

THE UNIVERSAL SERVICE E-RATE PROGRAM

HEARING

BEFORE THE

COMMITTEE ON COMMERCE,
SCIENCE, AND TRANSPORTATION

UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

OCTOBER 5, 2004

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SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

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THE UNIVERSAL SERVICE E-RATE PROGRAM

TUESDAY, OCTOBER 5, 2004

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Committee met, pursuant to notice, at 9:40 a.m. in room SD-253, Russell Senate Office Building, Hon. John McCain, Chairman of the Committee, presiding.

OPENING STATEMENT OF HON. JOHN MCCAIN, U.S. SENATOR FROM ARIZONA

The CHAIRMAN. Good morning. Today the Committee meets to hear testimony on problems in the E-rate program. When the program was established in the Telecommunications Act of 1996, Congress was hopeful that every classroom in the country would be wired to the Internet. Eight years later, there are many success stories. There are also tales of waste, fraud and abuse in the \$2.25 billion per year program and they are ubiquitous.

Among those examining the E-rate program are the FCC Inspector General's Office, along with the Inspector Generals at the Department of the Interior and Education, the Government Accountability Office, the Subcommittee on Oversight and Investigations of the House Energy and Commerce Committee, the FBI, and the Antitrust Division of the Department of Justice. I understand that there are currently over 40 criminal cases pending in Federal and State courts involving program abuses.

Criticisms of the program have been extensive and pointed. At a hearing earlier this summer, the former chairman of the House Subcommittee on Oversight and Investigations, Mr. Greenwood, said of E-rate, "While a well-intentioned idea, the E-rate program as it is currently structured is an invitation for disaster. Indeed, if one were to design a program to pour money out the window, this would be the way to do it."

I understand that Chairman Barton is committed to continuing his committee's revealing probes of the program.

Newspapers around the country have conducted their own investigations. The Atlanta Journal Constitution, which has provided some of the most revealing examinations, recently editorialized, quote: "Handed a blank check from the Federal Government, Atlanta frittered away nearly \$73 million on overblown and unnecessary computer systems that it now has to struggle to maintain. Born of the Internet boom and funded through a telephone service surcharge, the E-rate program was created to assure poor children computer access, and there is no proof that the lavish computer ar-

senal has done a thing to boost student learning. The only proven boost has been to the bottom lines of the technology companies that sold the schools all the pricey stuff.”

The extent to which technology companies have been unjustly enriched at telephone users’ expense is unknown, but the size of the schemes that were discovered and disallowed suggests that the enrichment has been substantial. In 2002 the E-rate Administrator, USAC, disallowed over \$500 million in applications in which IBM had worked with school districts to effectively circumvent the competitive bidding system process that was supposed to ensure the integrity of the E-rate program.

In May of this year, NEC Business Network Solutions agreed to plead guilty and pay \$20.6 million in criminal fines, civil settlement, and restitution relating to charges of bid rigging at five different school districts in Michigan, Wisconsin, Arkansas, and South Carolina and for fraud with respect to the San Francisco Unified School District.

Unscrupulous vendors are not the only problem. There is blame enough to go around. In Puerto Rico, State officials appear to be among those responsible for squandering over \$100 million in E-rate funds. School districts that have found ways to avoid paying their matching share for services and equipment have allowed themselves to be manipulated by crooked vendors or in some instances have been parties to bilking ratepayers and denying students much-needed equipment.

I understand that one school in Michigan had a \$750,000 television studio built for it by its E-rate vendor, which gives you an idea of the vendor’s excessive profits.

As for the regulators, they too are to blame. The FCC, while making rule changes in response to exploding scandals, has been reactive and too gentle. Only last year did the FCC allow for disbarments, but the new rules seem lax. Vendors are prohibited from participating in the program only if there is a criminal conviction or finding of civil liability and, given the length, this means vendors can participate for a very, very long time.

USAC, which administers E-rate, has had some successes in preventing the most blatant attempts to defraud the fund, but its audits have been too few, too late, and too forgiving.

Lest we overlook ourselves, Congress also is responsible. We created the program and, despite its endemic problems, its popularity makes clear that it is not going away. It is incumbent upon us to ensure, either through oversight or legislation if necessary, that E-rate functions as intended. Today’s hearing is just the beginning.

Senator Rockefeller.

**STATEMENT OF HON. JOHN D. ROCKEFELLER IV,
U.S. SENATOR FROM WEST VIRGINIA**

Senator ROCKEFELLER. Thank you, Mr. Chairman. I thank your accommodation with respect to the scheduling of this, and I look forward to hearing what people have to say.

I have to tell you that I am very, very disappointed that the FCC, which was invited to testify today, declined to do so. I do not think that was accidental. They have their purposes with respect to E-rate and have revealed them in recent years. The FCC is

charged with oversight of the universal service program. Both the FCC Inspector General, who is here, and the GAO have been critical of their oversight.

Mr. Chairman, all of us—the waste, fraud and abuse argument has been used from the very beginning and I am not denying that there is some of that. I think it is also important to point out that there are millions and millions of kids who have access to computers and who can learn Japanese and do all kinds of things that could not before. So we are all concerned about waste, fraud and abuse in this or any other Federal program, including the Department of Defense and wherever it might be.

So it is clear that USAC and the FCC have plans in place to combat waste and fraud. I want to hear about those. These are essential and should be monitored and strengthened as the Chairman has indicated.

I know the Chairman would prefer that the hearing be limited or at least focused on waste, fraud and abuse, but I have got something else I have got to say which I think is equally important. That is the suspension of the E-rate. There was a little article in the *New York Times*. I do not think most people know about it, but the E-rate and Rural Health Care funding commitments have been suspended due to changes in accounting practices which are very technical at the administration corporation, USAC, which they administer the USF program, the Universal Service Fund program.

They were forced to suspend these commitment letters. However, the policy, process, and impact leading up to this decision is unclear and needs to be resolved. The program is not in effect. Nobody is getting any money anywhere. So there is no waste, fraud and abuse going on now. There is not anything going on now.

I have heard from schools that the suspension of funding is causing a significant disruption to their operations. It is inconceivable to me that funding was stopped as the school year was beginning. It appears that if the FCC had acted in a more timely manner, the absent FCC, the deliberately absent FCC, on this issue we would not be in this situation.

Mr. Chairman, I want these questions answered today and I know that there are votes and other things. What are the plans to deal with the suspension of the E-rate and the Rural Health Care programs? I want to know. Is the FCC treating E-rate and Rural Health Care in a discriminatory fashion? I want to know. What happens in the first quarter of next year when the FCC has to find \$550 million to make up for undercollected E-rate funding? Are we facing a huge rate spike, which is my fear, or will schools lose their money forever, which is also my fear?

As many of you know, Senator Snowe and I sent a letter to the FCC asking for an explanation. I do not think we have heard anything from them.

Mr. Chairman, I know that the bulk of the issue that you wish to address involves what I mentioned before and you will find no stronger ally for somebody who cares so much about the E-rate about getting rid of waste, fraud and abuse because that has been a rap on it from the beginning. I think it is partly true and partly untrue. I also know that you share my concerns that the entire

Universal Service Fund is now jeopardized by recent events and we have an obligation to look into this matter further.

Mr. Chairman, I have a longer statement. I submit it for the record.

[The prepared statement of Senator Rockefeller follows:]

PREPARED STATEMENT OF HON. JOHN D. ROCKEFELLER IV,
U.S. SENATOR FROM WEST VIRGINIA

Mr. Chairman, I appreciate your cooperation in scheduling this hearing. I know that we are all pressed for time this week. I would also like to welcome our witnesses today. I look forward to hearing from you on issues affecting the E-Rate program.

The E-rate program has fundamentally transformed education in this country—we have connected our most remote schools and libraries to the world. The E-rate has enabled schoolchildren across this country to participate in the information society. I have seen firsthand the benefits of the E-rate in West Virginia schools and our libraries. All students in West Virginia can have free access to the Internet in local libraries, and through these connection they can access free practice tests for the ACT and SAT. Our libraries and our schools would not be connected without E-rate. Unfortunately this message has been lost in a spate of negative headlines about the program, which all too often have not told the full story.

All of us are concerned about waste, fraud and abuse in this program or any other Federal program. The E-rate program processes tens of thousands of applications annually. Unfortunately, a few bad actors have in some way tarnished the success of this program. We need to make sure that the E-rate program has strong program integrity and that any bad actors are appropriately punished so that we can make sure future bad actors cannot take advantage of schools or the program.

We cannot nor should we tolerate any waste, fraud or abuse in this program because our schools and libraries need the dollars that the E-rate provides. As the General Accountability Office has noted, we—Congress, the Federal Communications Commission (FCC), and the Universal Service Administrative Corporation (USAC)—need to provide more effective and consistent oversight of not just E-rate but all of the Universal Service Fund programs, including High Cost, Low-Income and Rural Health Care.

The impact of the E-rate on our schools has been impressive. For example, in 1996, when the Telecommunications Act was signed into law, only 14 percent of all classrooms were connected to the Internet, and among the poorest schools, only 5 percent of classrooms were connected. The most recent statistics for classroom connection are amazing—92 percent of all classrooms are connected, and 89 percent of the poorest classrooms are connected. This is a wonderful story of success over the past 7 years. In addition to the direct education benefit that this has provided our children, it has exposed rural and inner city kids to technology helping bridge the digital divide.

In addition to the impressive statistics on classroom connections, a recent GAO study released in September 2004 highlighted that 84 percent of rural superintendents reported that E-rate was helping them comply with the federally-mandated No Child Left Behind Act requirements. The superintendents reported that E-rate was helping to provide affordable teacher training and development so teachers could earn the highly qualified status. It also allows students in isolated rural schools to use distance learning to take courses from qualified teachers at other locations. Such access is critical for our schools if we want them to achieve the new higher academic standards, especially when Federal funding for the No Child Left Behind Act is billions of dollars less than promised.

Over the last several years, the FCC and USAC have been systematically improving the E-rate funding process and aggressively pursuing any hint of waste, fraud and abuse. USAC created its own whistler blower hotline to combat fraud and it established a task force to provide recommendation on ways to combat fraud. The FCC issued two orders to improve E-rate program integrity. These two actions will serve to strengthen the program.

I will work with my colleagues, the FCC, and USAC to improve the operation of the E-rate program. We must not let a few high-profile cases of waste, fraud and abuse undermine the program. We must and will make the necessary changes to prevent future cases.

As equally important to maintaining the E-rate's program integrity is making sure it can undertake its mission. I am deeply concerned by reports that in the last

week of the year-long conversion of the Universal Service Fund from GAAP to Government GAAP accounting standards, the FCC has instituted changes that may significantly affect the operation and administration of the entire Fund, and in particular, the schools and libraries ("E-rate") and rural health care funds. This action has led to the suspension since August 3, 2004 of the Funding Commitment Decision Letters ("Commitment Letters") issued under those programs and the Commission's determination that funds held in the Universal Service Fund are Federal funds for purposes of the Anti-Deficiency Act. This suspension has already had already significant negative impact on schools, libraries and rural health care providers across the country.

It is my understanding that the FCC and USAC are suggesting that the program will remain suspended until mid-November resulting in over 4,000 schools and libraries with eligible applications for this year worth about \$300 million being placed on hold. The number of schools and libraries waiting for funding will grow dramatically over the fall.

In addition to the decision to suspend E-rate Commitment letters, I am troubled by the seemingly inconsistent decisions made by the Commission as it has implemented the accounting conversion. First, at the same time the Commission was deciding whether to treat Commitment Letters as "obligations" for accounting purposes USAC to have monies in its account to cover all existing and future Commitment Letters, the Commission took steps to "under collect" E-rate revenues by a total of \$550 million. These decisions will require substantial reductions in available outlays for the schools and libraries and rural health care programs and will increase significantly the contribution rate assessed on providers of interstate communications services and passed through to consumers early next year. It could be perceived that the Commission's decisions have been politically motivated and designed to undermine the Fund.

Lastly, I am bothered that while the FCC has taken steps to ensure that the E-rate and rural health care programs are in compliance with the new accounting requirements, we understand the Commission has not completed a full review of the impact of the conversion on the high-cost fund. In particular, the Commission's apparent decision regarding treatment of the E-rate and rural health care Commitment Letters as obligations may also impact how projected costs used to calculate high-cost support should be treated for accounting purposes. If these projections are determined to be obligations, the high-cost fund could face disruptions similar to those currently being experienced in the E-rate and rural health care programs, putting in jeopardy billions of dollars relied on by rural telecommunications carriers that bring essential services to consumers.

