18.6	$2.1	$0.0	$4.6	$25.3	1,172,443	$1.80
40	North Carolina	$60.1	$10.9	$0.1	$29.8	$100.9	5,106,719	$1.65
41	Virginia	$71.5	$2.1	$0.1	$20.2	$93.9	4,760,302	$1.64
42	Indiana	$54.5	$4.1	$0.0	$15.0	$73.6	3,803,634	$1.61
43	Connecticut	$19.3	$5.5	$0.0	$18.4	$43.2	2,406,704	$1.50
44	New Hampshire	$13.5	$0.6	$0.0	$1.0	$15.1	855,403	$1.47
45	Ohio	$34.7	$26.3	$0.0	$53.3	$114.3	7,053,650	$1.35
46	Pennsylvania	$45.9	$10.4	$0.0	$70.1	$126.4	8,301,408	$1.27
47	Michigan	$26.5	$12.0	$0.4	$53.0	$91.9	6,149,365	$1.25
48	Hawaii	$6.7	$1.4	$0.2	$1.7	$10.0	721,233	$1.16
49	Rhode Island	$0.1	$4.9	$0.0	$3.6	$8.6	641,977	$1.12
50	Florida	$79.2	$15.5	$0.0	$45.0	$139.7	11,317,933	$1.03
51	Illinois	$38.0	$8.7	$0.1	$50.0	$96.8	8,012,870	$1.01
52	Massachusetts	$1.3	$17.6	$0.0	$30.1	$49.0	4,410,394	$0.93
53	D.C.	$0.0	$1.2	$0.0	$8.5	$9.7	919,587	$0.88
54	Maryland	$20.0	$0.4	$0.0	$10.0	$30.4	3,940,615	$0.64
55	New Jersey	$9.2	$4.7	$0.0	$31.2	$45.1	6,923,410	$0.54
56	Delaware	$1.5	$0.2	$0.0	$1.1	$2.8	589,979	$0.40
	TOTAL	$2,978.0	$673.1	$16.4	$1,682.7	$5,350.2	185,588,578	$2.40

Note: Numbers may not add due to rounding. Annual support amounts less than $50,000 show as $0 due to rounding. Support amounts shown are actual amounts disbursed. Amounts assessed and collected may be higher.

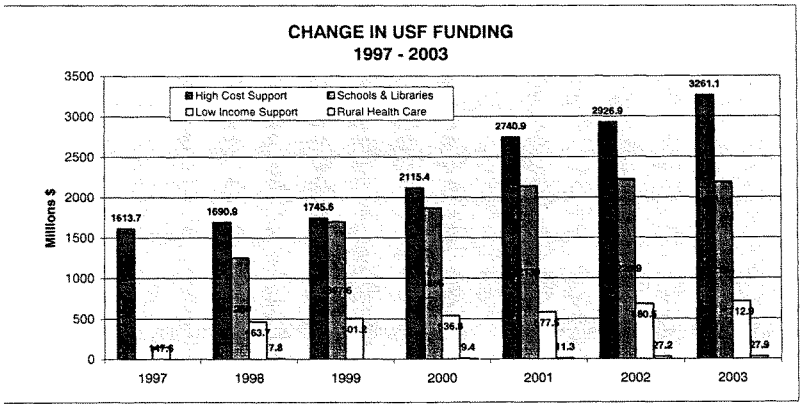
Source: USAC 2002 Annual Report
NECA 2002 USF Filing

Attachment 3

CHANGE IN USF FUNDING
1997-2003

USF Mechanism	1997	1998	1999	2000	2001	2002	2003	$ Change 1997-2003	% Change 1997-2003
High Cost Support	1,613.7	1,690.9	1,745.6	2,115.4	2,740.9	2,926.9	3,261.1	1,647.4	102.1%
Schools & Libraries	0.0	1,250.0	1,697.6	1,865.0	2,139.0	2,220.9	2,184.0	2,184.0	n/a
Low Income Support	147.6	463.7	501.2	536.8	577.5	680.5	712.9	565.3	383.0%
Rural Health Care	0.0	7.8	-1.7	9.4	11.3	27.2	27.9	27.9	n/a
Total USF Funding	1,761.3	3,412.4	3,942.7	4,526.6	5,468.7	5,855.5	6,185.9	4,424.6	251.2%
Interstate Revenue Base	65,350.0	69,274.0	75,305.5	80,359.5	80,708.0	74,158.1	68,912.1	3,562.1	5.5%
USF Assessment Rate*	2.70%	4.93%	5.24%	5.63%	6.78%	7.90%	8.98%	n/a	233.1%

*USF Funding Divided by Interstate Revenues. Not actual assessment rate.
All figures in millions of dollars, except where noted.
Source: USAC Reports; Universal Service Monitoring Reports
Interstate revenue base for 1997 estimated.