I will not sit by and watch the FCC undermine our ability to provide universal service. The only reason many West Virginians have access to telephone service is because of universal service. I do not want to see their telephone bills jacked up dramatically because the Commission has been artificially keeping rates low over the last year.

Mr. Chairman, this Committee will begin examining the future of telecommunications policy in the next Congress. Maintaining the integrity of universal service and the E-rate will be two of my highest priorities. Instead of a campaign to tear down these programs, we should be looking how we can leverage the investments we have already made in wiring schools and libraries to bring a wider array of new services to our most our children.

The CHAIRMAN. Senator Rockefeller, I also read the same article and I share your concern, particularly since apparently no one was notified, including the Congress nor members of this Committee. That is very disturbing. We may have to have a follow up hearing, perhaps during the lame duck session, depending on what we get out of this. If we are talking about this kind of money and this kind of a program, we may have to delve deeper into it.

Senator Burns.

**STATEMENT OF HON. CONRAD BURNS,
U.S. SENATOR FROM MONTANA**

Senator BURNS. Thank you, Mr. Chairman, and thank you for the hearing.

The CHAIRMAN. By the way, I would just like to say Senator Burns and Senator Rockefeller and Senator Snowe, the three members here, had a huge amount of influence on the whole E-rate program itself, and I thank them for their continuing involvement.

Senator BURNS. Well, thank you, Mr. Chairman. I want to associate myself with your words. There has been some waste, fraud and abuse, and to get to those, that is good.

But I want to ask unanimous consent that my full statement can be put in the record.

The CHAIRMAN. Without objection.

Senator BURNS. But I just want to point out a couple of things. The Anti-Deficiency Act, which is a Federal budget law, what it really caused here, and it is my understanding that the relationship between USAC and the FCC is not the best at this present time and it is causing real difficulties.

But to get a little history on this, the real change was intended to improve oversight on USAC's administration of E-rate funds to eliminate fraud and abuse. But this change apparently also limited USAC's ability to spend the money. So the E-rate program had excess money in the amount of around \$3 billion.

Now, that might not seem like much for a lot of folks, but that sounds like a hell of a lot of money to me. The FCC then reduced the contribution factor and the surplus was placed in investments. We will talk about that in a little bit. This was followed by a change in the E-rate rules which forced USAC to hastily sell this \$3 billion investment at a loss. Some would put the figure at around \$21 million.

I fail to see how these series of events resulted in more effective administration of the E-rate program. So I think this has caused a chain effect that has cost us money, not only in the fund, but also this drastic action of cutting off all funds now going to schools that need it. And I have got 33, 34 in my state that I have got phone calls from already. These are all rural schools. In Montana, like in West Virginia, when you talk about rural, we are rural.

These funds are vital as far as the telephones it takes and the communications it takes to communicate with the outside world, so to speak.

I just ask my full statement be put in the record, but thank you for calling this hearing.

[The prepared statement of Senator Burns follows:]

PREPARED STATEMENT OF HON. CONRAD BURNS, U.S. SENATOR FROM MONTANA

I thank the Chairman for calling today's hearing, which addresses a matter of urgent importance. A change in FCC rules and accounting has caused many eligible schools and libraries which are dependent on E-rate funds, including at least 33 in Montana, to suddenly lose this funding. While I have had many concerns over the administration of the E-rate program over the years, clearly the current situation is proving inappropriately harmful to many worthy institutions.

The state of interaction between the FCC, USAC, and the other relevant budget entities has deteriorated to the extent that the program's administration has been interrupted. The rule changes in question go back at least a year, which would seem to have provided enough time to productively address legitimate accounting concerns without freezing funds. The rule change was intended to improve oversight over USAC's administration of E-rate funds to eliminate fraud and abuse. But this change apparently also limited USAC's ability to spend money. So the E-rate program had excess money, in the amount of about \$3 billion; the FCC then reduced the contribution factor and the surplus was placed in investments. This was fol-

lowed by a change in the E-rate rules which forced USAC to hastily sell this \$3 billion investment at a loss. I fail to see how this sloppy series of events resulted in a more effective administration of the E-rate program.

I realize that this hearing will address troublesome cases of waste, fraud and abuse in the E-rate program, and I understand that the problem we have today in part a consequence of an attempt to provide better oversight for the program and to reduce fraud. Obviously these are lofty and commonly-held goals. But cutting off all the bona fide schools and libraries in this way is about the worst way deal with the situation.

I am seriously troubled at the dire prospects faced by scores of schools and libraries in Montana because of this cutoff of funds, and numerous other states face similar problems. A potential solution to restoring funding would be to simply postpone the budget rule changes that have been made until a full review can be undertaken.

Ultimately this system must be made more effective and must work the way it is supposed to work. Bearing this in mind, once the immediate problem of restoring the program to operation is addressed, we must also strive to determine the best way out of this current, unacceptable situation in the long-run. In other words, several key policy matters must be decided, including how exactly USAC funds should be accounted for, given that they are not appropriated monies, but rather collected from private carriers; how oversight should be organized, under what part of the government; and how we get there from here.

Should money held in universal service accounts, like E-rate, be included in the Federal budget? What other alternatives are there? Is generally accepted government accounting the only solution? If not, are there other ways to improve oversight? What can we learn from the ways that other universal service programs are run? I look forward to hearing the testimony of the witnesses on these vital issues. Thank you.

The CHAIRMAN. Without objection.
Senator Snowe.

**STATEMENT OF HON. OLYMPIA J. SNOWE,
U.S. SENATOR FROM MAINE**

Senator SNOWE. Thank you, Mr. Chairman. I am pleased to be here this morning to hopefully get some answers in terms of why we face this dilemma in the E-rate program at this juncture. I share the concerns and what has been expressed by the chairman and Senator Rockefeller and Senator Burns as well.

We have all worked mightily to ensure that this program works effectively, efficiently, and appropriately. It has been an enormous success. It is one of the most successful education-related programs in our nation's history, when you consider the fact when the Telecommunications Act was first enacted in 1996 that only 14 percent of classrooms in America had Internet connection and today we are talking almost 99 percent, 95, 99 percent, not to mention some of the poorest school districts in America.

Since the program was created, more than \$12 billion has been disbursed. I think absolutely we ought to be looking and focusing on those areas in which the money has not been appropriated within the legal parameters of the law, and if vendors and recipients are defrauding the government we ought to take appropriate action. I hope that the measures that have been put in place by the Inspector General, the FCC, those that have been identified by the General Accounting Office, also have been fully implemented as well. I know that the FCC has even issued recent actions with respect to taking some strong measures against fraud and abuse.

The other dimension to this problem, as Senator Rockefeller indicated: We have a letter that has been sent to the Chairman of the FCC, Mr. Powell, on the issue of why USAC has been placed in this situation with respect to letters of commitments now, not being

able to disburse those funds, with shifting to government accounting rules in midstream, especially since there had been some consideration of making this conversion last February, but they did not get notice until July, so that they had to put a halt to this in August.

So it does affect school districts and libraries across the country. It is also going to cost USAC money. As I understand it, it is going to force them to liquidate their assets. From what I understand, they are going to lose \$30 million in accrued interest as a result of having to liquidate these assets in order to meet these commitments.

It is arbitrary application of these government accounting principles as I understand it. Senator Rockefeller and I have not been able to get any answers as to, first, who is responsible for this decision? Is it the FCC, or is it OMB? How did this come about? Why in this untimely fashion, an inconsistent application?

The fact is they cannot offer a reason as to what exactly would require USAC to apply these rules at this moment in time. So now it is withholding more than \$300 million in disbursement for E-rates, affecting schools when this decision coincided at the beginning of the school year. So now it is affecting schools who are dependent on this money.

It is just really difficult to understand why this all transpired. I happen to think it may be another back door route to undermining this valuable program. So I hope that we are going to be able to get some answers here today, because obviously this was done in such a fashion to affect the well-being of the program, but ultimately affecting school districts across America, and the fact is not giving USAC the time in which to comply with this type rule, this kind of change, in the future.

We know that similar entities in government do not have to abide by the same standards. There was nothing to point to the fact that they should be required to move to these standards. But if that is the case, then why not give them appropriate timing in which to make the adjustments without having adverse and consequential impact on our schools as they are beginning the school year?

So I hope we get to the bottom of this, Mr. Chairman, as well. I want to thank my colleagues, Senator Rockefeller most especially, for all the work and the leadership that he has provided on this issue.

Thank you.

The CHAIRMAN. Thank you.

Our witnesses today are: Mr. Thomas Bennett, who is the Assistant Inspector General for USF Oversight, the Federal Communications Commission. He is accompanied by Mr. Cline from the FCC's Inspector General's Office. Mr. George McDonald, USAC Vice President, Schools and Libraries Division; Mr. Frank Gumper, USAC Chairman of the Board; and Mr. Winston E. Himsworth, President, E-Rate Central, and founder of State E-Rate Coordinators Alliance.

We only have about 4 minutes left in our vote, so I think it would probably be best to stand in recess for about 10 or 15 minutes so we can get to the floor, vote, and return. Then we will hear from

our witnesses then. We will stand in recess until our return in about 10 to 15 minutes. Thank you.

[Recess from 9:57 a.m. to 10:17 a.m.]

The CHAIRMAN. The Committee will reconvene. I thank the witnesses for their patience and I apologize that we were interrupted by a vote.

We will begin with Mr. Bennett, who is Assistant Inspector General for USF Oversight, the Federal Communications Commission. Welcome, Mr. Bennett.

STATEMENT OF THOMAS BENNETT, ASSISTANT INSPECTOR GENERAL, USF OVERSIGHT, FEDERAL COMMUNICATIONS COMMISSION; ACCOMPANIED BY THOMAS C. CLINE, ASSISTANT INSPECTOR GENERAL FOR AUDITS, OFFICE OF THE INSPECTOR GENERAL, FCC

Mr. BENNETT. Mr. Chairman and Members of the Committee: I appreciate the opportunity to come before you today—

The CHAIRMAN. You need to pull the microphone a little bit closer, please.

Mr. BENNETT. I appreciate the opportunity to come before you today to discuss oversight of the E-rate program and to discuss concerns that the FCC Office of Inspector General has with the program as a result of our involvement in audits and investigations.

My name is Tom Bennett and I am the Assistant Inspector General for USF Oversight with the FCC OIG. The FCC Inspector General, Walker Feaster, had intended to provide testimony today, but Mr. Feaster has taken ill and is unable to be with us.

I would like to introduce Tom Cline, who is the Assistant Inspector General for Audits with the FCC OIG. Tom has been heavily involved in oversight of the E-rate program.

In my testimony I will briefly summarize our involvement in USF oversight and discuss concerns we have regarding the program. The FCC Office of Inspector General first looked at the USF in 1999 as part of our audit of the Commission's Fiscal Year 1999 financial statement when the USF was determined to be part of the FCC's reporting entity for financial statement reporting purposes.

Starting with that audit, the Office of Inspector General has continued to devote considerable resources to oversight of the USF. Due to materiality and our assessment of audit risk, we have focused much of our attention on the USF mechanism for funding telecommunications and information services for schools and libraries, the E-rate program. We have designed an audit program around two corollary and complementary efforts. First, we have established a plan to conduct E-rate beneficiary audits, to evaluate beneficiary compliance with program rules and requirements, and to identify opportunities for programmatic improvement. Second, we have established a process for vigorously investigating allegations of fraud, waste and abuse in the program.

Unfortunately, several obstacles have impeded our ability to implement effective independent oversight. The primary obstacle has been a lack of adequate resources to conduct audits and provide audit support to investigations. We have demonstrated our commitment to independent oversight of the USF by adding staff auditor

positions and by organizing USF oversight activities under an Assistant Inspector General for USF oversight. We have also requested appropriated funding in each of the last three budget submissions to obtain contract support for our USF oversight activities.

Most recently, we have requested a significant increase in funding for USF oversight in our Fiscal Year 2006 budget submission. The requested increase is primarily a result of a Commission request for the conduct of audits to meet the requirements of the Improper Payments Information Act of 2002 and to calculate estimated improper payment error rates for USF programs, including E-rate.

The Inspector General has been advocating for some time that the cost of USF oversight should be provided for through direct access to the USF and we have been advised that this idea is being considered. We are currently considering alternatives for obtaining access to contract audit support to implement the USF oversight portions of our audit plan. We are working with USAC to establish a three-way contract under which we can obtain audit resources to conduct USF audits.

We are also working with USAC and a public accounting firm under contract to USAC to conduct the fourth large-scale audit of E-rate beneficiaries. 100 beneficiaries are being audited as part of this project. The project was initiated in August 2004, and is expected to be completed next summer.

Despite limited resources, the FCC OIG has implemented an aggressive independent oversight program. Our oversight program includes audits conducted using internal resources, audits conducted by other Federal offices of inspector general under reimbursable agreements, review of audit work conducted by USAC, and active participation in Federal investigations of E-rate fraud.

In addition to conducting audits, we are providing audit support to a number of investigations of E-rate recipients and service providers.

To implement the investigative component of our plan, we established a working relationship with the Antitrust Division of the ratings of Department of Justice. The Antitrust Division has established a task force to conduct E-rate investigations, comprised of attorneys in each of the Antitrust Division's seven field offices and the national criminal office. We are also supporting several investigations being conducted by assistant United States attorneys. We are currently supporting 22 investigations and monitoring an additional 15 investigations.

Allegations being investigated in these cases include: procurement irregularities, including lack of a competitive process and bid-rigging; false claims; service providers billing for goods and services not provided; ineligible items being funded; and beneficiaries not paying the local portion of costs, resulting in inflated costs for goods and services to the program; and potential kickback issues.

Our involvement in E-rate audits and investigations has highlighted numerous concerns with this program. General concerns include lack of clarity regarding program rules and lack of timely and effective resolution of audit findings.

Specific concerns regarding program design include: weaknesses in program competitive procurement requirements; ineffective use of purchased goods and services; reliance on applicant certifications; weaknesses in technology planning; and issues relating to discount calculation and payment.

The Office of Inspector General remains committed to meeting our responsibility for providing effective independent oversight of the USF and we believe we have made significant progress. While the Commission has taken steps to address programmatic weaknesses, more work remains to be done. Through our participation in the fourth large-scale round of E-rate beneficiary audits with USAC and through audits that we anticipate conducting under our three-way agreement with USAC, we are moving forward to evaluate the state of the program and to identify opportunities for programmatic improvements.

In order to continue this important work, it is our belief that the Commission should have direct access to the USF. This will provide the resources for an effective and independent oversight program.

Thank you. Tom Cline and I will be happy to answer any of your questions.

[The prepared statement of Mr. Feaster follows:]

PREPARED STATEMENT OF H. WALKER FEASTER III, INSPECTOR GENERAL,
FEDERAL COMMUNICATIONS COMMISSION

Executive Summary

- The FCC Office of Inspector General has devoted considerable resources to oversight of the USF, and the E-rate program in particular.
- Several obstacles have impeded our ability to implement effective, independent oversight of the program. The primary obstacle we have dealt with has been a lack of adequate resources to conduct audits and provide audit support to investigations.
- My office's involvement in E-rate audits and investigations has highlighted numerous concerns with this program. These include general programmatic and management concerns as well as specific concerns related to program design. General concerns include:
 - lack of clarity regarding program rules, and;
 - lack of timely and effective resolution of audit findings.

Specific concerns regarding program design include;

- weaknesses in program competitive procurement requirements;
- ineffective use of purchased goods and services;
- reliance on applicant certifications;
- weaknesses in technology planning; and
- issues relating to discount calculation and payment.
 - Until my office has access to the resources and funding necessary to provide effective, independent oversight for the program, I am unable to provide assurance that the program is protected from fraud, waste and abuse.

Mr. Chairman and Members of the Committee, I appreciate the opportunity to come before you today to discuss oversight of the E-rate program and to discuss concerns that my office has with the program as a result of our involvement in audits and investigations. In my testimony, I will briefly summarize my office's involvement in USF oversight and discuss concerns my office has regarding the program.

Background on Independent Oversight of the Universal Service Fund (USF)

My office first looked at the USF in 1999 as part of our audit of the Commission's FY 1999 financial statement when the USF was determined to be part of the FCC's reporting entity for financial statement reporting. During that audit, we questioned

the Commission regarding the nature of the USF and, specifically, whether it was subject to the statutory and regulatory requirements for Federal funds. Starting with that inquiry, the Office of Inspector General has continued to devote considerable resources to oversight of the USF.

Due to materiality and our assessment of audit risk, we have focused much of our attention on the USF mechanism for funding telecommunications and information services for schools and libraries, also known as the "Schools and Libraries Program" or the "E-rate" program. Applications for E-rate funding have increased from 30,675 in funding year 1998 to 43,050 for the current funding year. Applications have been received from schools and libraries in each of the 50 states, the District of Columbia, and most territories and included 15,255 different service providers. Requested funding has increased from \$2,402,291,079 in funding year 1998 to \$4,538,275,093 for the current funding year.

OIG Oversight

During FY 2001, we worked with Commission representatives as well as with the Defense Contract Audit Agency (DCAA) and the Universal Service Administrative Company (USAC), to design an audit program that would provide the Commission with programmatic insight into compliance with rules and requirements on the part of E-rate program beneficiaries and service providers. Our program was designed around two corollary and complementary efforts. First, we would conduct reviews on a statistical sample of beneficiaries large enough to allow us to derive inferences regarding beneficiary compliance at the program level. Second, we would establish a process for vigorously investigating allegations of fraud, waste, and abuse in the program.

Unfortunately, several obstacles have impeded our ability to implement effective, independent oversight of the program. The primary obstacle has been a lack of adequate resources to conduct audits and provide audit support to investigations. Since our initial involvement in independent oversight of the USF as part of our conduct of the FY 1999 financial statement audit, we have demonstrated our commitment to independent oversight of the USF by adding two (2) staff auditor positions and by organizing USF oversight activities under an Assistant Inspector General for USF Oversight. This represents dedication of three (3) of the eight (8) auditors on the staff of the FCC OIG to USF oversight. In addition to the OIG staff dedicated to USF oversight, two (2) audit staff members responsible for financial audit are also involved in USF oversight as part of the financial statement audit process. In July 2004, I was advised that the OIG would two (2) additional staff for USF oversight. We are currently in the process of hiring these additional staff.

We have also requested appropriated funding to obtain contract support for our USF oversight activities. In our FY 2004 budget submission, we requested \$2 million for USF oversight. That request was increased to \$3 million in the President's budget submission for FY 2004. This funding was not included in the Commission's final budget for FY 2004 and report language indicated that monies for USF audits should come from the fund itself. In our FY 2005 budget submission, we requested \$5 million for USF oversight. We have been advised that this request was not included in this year's budget. We have requested a significant increase in funding for USF oversight in our FY 2006 budget submission. The requested increase is primarily a result of a Commission request for the conduct of audits to meet the requirements of the Improper Payments Information Act of 2002 and calculate estimated improper payment error rates for USF programs including E-rate. I have been advocating for some time that the cost of USF oversight should be provided for through direct access to the USF. I have been advised that this alternative is being considered.

We are currently considering alternatives for obtaining access to contract audit support to implement the USF oversight portions of our audit plan. We are working with USAC to establish a three-way contract under which my Office can obtain audit resources to conduct USF audits. We are also working with USAC and a public accounting firm under contract to USAC to conduct the fourth large-scale audit of E-rate beneficiaries. One-hundred beneficiaries are being audited as part of this project. The project was initiated in August 2004 and is expected to be completed next summer.

Despite limited resources, my office has implemented an aggressive independent oversight program. My oversight program includes: (1) audits conducted using internal resources; (2) audits conducted by other Federal Offices of Inspector General under reimbursable agreements; (3) review of audit work conducted by USAC; and (4) active participation in Federal investigations of E-rate fraud.

One-hundred and thirty five (135) audits have been completed by my office, USAC internal auditors, or USAC contract auditors in which the auditor reached a conclu-

sion about beneficiary compliance. Of the 135 audits, auditors determined that beneficiary were not compliance in 48 audits (36 percent) and generally compliant in an additional 22 audits (16 percent). Beneficiaries were determined to be compliant in 65 audits (48 percent). Recommended fund recoveries for those audits where problems were identified total over \$17 million.

OIG Audits Using Internal Resources

My office has completed thirteen (13) audits that we initiated during Fiscal Year 2002 using auditors detailed from the Commission's Common Carrier Bureau (since reorganized as the Wireline Competition Bureau). For these thirteen (13) audits, we concluded that applicants were compliant with program rules in five (5) of the audits, that applicants were generally compliant in two (2) of the audits, and that the applicants were not compliant with program rules in six (6) of the audits. We have recommended recovery of \$1,794,792 as shown below:

Report Date	Applicant	Conclusion	Potential Fund Recovery
09/11/02	Enoch Pratt Free Library	Compliant	\$0
02/03/03	Robeson County Public Schools	Compliant	0
02/05/03	Wake County Public Schools	Compliant	0
08/27/03	Albemarle Regional Library	Compliant	0
12/22/03	St. Matthews Lutheran School	Not Compliant	136,593
12/22/03	Prince William County Schools	Generally Compliant	5,452
12/22/03	Arlington Public School District	Generally Compliant	7,556
03/24/04	Immaculate Conception School	Not Compliant	68,846
04/06/04	Children's Store Front School	Not Compliant	491,447
05/19/04	St. Augustine School	Not Compliant	21,600
05/25/04	Southern Westchester BOCES	Compliant	0
06/07/04	United Talmudical Academy	Not Compliant	934,300
08/12/04	Annunciation Elementary School	Not Compliant	129,003
			\$1,794,792

Audits Conducted by Other Federal Offices of Inspector General

On January 29, 2003, we executed a Memorandum of Understanding (MOU) with the Department of the Interior (DOI) OIG. The MOU is a three-way agreement among the Commission, DOI OIG, and USAC for reviews of schools and libraries funded by the Bureau of Indian Affairs and other universal service support beneficiaries under the audit cognizance of DOI OIG. Under the agreement, auditors from the Department of the Interior perform audits for USAC and the FCC OIG. In addition to audits of schools and libraries, the agreement allows for the DOI OIG to consider requests for investigative support on a case-by-case basis. We have issued two (2) final audit reports under this MOU, three (3) draft audit reports, and have completed fieldwork on two (2) additional audits. For the audit where we determined that the applicant was not compliant, we have recommended recovery of \$2,084,399. A summary of completed audits is as follows:

Report Date	Applicant	Conclusion	Potential Fund Recovery
11/06/03	Santa Fe Indian School	Compliant	\$0
01/07/04	Navajo Preparatory Academy	Not Compliant	2,084,399

We have also established a working relationship with the Office of Inspector General at the Education Department (Education OIG). In January 2004, Education OIG presented a plan for an audit of telecommunication services at the New York City Department of Education (NYCDOE). Because of the significant amount of E-rate funding for telecommunication services at NYCDOE, Education OIG has proposed that they be reimbursed for this audit under a three-way MOU similar to the existing MOU with DOI OIG. In April 2004, the Universal Service Board of Directors approved the MOU. In June 2004, the MOU was signed and the audit was initiated.

Review of USAC Audits

We have reviewed work performed by USAC's Internal Audit Division and performed the procedures necessary under our audit standards to rely on that work. In December 2002, USAC established a contract with a public accounting firm to perform agreed-upon procedures at a sample of seventy-nine (79) beneficiaries from funding year 2000. The sample of beneficiaries was selected by the OIG. In a departure from the two previous large-scale rounds of E-rate beneficiary audits conducted by USAC contractors, the agreed-upon procedures being performed under this contract would be performed in accordance with both the Attestation Standards estab-

lished by the American Institute of Certified Public Accountants (AICPA) Standards and Generally Accepted Government Auditing Standards, issued by the Comptroller General (GAGAS or “Yellow Book” standards). In March 2003, we signed a contract with a public accounting firm to provide audit support services for USF oversight to the OIG. The first task order that we established under this contract was for the performance of those procedures necessary under “Yellow Book” standards to determine the degree to which we can rely on the results of that work (*i.e.*, to verify that the work was performed in accordance with the AICPA and GAGAS standards). The OIG review team is currently completing this work. Many of the audit findings raised by this body of work are reflected in the section addressing concerns with the E-rate program.