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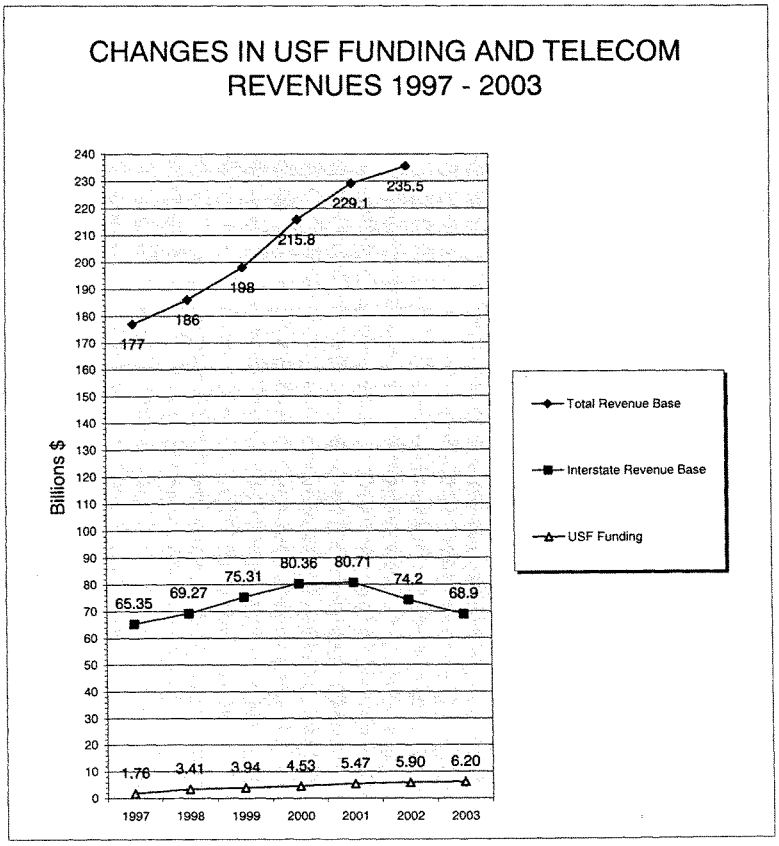
Attachment 4

CHANGES IN USF FUNDING AND TELECOM REVENUES
1997 - 2003
$ Billions

	1997	1998	1999	2000	2001	2002	2003
Total Revenue Base	177.0	186.0	198.0	215.8	229.1	235.5	na
Interstate Revenue Base	65.4	69.3	75.3	80.4	80.7	74.2	68.9
USF Funding	1.8	3.4	3.9	4.5	5.5	5.9	6.2



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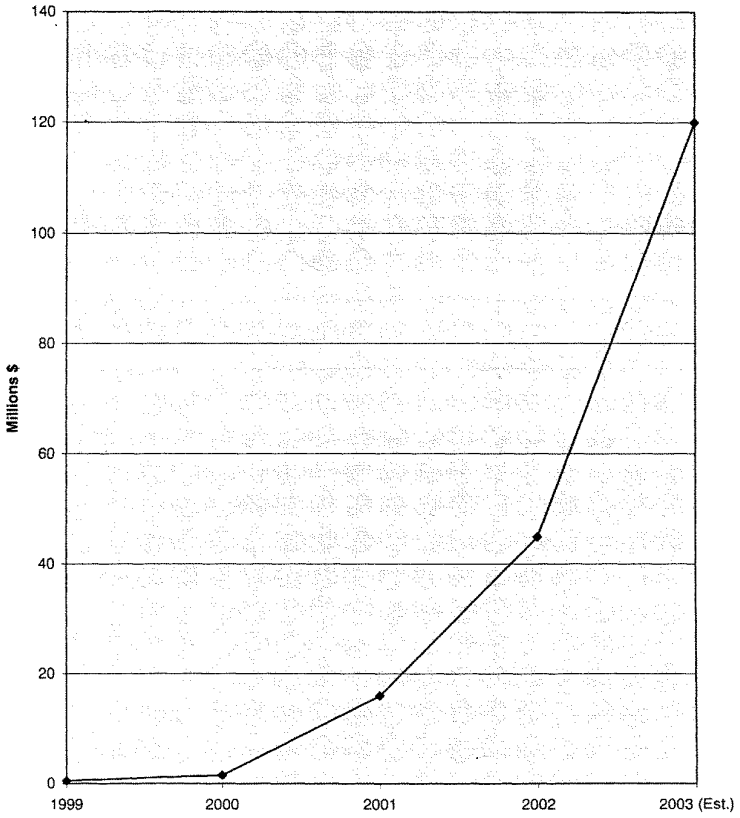
GROWTH IN UNIVERSAL SERVICE SUPPORT FOR WIRELESS CARRIERS 1999-2003