Support to Investigations

In addition to conducting audits, we are providing audit support to a number of investigations of E-rate recipients and service providers. To implement the investigative component of our plan, we established a working relationship with the Antitrust Division of the Department of Justice (DOJ). The Antitrust Division has established a task force to conduct USF investigations comprised of attorneys in each of the Antitrust Division’s seven (7) field offices and the National Criminal Office. We are also supporting several investigations being conducted by Assistant United States Attorneys.

We are currently supporting twenty-two (22) investigations and monitoring an additional fifteen (15) investigations. Unfortunately, the increased interest in these cases has resulted in an increased demand for OIG audit support. In fact, the amount of audit support has exacerbated our previously stated concern about the availability of resources and our ability to implement other components of our USF oversight plan. Allegations being investigated in these cases include the following:

- Procurement irregularities—including lack of a competitive process and bid rigging;
- False Claims—Service Providers billing for goods and services not provided;
- Ineligible items being funded; and
- Beneficiaries are not paying the local portion of the costs resulting in inflated costs for goods and services to the program and potential kickback issues.

Concerns with the E-rate Program

My office’s involvement in E-rate audits and investigations has highlighted numerous concerns with this program. These include general programmatic and management concerns as well as specific concerns related to program design. General concerns include:

- lack of clarity regarding program rules, and;
- lack of timely and effective resolution of audit findings.

Specific concerns regarding program design include;

- weaknesses in program competitive procurement requirements;
- ineffective use of purchased goods and services;
- reliance on applicant certifications;
- weaknesses in technology planning; and
- issues relating to discount calculation and payment.

Lack of Clarity Regarding Program Rules

Under Commission staff oversight, USAC has implemented numerous policies and procedures to administer the E-rate program. In some cases, the Commission has adopted these USAC operating procedures, in other cases however, USAC procedures have not been formally adopted by the FCC. In those cases where USAC implementing procedures have not been formally adopted by the Commission, it is the position of Commission staff that there is no legal basis for recovery of funds when applicants fail to comply with these procedures.

We are concerned about the distinction that Commission staff makes between program rules and USAC implementing procedures for a number of reasons.

- First, we believe that this distinction represents a weakness in program design. Within their authority under program rules, USAC has established implementing procedures to ensure that program beneficiaries comply with program rules and that the objectives of the program are met. In those cases where USAC has established implementing procedures that are not supported by pro-

gram rules, USAC and the Commission have no mechanism for enforcing beneficiary compliance.

- Second, we believe that it is critical that participants in the E-rate program have a clear understanding of the rules governing the program and the consequences that exist if they fail to comply with those rules. We are concerned that the Commission has not determined the consequences of beneficiary non-compliance in many cases and that, in those instances where the Commission has addressed the issue of consequences for non-compliance, the consequences associated with clear violations of program rules do not appear to be consistent.
- Third, a clear understanding of the distinction between program rules and USAC implementing procedures is necessary for the design and implementation of effective oversight. It is necessary for the timely completion of audits and the timely resolution of audit findings and implementation of corrective action resulting from audits.

Lack of Timely and Effective Resolution of Audit Findings from E-rate Beneficiary Audits

Since our involvement in this program, I have become increasingly concerned about efforts to resolve audit findings and to recover funds resulting from E-rate beneficiary audits. It has been our observation that audit findings are not being resolved in a timely manner and that, as a result, actions to recover inappropriately disbursed funds are not being taken in a timely manner. In some cases, it appears that audit findings are not being resolved because USAC is not taking action in a timely manner. In other cases, findings are not being resolved because USAC is not receiving guidance from the Commission that is necessary to resolve findings. USAC is prohibited under program rules from making policy, interpreting unclear provisions of the statute or rules, or interpreting the intent of Congress. As a result of this prohibition, USAC must seek guidance from the Commission when audit findings are not clearly violations of Commission rules.

The second large-scale audit of E-rate beneficiaries was conducted by the public accounting firm of Arthur Andersen under contract to USAC. In 2001, USAC contracted with Arthur Andersen to conduct audits at twenty-five (25) beneficiaries from funding years 1999 and 2000. E-rate disbursements to these beneficiaries totaled \$322 million. Arthur Andersen provided a draft audit report summarizing the results of these audits on May 31, 2002. The final report, including responses from the USAC Schools and Libraries Division, was released by the Schools and Libraries Committee of the USAC Board of Directors on April 23, 2003, eleven months after the draft report was provided by Arthur Andersen. The audit report disclosed monetary findings at fourteen (14) of the twenty-five (25) beneficiaries including \$11.4 million in inappropriate disbursements and unsupported costs. As of September 30, 2003, USAC had recovered \$1,927,579 in inappropriate disbursements and unsupported costs and initiated recovery actions for another \$1,353,741, of which \$709,013 is under appeal. We have been advised that USAC initiated recovery actions for the remaining \$8,059,141.

The final report adopted by the Universal Service Board also identified eleven (11) policy issues, relating to thirty-three (33) separate findings, for which USAC determined that FCC policy guidance was required. The dollar value of potential fund recoveries associated with these thirty-three (33) findings was not available because, in most cases, the final report indicated that those amounts had not been determined. Policy issues identified included the lack of fixed asset and associated records, maintenance of connectivity once it is established, technology plan approver control and requirements, insufficient documentation including lack of invoice detail and vendor payment information, incomplete or insufficient competitive bidding documentation, monitoring of technology plan goals and objectives, and physical security of equipment. Although the final report was released on April 23, 2003, USAC did not request policy guidance from Commission staff until October 2003. In January 2004, Commission staff provided "informal" guidance to USAC related to E-rate beneficiary audits being conducted by KPMG. These informal comments included reference to four (4) of the eleven (11) Arthur Anderson round 2 policy questions raised by USAC in their October 2003 request. On March 4, 2004, Commission staff provided guidance to USAC on the eleven (11) policy issues, almost two years after the draft report was submitted by Arthur Andersen. Many of the policy questions raised in USAC's request for guidance address issues identified in other audits including other E-rate beneficiary audits conducted by USAC's Internal Audit Division and those conducted by the FCC OIG.

Weaknesses in Program Competitive Procurement Requirements

Program rules require that applicants use a competitive procurement process to select vendors. In establishing this requirement, the Commission recognized that “(c)ompetitive bidding is the most efficient means for ensuring that eligible schools and libraries are informed about all of the choices available to them” and that “(a)bsent competitive bidding, prices charged to schools and libraries may be needlessly high, with the result that fewer eligible schools and libraries would be able to participate in the program or the demand on universal service support mechanisms would be needlessly great.”

Applicants are required to submit a form 470 identifying the products and services needed to implement the technology plan. The form 470 is posted to the USAC web page to notify service providers that the applicant is seeking the products and services identified. Applicants must wait at least 28 days after the form 470 is posted to the website and consider all bids they receive before selecting the service provider to provide the services desired. In addition, applicants must comply with all applicable state and local procurement rules and regulations and competitive bidding requirements. The form 470 cannot be completed by a service provider who will participate in the competitive process as a bidder and the applicant is responsible for ensuring an open, fair competitive process and selecting the most cost-effective provider of the desired services. Further, although no program rule establishes this requirement, applicants are encouraged by USAC to save all competing bids for services to be able to demonstrate that the bid chosen is the most cost-effective, with price being the primary consideration.

Although the programs competitive bidding requirements were intended to ensure that schools and libraries are informed about all of the choices available to them, we have observed numerous instances in which beneficiaries are not following the program’s competitive bidding requirements or are not able to demonstrate that competitive bidding requirements are being followed. We question whether the rules are adequate to ensure a competitive process is followed. In addition, weak record-keeping requirements to support the procurement process, as well as other aspects of the E-rate application, offer little protection to the program. We believe that the competitive procurement requirements are based on some faulty assumptions. For example,

- Form 470s will have enough information for meaningful proposals from prospective service providers.
- Service providers are reviewing and considering posted form 470s (particularly for smaller schools).
- “Applicable” state and local procurement regulations exist and those regulations are consistent with program rules.

Ineffective Use of Purchased Goods and Services

Site visits are conducted during most E-rate beneficiary audits. Site visits are conducted for several reasons including to evaluate the eligibility of facilities where equipment is installed, verify that equipment is installed and operational, and to verify that equipment is being used for its intended purpose. Examples of concerns identified during audits and investigations are as follows:

- Goods and services not being provided.
- Unauthorized substitution of goods and services.
- Goods and services being provided to ineligible facilities (*e.g.*, non-instructional building including dormitories, cafeterias, and administrative facilities).
- Equipment not being installed or not operational. Program rules require that nonrecurring services be installed by a specified date. However, there is no specific FCC rule requiring beneficiaries to use equipment in a particular way, or for a specified period of time, or to full efficiency. Commission staff have provided guidance stating that if the equipment was uninstalled (*i.e.*, still in a box) that would represent a rule violation. However, Commission staff have also provided guidance stating that the rules do not require that beneficiaries effectively utilize the services provided or that the beneficiaries maintain continuous network or Internet connectivity once internal connections are installed.

Reliance on Applicant Certifications

The E-rate program is heavily reliant on applicant and service provider certifications. For example, on the form 470, applicants certify that the support received is conditional upon the ability of an applicant to secure access to all of the resources, including computers, training, software, maintenance, and electrical connections, necessary to use effectively the services that will be purchased under this mecha-

nism. On the form 471, applicants make several important certifications. Applicants certify that they have “complied with all applicable state and local laws regarding procurement of services for which support is being sought” and that “the services that the applicant purchases . . . will not be sold, resold, or transferred in consideration for money or any other thing of value.” Other certifications are required on various program forms.

My office started to raise concerns about perceived weaknesses in the competitive procurement process and over reliance on certifications shortly after we became involved in program oversight. We first became concerned about the competitive procurement process as a result of our involvement in the Metropolitan Regional Education Service Agency (MRESA) investigation. During that investigation we observed how weaknesses in competitive bidding requirements and reliance on self certification were exploited resulting in, at a minimum, a significant amount of wasteful spending. We continued to express our concerns as we designed our oversight program, developed a program for auditing beneficiaries, and supported E-rate fraud investigations. In fact, we established a working relationship with the Antitrust Division of the Department of Justice in a large part because of the number of investigations that we were supporting that involved allegations regarding the competitive procurement process.

Our level of concern regarding both the competitive procurement process and reliance on self-certification was heightened as we started to work with the Antitrust Division. During our discussions with Antitrust, they expressed a general concern with the lack of information regarding the competitive process and specific concerns regarding applicant and service provider certifications. Although we started to pursue these issues with Commission staff in the fall of 2002, the Commission has only recently started to address some of the recommendations from Antitrust, and none of these recommendations are fully implemented. We have been informed by WCB that several of the Antitrust suggestions have been incorporated into the appropriate E-rate forms and that those forms are now at the Office of Management and Budget for approval. Other recommended certifications, particularly regarding the competitive process, are still in the process of public comment, and we are as yet uncertain what the FCC may ultimately do with these recommendations. Numerous of the suggestions from Antitrust involved USAC obtaining and reviewing critical procurement documents during the application review process. The Commission’s response to these suggestions was to include in the 5th Report and Order the requirement that the applicant retain these documents, but providing these documents for review along with an E-rate application was not required. And lastly, WCB has informed us that at this time they will not incorporate certain recommendations. I believe that the delay in implementing Antitrust’s recommendations, and the exclusion of some of the recommendations from implementation, continues to place the program at risk.

Weaknesses in Technology Planning

Program rules require that applicants prepare a technology plan and that the technology plan be approved. The approved technology plan is supposed to include a sufficient level of information to justify and validate the purpose of a request for E-rate funding. USAC implementing procedures state that approved technology plans must establish the connections between the information technology and the professional development strategies, curriculum initiatives, and library objectives that will lead to improved education and library services. Although the technology plan is intended to serve as the basis for an application, we have observed many instances of non-compliance with program rules and USAC procedures related to the technology planning process. Examples of technology planning concerns identified during audits and investigations are as follows:

- Technology plans are not being reviewed and approved in accordance with program rules.
- Technology plans do not address all required plan elements in accordance with USAC implementing procedures for technology planning. Commission staff have provided guidance that failure to comply with USAC implementing procedures for technology plans is not a rule violation and does not warrant recovery of funds.
- Applicants not being able to provide documentation to support the review and approval of technology plan.

USAC guidance on technology planning states that “(i)n the event of an audit, you may be required to produce a certification similar to the SLD sample “Technology Plan Certification Form,” in order to document approval of your technology plan.” Numerous audits have included findings beneficiaries were unable to provide docu-

mentation to demonstrate the review and approval of technology plans. Although program rules require that applicants have a technology plan and that the plan be approved, the rules do not require that the applicant maintain specific documentation regarding the approval process.

Discount Calculation and Payment of the Non-Discount Portion

The E-rate program allows eligible schools and libraries to receive telecommunications services, Internet access, and internal connections at discounted rates. Discounts range from 20 percent to 90 percent of the costs of eligible services, depending on the level of poverty and the urban/rural status of the population served, and are based on the percentage of students eligible for free and reduced lunches under the National School Lunch Program (NSLP) and other approved alternative methods. A number of audits have identified audit findings that applicants have not followed program requirements for discount rate calculation or were unable to support the discount rate calculated.

Applicants are required to pay the non-discount portion of the cost of the goods and services to their service providers and service providers are required to bill applicants for the non-discount portion. The discount rate calculation and program requirement for payment of the non-discount portion are intended to ensure that recipients avoid unnecessary and wasteful expenditures and encourage schools to seek the best pre-discount rate. Examples of concerns identified during audits and investigations are as follows:

- Applicant not paying the non-discount portion;
- Applicant not paying the non-discount portion in a timely manner; and
- Service providers not billing recipients for the non-discount portion.

Conclusion

The Office of Inspector General remains committed to meeting our responsibility for providing effective independent oversight of the USF and we believe we have made significant progress. While the Commission has taken steps to address programmatic weaknesses, more work remains to be done. Through our participation in the fourth large-scale round of E-rate beneficiary audits with USAC and through audits that we anticipate conducting under our three-way agreement with USAC, we are moving forward to evaluate the state of the program and identify opportunities for programmatic improvements. In order to continue this important work it is my belief that the Commission should have direct access to the USF. This will provide the resources for an effective and independent oversight program.

The CHAIRMAN. Thank you very much.
Mr. Gumper, welcome.

**STATEMENT OF FRANK GUMPER, CHAIRMAN OF THE BOARD,
UNIVERSAL SERVICE ADMINISTRATIVE COMPANY**

Mr. GUMPER. Good morning, Mr. Chairman and Members of the Committee. My name is Frank Gumper. I am the Chairman of the Board of Directors of the Universal Service Administrative Company, USAC. It is my privilege to be here today to speak with you about USAC and its administration of the schools and libraries universal service support mechanisms, commonly referred to as the E-rate program.

USAC is a not-for-profit corporation designated by the FCC to administer the four universal service mechanisms based on the Telecommunications Act of 1996 and FCC regulations adopted pursuant to the Act. USAC is governed by a Board of Directors, each of whom is appointed by the Chairman of the FCC. The Board consists of 19 Directors, each of whom represents the interests of a particular constituency defined in FCC regulations. I represent large incumbent local exchange carriers. I was appointed by Chairman Reed Hundt in 1997, reappointed by Chairman Michael Powell in 2001, and have served on the Board since the creation of USAC. I was elected Chairman of the Board in January 2000.

The USAC Board of Directors are purposely structured to ensure that the views of many different interests are heard and considered. Each Director brings to the attention of the Board the particular sensitivities and concerns of his or her constituency, thereby assisting the entire board and enhancing the Board's decision-making process.

Each director must ultimately use his or her position to represent USAC's overall interests, that is the interest of USAC as a corporate entity and not the interest of his or her constituency. To that end, each Director is bound by a stringent statement of ethical conduct. All USAC Board members are obligated to discharge their responsibility to ensure that the universal service support mechanisms—High Cost; Low Income; Rural Health Care; and Schools and Libraries—are properly administered.

My experience serving on the Board for the past 7 years has been that the USAC Board of Directors are particularly active and engaged with the issues facing the administration of the support mechanisms. The Board of Directors and USAC committees convene on a quarterly basis and as needed between the quarterly Board meetings. At each meeting USAC staff brings critical issues to the attention of the board, which takes action as needed.

The Board is particularly concerned about waste, fraud and abuse. The Board represents all relevant constituencies, including consumer advocates and schools and libraries, and our job is to ensure that all contributions to the fund go to fulfil the promise of universal service, which in the case of the E-rate program is to provide access to advanced telecommunications services for schools and libraries.

Working with USAC staff, numerous actions have been taken to protect the E-rate program and the Universal Service Fund in general. As a board member, I am confident that USAC's administration of the E-rate program has become increasingly sophisticated over time as USAC board and staff have responded to those who would abuse the program.

There have been program violations and the USAC board and staff take these violations seriously. However, we have taken many actions to address them, including but certainly not limited to: improving the application and invoice review procedures; increasing the number of staff devoted to responding to whistleblower calls; increasing the number of audits; launching new initiatives, such as the thousand site visits that will occur over the next year; and providing support to law enforcement investigations. George McDonald, the Vice President of USAC responsible for the administration of the E-rate program, will discuss these tools in greater depth in his testimony.

USAC is launching an important new communication and education initiative. At the last Board meeting, Board members engaged in a lively discussion of different strategies the prevent program rule violations from occurring. USAC denies funding requests when it determines that a violation has already occurred. USAC already provides a great deal of applicant and service provider training, but in light of the audit findings Board members questioned whether all the program participants are receiving the benefits of this coalition. Board members considered what steps could be taken

to try to prevent program rule violations from happening in the first place and charged USAC's CEO with presenting a plan for implementing that effort at the next Board meeting later this month.

We believe that this effort will help prevent waste, fraud and abuse by more effectively educating applicants and service providers about program requirements. In addition, USAC is working closely with the FCC's Office of Inspector General to expand our audit activity in all of the programs.

Mr. Chairman, thank you for providing me the opportunity to address the Committee. We look forward to continuing to work with Congress to improve the schools and libraries support mechanism. I would be happy to respond to any questions you may have about these issues or the accounting issues you raised earlier.

[The prepared statement of Mr. Gumper follows:]

PREPARED STATEMENT OF FRANK GUMPER, CHAIRMAN OF THE BOARD OF DIRECTORS,
UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

Good morning, Mr. Chairman and Members of the Committee. My name is Frank Gumper. I am the Chairman of the Board of Directors of the Universal Service Administrative Company ("USAC"). It is my privilege to be here today to speak with you about USAC and its administration of the Schools and Libraries Universal Service Support Mechanism, commonly referred to as the "E-rate" program.

Overview

USAC is the not-for-profit corporation designated by the Federal Communications Commission ("FCC") to administer four universal service support mechanisms based on the Telecommunications Act of 1996 and FCC regulations adopted pursuant to the Act. USAC is governed by a Board of Directors, each of whom is appointed by the Chairman of the FCC. The Board consists of 19 Directors, each of whom represents the interests of a particular constituency defined in FCC regulations. I represent large incumbent local exchange carriers. I was appointed by Chairman Reed Hundt in 1997, re-appointed by Chairman Michael Power in 2001, and have served on the Board since the creation of USAC. I was elected Chairman of the Board in January 2000.

The USAC Board of Directors is purposely structured to ensure that the views of many differing interests are heard and considered. Each Director brings to the attention of the Board the particular sensitivities and concerns of his or her constituency, thereby assisting the entire Board and enhancing the Board's decision making process. Each Director must ultimately use his or her position to represent USAC's overall interests; that is, the interests of USAC as a corporate entity, and not the interests of his or her constituency. To that end, each Director is bound by a stringent Statement of Ethical Conduct.

The E-rate Program

All USAC Board Members are obliged to discharge their responsibilities to ensure that the universal service support mechanisms—High Cost, Low Income, Rural Health Care, and Schools and Libraries, commonly known as the E-rate Program—are properly administered. My experience serving on the Board for the past seven years has been that the USAC Board of Directors is particularly active and engaged with the issues facing the administration of the support mechanisms. The Board of Directors and the USAC Committees convene on a quarterly basis and as needed between the quarterly board meetings. At each meeting, USAC staff brings critical issues to the attention of the Board, which takes action as needed.

The Board is particularly concerned about waste, fraud and abuse. The Board represents all relevant constituencies, including consumer advocates and schools and libraries, and our job is to ensure that all contributions to the fund go to fulfill the promise of universal service—which in the case of the E-rate program is to provide access to advanced telecommunications service for schools and libraries.

Working with USAC staff, numerous actions have been taken to protect the E-rate program, and the Universal Service Fund in general. As a Board member, I am confident that USAC's administration of the E-rate program has become increasingly sophisticated over time as USAC's Board and staff have responded to those who would abuse the program. There have been program violations, and USAC's Board and staff takes those violations seriously. However, we have taken many ac-

tions to address them, including, but certainly not limited to, improving the application and invoice review procedures, increasing the number of staff devoted to responding to whistleblower calls, increasing the number of audits, launching new initiatives such as the 1,000 site visits that will occur over the next year, and providing support to law enforcement investigations. George McDonald, the Vice President of USAC responsible for the administration of the E-rate program, will discuss these tools in greater depth in his testimony.

USAC is launching an important new Communications and Education initiative. At the last Board meeting, Board Members engaged in lively discussion of different strategies to prevent program rule violations from occurring. USAC denies funding requests when it determines that a violation has already occurred. USAC already provides a great deal of applicant and service provider training, but in light of audit findings, Board members questioned whether all program participants are receiving the benefits of this training. Board members considered what steps could be taken to try to prevent program rule violations from happening in the first place, and charged USAC's Chief Executive Officer with presenting a plan for implementing that effort at the next Board meeting later this month. We believe that this effort will help to prevent waste, fraud and abuse by more effectively educating applicants and service providers about program requirements. In addition, USAC is working closely with the FCC's Office of Inspector General to expand our audit activity in all of the programs.

Conclusion

Mr. Chairman, thank you for providing me with the opportunity to address the Committee. We look forward to continuing to work with Congress to improve the Schools and Libraries Support Mechanism. I would be happy to respond to any questions you may have.

The CHAIRMAN. Thank you very much.
Mr. McDonald, welcome.

STATEMENT OF GEORGE McDONALD, VICE PRESIDENT, SCHOOLS AND LIBRARIES DIVISION, UNIVERSAL SERVICE ADMINISTRATIVE COMPANY

Mr. McDONALD. Thank you, Mr. Chairman, Senator Rockefeller. I am George McDonald, Vice President of the Universal Service Administrative Company responsible for the Schools and Libraries Division. I am pleased to be here today to discuss USAC's administration of the E-rate program.

As Mr. Gumper has said, USAC is committed to helping prevent waste, fraud and abuse in the universal service support mechanisms and we devote substantial resources toward that goal so that the benefits of the discounts go only to eligible entities for eligible uses. Before we began making funding commitments in 1998, we hired an independent consultant, PriceWaterhouseCoopers, to advise us on our internal controls and attest to the adequacy of those controls. Our internal controls are designed to ensure that commitment and disbursement of E-rate funds are consistent with FCC rules relating, for example, to the eligibility of entities, of services, and appropriate discount rates.

At your request as Chair of this Committee, Senator McCain, staff of the then-U.S. General Accounting Office reviewed our draft procedures in 1998 and recommended changes, which we implemented. We employ many tools to help ensure compliance with program rules. These include detailed application and invoice review procedures, denying funding commitments when appropriate, rejecting incorrect invoices, auditing program beneficiaries and service providers, recovering funds where rule violations are found, investigating whistleblower hot line complaints, supporting law en-

forcement investigations, and referring matters involving suspected program abuse to law enforcement authorities.

USAC's application and invoice review procedures have greatly evolved over the past 6 years, becoming more detailed and comprehensive as we have gained experience with the program. For example, as we saw instances of service providers not making applicants pay the non-discount share, a key rule of the program, we initiated verification of payment of that share into our invoice review process. USAC's internal controls have prevented the unlawful disbursement of hundreds of millions of dollars, either as a result of denials based on failure to comply with program rules or cancellation of funding requests by the applicant as a result of our inquiries.

Pursuant to SEC rules, USAC engages an independent auditor to conduct annual financial and operational audits of USAC. As part of that annual effort, auditors assess whether we are properly implementing our procedures, and there have been no significant issues raised in those audits.

We receive approximately 35,000 E-rate applications per year. In addition, we process an average 80,000 individual requests for payment annually. Our fundamental responsibility is to make well-founded decisions to approve or deny these requests. Each of these documents is individually processed using detailed program integrity assurance, or PIA, review procedures to arrive at an appropriate decision consistent with program rules.

We also conduct audits of beneficiaries to assess program rule compliance. As a result of audit findings, we have modified and strengthened our internal controls, improved our outreach, and better educated applicants and service providers regarding program rules.

In order to provide the public with the means of reporting activities that may be in violation of E-rate program rules, USAC maintains a whistleblower hot line. USAC's special investigations team investigates every call to determine if further action is required. We receive and follow up on over 100 calls per year.

Comprehensive applicant and service provider training in program requirements are vital components of program integrity. USAC's applicant training, an annual conference of State E-rate coordinators, and regional meetings throughout the year emphasizes the importance of compliance with program rules and the consequences of noncompliance. USAC also provides training and education opportunities to service provider participants in the program and, as Mr. Gumper said, we are looking to significantly expand our outreach activities.

One of the key lessons we have learned from our experience in administering the program and from the audits we have conducted as well as from law enforcement investigation and media reports is that USAC needs a larger oversight presence in the field. Site visits will allow us to assess more fully in real time how E-rate funds are being used, to learn about and publicize best practices in education technology and program compliance, and to help ensure that products and services have in fact been delivered and are being used effectively. We are currently in the process of selecting a vendor that will conduct some 1,000 site visits a year.

While USAC has responsibility for ensuring applications are properly reviewed, applicants and service providers alike have responsibility for knowing and following the spirit, intent, and letter of the law and rules of the program. The FCC in a series of recent rulemakings has stressed that accountability. For example, applicants must conduct a fair and open competitive process to select service providers and must select the most cost-effective offeror, with price the primary factor. Applicants cannot abdicate their responsibility to a service provider who is soliciting their business or to a consultant.

Service providers who are seeking an applicant's business cannot provide assistance to the applicant during the competitive bidding process. Similarly, service providers cannot waive the applicant's share of the cost and applicants must pay their share.

USAC's responsibility as administrator of the E-rate program is to prevent commitments and disbursements from being made in violation of program rules. During application review we deny requests for such reasons as: the request includes ineligible services; or we conclude that applicants did not conduct a fair and open competitive process or cannot pay their share of the costs; or applicants fail to meet deadlines.

To provide just a few examples, in funding year 2002 we denied funding requests totaling over \$500 million associated with IBM Corporation because of a procurement approach that we determined was inconsistent with program rules. IBM and some applicants appealed our decision to the FCC and the FCC upheld our determination that the approach violated E-rate rules.

In funding year 2001, 2002 and 2003, USAC denied funding requests totaling over \$47 million associated with Connect2 Internet Networks because of a variety of program rule violations. The owner and employees of Connect2 pled guilty to charges related to abuse of the program and two persons associated with that company have been debarred from the E-rate program by the FCC. We provided a great deal of assistance to law enforcement officials as they investigated that case.

Finally, over different program years USAC has denied millions of dollars in funding requests when we have determined that consultants who provided free services to applicants were actually associated with the applicant's service provider.

Mr. Chairman, thank you for providing me with the opportunity to address the Committee and we look forward to working with Congress to improve the E-rate program and I would be happy to respond to any questions you may have.

[The prepared statement of Mr. McDonald follows:]

PREPARED STATEMENT OF GEORGE McDONALD, VICE PRESIDENT, SCHOOLS AND LIBRARIES DIVISION, UNIVERSAL SERVICE ADMINISTRATIVE COMPANY,

Good morning, Mr. Chairman and Members of the Committee. My name is George McDonald. I am Vice President of the Universal Service Administrative Company ("USAC") responsible for the Schools and Libraries Division. I am pleased to be here today to discuss USAC's administration of the Schools and Libraries Universal Service Support Mechanism, commonly referred to as the "E-rate" program.

Overview

USAC is the not-for-profit corporation designated by the Federal Communications Commission ("FCC") to administer the E-rate program based on the Telecommuni-

cations Act of 1996 and FCC regulations adopted pursuant to the Act. In order to accomplish our mission, we work closely with the FCC, consulting almost daily on issues of implementation.

We are committed to helping prevent waste, fraud, and abuse in the universal service support mechanisms, and we devote substantial resources towards that goal so that the benefits of the discounts go only to eligible recipients for eligible uses. I would like to describe some of the administrative procedures we use to help ensure program integrity. I will also outline a new initiative designed to further improve compliance with program rules. Finally, I will briefly discuss applicant and service provider responsibilities, and provide some examples of funding requests that we have denied because of non-compliance with program rules.

Before we began making funding commitments in 1998, we hired an independent consultant, Coopers and Lybrand—which later became PricewaterhouseCoopers—to advise us on our internal controls and attest to the adequacy of those controls. Our internal controls are designed to ensure that commitment and disbursement of E-rate funds are consistent with FCC rules relating, for example, to the eligibility of entities, of services, and appropriate discount rates. At your request as Chair of this Committee, Senator McCain, staff of the then-U.S. General Accounting Office reviewed our draft procedures and recommended changes, which we implemented. For example, we moved a procedure to scrutinize the resources applicants have to make effective use of the discounted services from after commitment of funds to before.

We employ many tools to help assure compliance with program rules. These include detailed application and invoice review procedures, denying funding commitments when appropriate, rejecting incorrect invoices, auditing program beneficiaries and service providers, recovering funds where rule violations are found, investigating whistleblower hotline complaints, supporting law enforcement investigations, and referring matters involving suspected program abuse to law enforcement authorities.

USAC's application and invoice review procedures have greatly evolved over the past six years, becoming more detailed and comprehensive, as we have gained experience with the program. For example, as we saw instances of service providers not making applicants pay the nondiscount share (a key rule of the program), we initiated verification of payment of that share into our invoice review process. USAC's internal controls have prevented the unlawful disbursement of hundreds of millions of dollars, either as a result of denials based on failure to comply with program rules or cancellation of funding requests by the applicant as a result of USAC inquiries.

Pursuant to FCC rules, USAC engages an independent auditor to conduct annual financial and operational audits of USAC. As part of that annual effort, auditors assess whether we are properly implementing our procedures, and there have been no significant issues raised in those audits.

Application and Invoice Volumes

We receive approximately 35,000 E-rate applications per year. In addition, we process an average 80,000 individual requests for payment annually. Our fundamental responsibility is to make well-founded decisions to approve or deny these requests. Each of these documents is individually processed using detailed Program Integrity Assurance, or PIA, review procedures to arrive at an appropriate decision consistent with program rules.

Audits

We also conduct audits of beneficiaries to assess program rule compliance. As a result of audit findings, we have modified and strengthened our internal controls, improved our outreach, and better educated applicants and service providers regarding program rules.

Whistleblower Hotline and Special Investigations Team

In order to provide the public with a means of reporting activities that may be in violation of E-rate program rules, USAC maintains a whistleblower hotline. USAC's Special Investigations Team investigates every call to determine if further action is required. We receive and follow up on over 100 calls per year.

Education Regarding Program Requirements

Comprehensive applicant and service provider training in program requirements are vital components of program integrity. USAC's applicant training—an annual conference of state E-rate coordinators and regional meetings throughout the year—emphasizes the importance of compliance with program rules and the consequences of non-compliance. USAC also provides training and education opportunities to service provider participants in the program

New Site Visit Initiative

One of the key lessons we have learned from our experience in administering the program and from the audits we have conducted, as well as from law enforcement investigations and media reports, is that USAC needs a larger oversight presence in the field. Site visits will allow us to assess more fully, in real-time, how E-rate funds are being used, to learn about and publicize best practices in education technology and program compliance, and to help ensure that products and services have in fact been delivered and are being used effectively. We are currently in the process of selecting the vendor that will conduct some 1,000 site visits a year. This step will further enhance program integrity.

Applicant and Service Provider Responsibilities

While USAC has responsibility for ensuring applications are properly reviewed, applicants and service providers alike have responsibility for knowing and following the spirit, intent and letter of the law and rules of the program. The FCC, in a series of recent rulemakings, has stressed that accountability. For example, applicants must conduct a fair and open competitive process to select service providers, and must select the most cost-effective offer with price the primary factor. Applicants cannot abdicate their responsibility to a service provider who is soliciting their business, or to a consultant. Service providers who are seeking an applicant's business cannot provide assistance to the applicant during the competitive bidding process. Similarly, service providers cannot waive the applicant's share of the cost, and applicants must pay their share.

USAC's Responsibility is to Deny Funding Requests that Do Not Comply with Program Rules

USAC's responsibility as administrator of the E-rate program is to prevent commitments and disbursements from being made in violation of program rules. During application review, we deny requests for such reasons as the requests include ineligible services or services to ineligible entities, or we conclude that applicants did not conduct a fair and open competitive process or cannot pay their share of the costs, or applicants failed to meet deadlines. To provide just a few examples, in Funding Year 2002, we denied funding requests totaling over \$500 million associated with IBM Corporation ("IBM") because of a procurement approach that we determined was inconsistent with program rules. IBM and some applicants appealed our decision to the FCC, and the FCC upheld our determination that the approach violated E-rate rules. In Funding Years 2001 through 2003, USAC denied funding requests totaling over \$47 million associated with Connect2 Internet Networks, Inc. because of a variety of program rule violations. The owner and employees of Connect2 pled guilty to charges related to abuse of the program and two persons associated with that company have been debarred from the E-rate program by the FCC. We provided a great deal of assistance to law enforcement officials as they investigated that case. Finally, over different program years, USAC has denied millions of dollars in funding requests when we have determined that "consultants" who provided free services to applicants were actually associated with the applicants' service provider.

Conclusion

Mr. Chairman, thank you for providing me with the opportunity to address the Committee. We look forward to continuing to work with Congress to improve the Schools and Libraries Support Mechanism. I would be happy to respond to any questions you may have.

The CHAIRMAN. Thank you.
Mr. Himsworth, welcome.

STATEMENT OF WINSTON E. HIMSWORTH, EXECUTIVE DIRECTOR, E-RATE CENTRAL, AND FOUNDER, STATE E-RATE COORDINATORS ALLIANCE

Mr. HIMSWORTH. Thank you, Mr. Chairman, Senator Rockefeller.
Let me make my position clear now. E-rate is my life. One of my kids once asked me to stay out of his and told me to get my own. This is what I got.

E-Rate Central, which I am the Executive Director of, is involved in E-rate and has been involved in E-rate since 1997, before the

program got started, at the local level working with applicants; at the state level, we have been serving as State Coordinator for E-rate for New York; and at the national level, working with a group of other state E-rate Coordinators in a group called the State E-rate Coordinators Alliance.

I want to try to make four points in a few minutes. One, this is a great program. It is doing what it is supposed to do. It is allowing schools to do things that it could not have done otherwise. I work with New York City, which has used this program to bring Internet access into 1,200 schools in a well thought out project started early in the program called Project Connect. I work at the other extreme with a small school up in Alaska, Chatham, Alaska, that you best get to with float plane. Internet access at the T-1 level there is almost \$20,000 a month. They just could not afford that type of service without this program.

The second point I want to make is that tight application reviews and audits are important, but they seem to be working. I was glad, Mr. Chairman, you recognized and Mr. McDonald again said today that the problems that were talked about in the last House hearing on \$500 million in requests that were not properly bid and/or were excessive were denied. So the program in that sense is working.

I am a little concerned that some of the audit results that we are seeing are being a bit misconstrued. I have looked at a number of them. The Office of Inspector General did 11 with their internal sources. Four of those were noncompliant. In my state we had three of those noncompliant schools. All three were associated with Connect2, which, as Mr. McDonald said, has already been found guilty of all these things.

There may be some laxness on the part of the schools in those cases. They are very small schools. But I view them more as victims.

We also looked at the——

The CHAIRMAN. How are they victims, Mr. Himsworth?

Mr. HIMSWORTH. They are victims, sir, because if you look through the reports what you find is that——

The CHAIRMAN. Are they not always victims when there is wrongdoing, Mr. Himsworth?

Mr. HIMSWORTH. Are they always victims when there is wrongdoing?

The CHAIRMAN. People do wrong things that are in charge of programs, like in Puerto Rico where many tens of millions of dollars were misused. I guess they were victims too.

Mr. HIMSWORTH. I think in those cases at least the children were, sir.

The CHAIRMAN. Absolutely.

Go ahead.

Mr. HIMSWORTH. I also looked at the KPMG audits, where in New York we had three noncompliers. Again, those were instances of administrative problems, violations of rules no doubt, but not what I would characterize as waste, fraud and abuse.

The third point I want to make is, we need to be careful not to try to solve all the program's, the problems of a program like this, with more rules. Rules are important, but this is already a complex

program with lots of rules, and that in fact is causing problems for a number of the applicants, just trying to keep up with them all.

The fourth point I want to make is, we believe that perhaps more important than more and more rules is the program should be changed in a couple fundamental ways to decrease the incentives that certain applicants and vendors have to get involved in waste, fraud and abuse practices. The biggest change that needs to be made in our opinion, both personally, through our State E-Rate Coordinators Alliance, and I was also on the waste, fraud and abuse task force, the recommendation coming out of there, was to limit the amount of discount that's allowed in this program, to change the discount matrix so that the 90 percent discount maximum is lowered by 10 to 20 percent. A 10-percent share is just not enough to foster careful planning and it is presenting too large a target for certain vendors.

I do not talk in my testimony about the funding freeze that was brought up this morning by several Senators. We are also concerned about that and I hope we will get into that in this discussion as well.

Thank you, sir.

[The prepared statement of Mr. Himsworth follows:]

PREPARED STATEMENT OF WINSTON E. HIMSWORTH, EXECUTIVE DIRECTOR,
E-RATE CENTRAL

Thank you for inviting me to appear before you this morning. Let me make my position clear from the outset. E-rate is a great program. It may not be perfect—few programs are—but it is evolving in a responsive and responsible way to meet the needs of its school and library applicants and to satisfy the need for even greater accountability.

E-Rate Central has been involved in the E-rate program since its inception. Our small company currently provides comprehensive E-rate support to approximately 125 medium-sized schools and school districts and to several large city school districts and school consortia. During the past six years, E-Rate Central has served as the New York State's E-rate coordinator. In that role, it was one of the founding members of the State E-Rate Coordinators' Alliance ("SECA"), an association of 41 state coordinators, which has been a proactive supporter and change agent for the E-rate program at the national level. Under the SECA banner, E-Rate Central maintains a nationally-recognized E-rate website, and distributes a widely-read weekly E-rate newsletter for New York applicants and for redistribution to other applicants through their state coordinators. To avoid conflicts of interest, E-Rate Central does not offer any E-rate eligible services.

In my testimony here today, it is my hope that four points will become clear.

- *E-rate is a successful and valuable program serving mission-critical needs of schools and libraries across the country—large and small, rich and poor. It is doing precisely what its early Senate sponsors envisioned.*

New York City Department of Education has been a large recipient of E-rate funds stemming from an early and concerted effort, dubbed "Project Connect," to provide Internet access to 5–10 rooms in each of its 1,200 schools over the first few years of the program. NYCDOE has been building upon this early success by upgrading and expanding the LAN networks and equipment in its schools and by developing a robust WAN network to interconnect them. This could not have been done without E-rate.

Chatham School District in Alaska is at the opposite end of the spectrum. This small and poor school district (less than 300 students with a 90 percent discount rate) is located in an area best reached by float plane. Telecom services, and most particularly high speed T-1 access, in such a remote area are expensive. Chatham's ongoing telecom and Internet budget this year is over \$225,000, almost \$1,000 per student. Without E-rate—which is already a problem because of the current freeze on new funding—Chatham would, at best, be able to afford dial-up Internet.

About half the school districts in Nassau County (Long Island, NY) have recently installed or are planning to install high-speed WANs. As these networks are developed, they will provide interconnectivity to share educational resources throughout the county (and ultimately, perhaps, the state). While only a few of the Nassau districts qualify for higher discounts, the E-rate program has clearly provided the impetus, and partial funding support, for this effort.

- *Certain applicants and vendors have attempted to make unfair, or even fraudulent, use of the program, but USAC has been quite successful in thwarting these efforts before funding is actually disbursed and/or in seeking to recover funds disbursed in error during the program's early years. Many of the audit statistics on compliance problems reflect failures to meet administrative rules which, while important, should not be characterized as examples of waste, fraud, and abuse ("WFA").*

E-rate is a program that was built on the fly. When the program began (technically, January 1, 1998), application forms had not yet been released. It was not until 1999 that applicants saw any real funding. To counter skepticism about the program, the administrators—quite properly in my opinion—focused most on getting applications approved and funds flowing. Many of the problems that have come to light over the past few years can be traced to the early years.

In recent years, USAC's compliance standards and enforcement efforts have been greatly strengthened. As a result, USAC had denied all or most applications that are now being put forth as examples of abuse. The House hearings last month, for example, focused on a number of applications submitted by large city school districts for IBM services in FY 2002. Valid questions were raised about the bidding procedures used by these districts, and about the scope and costs of services being proposed. Not stressed, however, was the fact that all of these applications were denied by USAC, and that the denials were upheld by the FCC on appeal. We believe that the lesson to be taken from this experience is that abusive incentives remain in the program, but that the program's administrators have developed increasing capabilities to deal with potential problems.

We are also concerned with reports that a high percentage of E-rate audits are finding evidence of non-compliance. We believe that it is important to understand that these audits are not completely "random," as is often indicated, and that the many of the instances of non-compliance are not as severe or prevalent as implied.

The FCC's Inspector General's testimony before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce last June listed the results of eleven audits of FY 1999 and FY 2000 applicants conducted by the OIG's own internal auditors. Four of the eleven audits (or 36 percent) classified as "Not Compliant." In our role as New York State coordinator, we have reviewed the audit reports for the three non-compliant schools located in New York. All three appear to have been targeted audits of customers of one specific supplier, Connect 2, whose officers have already been convicted of E-rate fraud. Most of the serious audit findings in these three cases were attributed directly to Connect 2 invoicing, often without the apparent knowledge of the schools. While not excusing the laxness on the part of these small private schools, we view the schools as victims, not perpetrators, of E-rate abuses.

We have also reviewed the results of seven New York audits of FY 2000 funding commissioned by USAC and performed by KPMG. Of these audits, three were classified as "Not Compliant." The problems in these cases appear to be largely administrative in nature, and are not the result of rampant waste, fraud, or abuse.

- One small school was found non-compliant because it had used an unapproved method to determine its discount rate. Because the school was not a participant in the National School Lunch Program, it had submitted a letter to USAC "explaining its situation and providing an estimate of the number of students who it believed would qualify for the NSLP." USAC had apparently accepted the estimate, but the auditors subsequently determined that the method used was not approved. There was no indication that the discount rate was wrong or that the funding requested was for inappropriate services. We do not view this report as an example of WFA.
- One small library was found non-compliant because it had not maintained invoices to support its discount reimbursements and other documentation to support its discount rate calculation. Again, there was no indication that the

discount rate was wrong or that the funding requested was inappropriate. We do not view this report as an example of WFA.

- One larger school district was found non-compliant primarily because it did not have an approved technology plan. Although this is a clear program violation, our investigation determined that the district did in fact have a plan, but one that they had neglected to submit for formal E-rate approval. The district is being asked to repay almost \$200,000 in FY 2000 discounts. In our view, this is an inappropriately large penalty for what we deem to be an administrative oversight. Again, we do not view this audit finding as an example of WFA.
- *One unfortunate aspect of the intensive focus on waste, fraud, and abuse is the proliferation of new, and ever more complicated, rules. Attempts to enforce these rules are frustrating applicants, leading to funding delays, and probably diverting USAC resources away from more targeted reviews.*

Each year, the E-rate rules and procedures have become increasingly complex as USAC and FCC have refined service eligibility definitions, added new certifications, and intensified application and invoice reviews. Here are a few indicators or examples of the problem:

- A reported 20–30 percent of all applications are rejected by USAC, many for minor problems to meet minimum process standards which, at least in the past, could be as simple of leaving one field blank when it should have been a zero.
- The two key application forms for FY 2005 are 13 and 16 pages long; the instructions are 20 and 35 pages long, respectively.
- New procedures for application review in FY 2005 will require virtually every applicant to respond to additional inquiries from PIA reviewers.
- E-rate is a deadline driven program. For most applicants, E-rate is not a full *time* job, but it is most certainly a full *year* job. All four of the most common applicant forms have deadlines or timing requirements which, if missed, will result in funding denials or reductions. Appeals, SPIN changes, and service substitutions all have deadlines. To further compound the problem, some deadlines are fixed for all applicants while others depend upon applicant-specific conditions.
- Eligibility allocations for certain products and services are often hidden from applicant view. We were recently asked to breakout the costs for a firewall, a product type which USAC lists as fully eligible, because, as it turned out, this particular model had a 2.5 percent ineligible feature.
- The FCC's new "2 in 5" rule, that limits new funded equipment installations to two out of every five years on a site-by-site basis, is going to be difficult to administer for applicants and administrators alike.

E-rate was initially conceived as being a simple program. In 1997, we were told that an applicant would fill out a simple application and that the vendors would simply discount the bills. This vision never materialized.

In frustration, many applicants have been turning to consultants for assistance. While this may be good for our business, we view it as bad for the program. Even those of us, for whom E-rate is a way of life, find it challenging to keep up and comply with all the changing rules, procedures, and interpretations. The knowledge that applications may be rejected for simple oversights is a source of constant fear.

- *As an alternative to relying entirely on ever more rules and audits, we favor certain basic program changes—including a change to the discount matrix—to help establish proper program incentives.*

One of the biggest problems in the E-rate program is its reliance on small percentage payments by the highest applicants to assure cost-effective procurement of technology products and services. The 10 percent that must be paid by the applicants eligible for 90 percent discounts is just not high enough to assure real cost accountability. As a result, it is the poorest schools, often those with the least technological experience, that have become the focus of vendor marketing programs. This has led, if not to outright fraud, at least to expansive product and service proposals that the same vendors would not bother to market to schools and libraries at lower discount levels. The problems have been especially prevalent in the Internal Connections category.

Over the past year, several important and knowledgeable parties—including SECA and USAC's Taskforce on Waste, Fraud and Abuse—have recommended to the FCC that the maximum discount on Internal Connections be lowered from 90 percent to 70–80 percent. We understand that the FCC staff is about to recommend a similar change. As a member of both SECA and the Taskforce, I concur with this approach.

I thank you again for the invitation to testify. I stand ready to answer any questions you may have.

The CHAIRMAN. Thank you very much.

I think it has been made clear, Mr. Himsworth, that all members of this Committee, at least that I know of, support this program. We also feel we have an obligation, and the Commerce Committee on the other side has been in the lead on this issue. Who is the victim when in February 2004, the House Energy and Commerce Committee staff, we do not usually hire staffs for their sleuth capabilities, discovered nearly \$23.5 million in E-rate-funded wireless Internet connection equipment in a warehouse that was to be used with 100,000 computers? Who is the victim there?

Mr. HIMSWORTH. The victim there is again the students and—

The CHAIRMAN. Exactly. So is it not our obligation to make sure that there is not \$23.5 million, that it is the staff of the House Commerce Committee that finds \$23.5 million in Internet connection equipment in a warehouse? We have to rely on the staff of the House Commerce Committee to find that out?

Mr. HIMSWORTH. I should hope not, sir.

The CHAIRMAN. I should hope not, but it is obvious that is what happened.

I guess I would like to have the witnesses' response to a Providence Journal article of July 22, 2004. It stated that: "The problem with the E-rate program is twofold: First, the money is controlled, not by the government, but by the Universal Service Administrative Company, which is controlled by the very telecom companies that are bidding for contracts. Second, the Federal Communications Commission, which is supposed to oversee the program, has conducted audits on fewer than 200 of the 20,000 grants issued by the program, less than 1 percent. All this adds up to a situation in which it is easy for sly computer and telecom companies to persuade poor and technologically unsavvy school districts to buy equipment and services that they do not need and to overcharge the districts, knowing that most of the tab will be picked up by E-rate."

I will begin with you, Mr. Bennett and Mr. Cline, if either one of you want to comment on that statement, particularly the first part of it, where the Universal Service Administration Company "is controlled by the very telecom companies that are bidding for contracts"? We will begin with you, Mr. Bennett, and go through our witnesses.

Mr. BENNETT. I do not know that we have a real concern with the first issue you raised. Certainly the second issue you raised, with the number of audits that have been done, has been our primary of concern. It has been our feeling that we have not done enough work necessary to get our hands around the issue of what is the level of fraud, waste, and abuse in this program.

The CHAIRMAN. I think it would be hard if you only audited 200 of 20,000 grants.

Mr. BENNETT. The Office of the Inspector General has been trying from the earliest days to get access to the resources necessary to do the appropriate amount of work. We are a very small office.

The CHAIRMAN. What do you need from us and why have you not come to us for additional help if you need it?

Mr. BENNETT. Well, I believe that we have. We have requested in our last three budgets funds for oversight of USF. The Inspector General has advocated—

The CHAIRMAN. Was that in the President's budget?

Mr. BENNETT. The 2004 President's budget included a request for \$3 million to provide contract audit support for audits and audit support to investigations.

The CHAIRMAN. Well, thank you for bringing that to this committee's attention. The failing is in this body as well, I would assume. Thank you.

Mr. Gumper?

Mr. GUMPER. As far as the first point, Mr. Chairman, I strongly disagree that the USAC Board is controlled by telecommunications service providers. As I mentioned in my statement, all board members are appointed by the Chairman of the FCC. The Board members, there are 19 of them. They spanned consumer advocate groups, state commissioners. We have people representing large, small telephone companies, long distance carriers, wireless. So the Board is constructed so that the people who pay into the fund, the people who provide services, the constituents who use the moneys, and the constituents themselves. The schools and libraries have four representatives on the Board.

It is true I work for Verizon, but I can assure you that when it comes to the interests of USAC and the administration of USAC I basically report to the FCC. And, my boss Tom Tauke and Verizon, understands that and has never once ever told me I should do something in my capacity as Chairman of the Board that would be to the advantage of Verizon and the detriment of USAC or the administration of this program.

As far as the number of audits, I will tell you this Board is very concerned about it. We realized very early in the process as we started to do selective audits that we had to expand the number, and we are very actively working now with the Inspector General to ensure that we have a significant expansion in the number of audits that we conduct.

The CHAIRMAN. Has there been sufficient rules put forth by USAC to ensure that these abuses are curbed?

Mr. GUMPER. I believe that, as Mr. McDonald can go into more detail, given the results of audits as we have gone through this process, we have significantly tightened up the oversight of the application process. In fact, you heard the comments earlier that we are getting too many rules now. I disagree with that. I think what we need to do is to get out there and educate people about the programs and the requirements.

As I also mentioned, one of the things we directed them to do at the last meeting was to provide us with a recommendation as to

how we can educate people better who file applications in this program.

The CHAIRMAN. Mr. McDonald?

Mr. MCDONALD. Sir, I have been with Schools and Libraries Corporation/USAC since September 1997. I have watched this Board at work. My sense is this Board has been scrupulous about avoiding any conflict of interest. Board members recuse themselves when there are issues relating to their interests in discussion before the Board.

We faced the issue of turning over our internal procedures, our internal controls, to Board members and the board agreed that that was not appropriate, so Board members do not know the triggers we use to decide what reviews to do, et cetera. I have never seen a discussion in the board where I thought anybody was trying to influence a decision in their company's interests or their school association or library association's interests.

So from my perspective as a staff guy in this, I think the board has done a great job. They know the programs, they know the stakeholders in the programs, and I think they have worked together amazingly well over the years to protect the program's integrity.

On the audit side, yes, we need to do more audits. We have ramped up significantly. We did 17 audits in the first program year, we did 25 audits in the second program year, we did 79 in the third. Now we are going to do 100 audits. Then if the IG is successful in the three-way agreement, we will do 250 or more.

These audits are very expensive. My budget next year for audits is going to go from \$5 million this year for the 79 audits to as much as \$17 million next year to support the three-way agreement and audits we will do. It seems to me that we have to have a different approach than these comprehensive audits and that is why we are kicking off this thousand site visits that, we went to Puerto Rico in that first funding year as part of our first round of audits. We saw that they did not have computers. We cut off the commitments and disbursements to Puerto Rico. So yes, \$100 million did get out the door, but they have gone 3 years with no additional money.

So I think the site visits, if we had gone even as a site visit and seen that there were no computers in the school, that would have been the trigger that we needed to cutoff those funds sooner. So I think the site visit initiative is a cost effective way to get a better handle on what's really happening.

The CHAIRMAN. Mr. Himsworth?

Mr. HIMSWORTH. We have got 30,000 applicants here and it is true that there has been a relatively small number of audits. As you have heard, the number of audits is going up. I view that as good from the applicants' standpoint. I also look at the thousand site visits that the program plans to do and, although we may not call those audits, from the standpoint of an applicant if someone shows up at their door from the SLD they are going to treat that as an audit. So I think we are doing—

The CHAIRMAN. That is what they plan to do, not what they have done, what they plan to do.

Mr. HIMSWORTH. Plan to, sir, yes.

The only other point I would like to make is, I have seen through the review process that the SLD has been fairly successful in finding patterns of what could be abuse and stopping funding. In some cases that works very well and I believe, among other things, that led to the problems that were found with Connect2.

We see the other side of that as well, though, because over the last couple years we have had several hundred small schools in New York who have just not received any funding for 2 or 3 years because they were all using one of a dozen specific vendors. We cannot tell from our position whether there is anything wrong with those vendors or they are still under investigation. I suspect some of them are good and some of them are bad, but all those schools are sitting without funding.

So I would like to see more dollars put into the investigatory aspects of this thing, not necessarily random audits, but when you identify problems or potential problems putting dollars to work specifically in those areas.

The CHAIRMAN. Thank you.

Senator ROCKEFELLER.

Senator ROCKEFELLER. Thank you, Mr. Chairman. Before I ask a couple questions I want to, with your permission, put into the record an October 1 letter to Chairman Powell that Olympia Snowe and I wrote, addressing a number of the questions which you have raised and others, as well as a letter to USAC. And Olympia, I do not have a copy with me and I do not know whether you signed it or not, but I think we both did. We always do.

I am going to do something different—

The CHAIRMAN. Without objection.

[The letter referred to follows:]

U.S. SENATE
Washington, DC, October 1, 2004

Hon. MICHAEL K. POWELL,
Chairman,
Federal Communications Commission,
Washington, DC.

Dear Chairman Powell:

Under the 1996 Telecommunications Act, Congress codified its long-standing commitment to universal service, explicitly directing the Commission to ensure that consumers in rural, insular, and high cost areas have access to reasonably comparable telecommunications and information services at reasonably comparable rates and to expand universal service support to include eligible schools, libraries, and rural health care providers.

Given Congress's commitment to universal service, we are seriously concerned by reports that in the final week of a year-long conversion of the Universal Service Fund from GAAP to Government GAAP accounting standards, the Federal Communications Commission ("Commission") has instituted changes that may significantly affect the operation and administration of the entire Fund, and in particular, the schools and libraries ("E-rate") and rural health care funds. We are particularly troubled that E-rate and rural health care funding has been suspended since August 3, 2004, as a result of the uncertainty surrounding the accounting treatment of the Funding Commitment Decision Letters ("Commitment Letters") issued under those programs and the Commission's determination that funds held in the Universal Service Fund are Federal funds for purposes of the Anti-Deficiency Act. This suspension has already had a significant negative impact on schools, libraries and rural health care providers across the country. It is our understanding that Commitment Letters are unlikely to be issued again before November of this year, only exacerbating the impact on these institutions.

We are also deeply troubled by the seemingly inconsistent decisions made in implementing the accounting conversion. First, at the same time the Commission at

the direction of the OMB, was considering whether to treat Commitment Letters as “obligations” for accounting purposes (thus requiring the Universal Service Administrative Company (“USAC”) to have monies in its account to cover all existing and future Commitment Letters), the Commission decided to “under collect” E-rate revenues by a total of \$550 million in order to limit increases to the Universal Service contribution factor. As recently as September 16, 2004, the FCC issued a decision to reduce E-rate collections by \$150 million. Despite objections filed by several affected entities, the Commission allowed this decision to take effect, unchanged. We are concerned that the result of these decisions will be to require substantial reductions in available outlays for the E-rate and rural health care programs and to increase significantly early next year the contribution rate assessed on providers of interstate communications services and passed through to consumers.

Second, during the same period that USAC was converting to the more stringent government accounting standards, we understand that the Commission also approved USAC’s investment of over \$3 billion in long-term investment instruments. In the last week, we understand that the Commission reversed course and required USAC to liquidate these investments in order to comply with Government GAAP and to avoid criminal liability for FCC personnel under the Anti-Deficiency Act. It is our understanding that the forced sale of these investments has resulted in losses of millions of dollars.

Finally, we are troubled that while the Commission has taken steps to ensure that the E-rate and rural health care programs are in compliance with the new accounting requirements, we understand that it has not completed a full review of the impact of the accounting conversion on the high-cost and low income fund. In particular, the Commission’s apparent decision regarding treatment of the E-rate and rural health care Commitment Letters as obligations may also impact how projected costs used to calculate high-cost and low income support should be treated for accounting purposes. If these projections are determined to be obligations, the high-cost and low income funds could face disruptions similar to those currently being experienced in the E-rate and rural health care programs, putting in jeopardy billions of dollars relied on by rural telecommunications carriers that bring essential services to consumers and could jeopardize affordable telephone service for low income consumers. Furthermore, it is our understanding that Commission personnel could be subject to criminal sanctions for non-compliance with the Anti-Deficiency Act.

Given the significance of these issues, we would appreciate your providing us with relevant information and responses to our questions prior to the Senate Committee on Commerce, Science and Transportation hearing on the E-rate program.

- Is it the Commission’s legal opinion that the Universal Service Fund is subject to the provisions of the Federal Anti-Deficiency Act?
 - If so, on what basis? What written or unwritten guidance has the Commission received from the Office of Management and Budget?
 - If so, is such a conclusion consistent with an August 2000 legal opinion from the Office of Management and Budget concluding that “the Universal Service Fund does not constitute public money . . . and is appropriately maintained outside the Treasury by a non-governmental manager”?
 - If so, is such a conclusion consistent with Congress’ intent in an 1997 amendment to the Commerce, Justice, State appropriations legislation stating that “federal and state universal service contributions are administered by an independent, non-Federal entity and are not deposited into the Federal Treasury and therefore [are] not available for Federal appropriations?”
- If the Commission concludes that funds held in the Universal Service Fund are “federal funds,” can a non-governmental entity such as USAC hold and disburse such funds?
- How should projected cost estimates used in the administration of the universal service high-cost and low income funds be treated for accounting purposes? If the Commission is unable to decide this question, does such a result create potential liability under the Anti-Deficiency Act if actual high-cost and low income outlays exceed projected estimates?
- Given these accounting changes, what action, if any, does the Commission expect will be necessary to recover the \$550 million that will have failed to collect over the 2nd, 3rd and 4th Quarters of 2004 to cover E-rate and rural health care obligations?
- It is our understanding that these accounting changes will require USAC to make changes in the way that cash balances are invested. What guidelines gov-

ern the investment of cash balances in the Universal Service Fund programs. Are those guidelines subject to approval by USAC and/or the Commission? What effect will recent changes ordered by the Commission have on expected interest income?

Thank you for your prompt response to our inquiries. If you have any questions, please contact either Ray Kvncevic in Senator Snowe's office or James Reid in Senator Rockefeller's office.

Sincerely,

Olympia J. Snowe

John D. Rockefeller IV

cc: Commissioner Kathleen Q. Abernathy
Commissioner Jonathan S. Adelstein
Commissioner Michael J. Copps
Commissioner Kevin J. Martin

Senator ROCKEFELLER. Thank you.

If the chairman will allow, I am going to ask a series of questions and it will not go over my time limit. George McDonald: How many schools and libraries now have legitimate applications, cannot get their funding due to suspension? What will the demand be for the program by November 1? Question number one.

The IBM problems have attracted a great deal of press and attention, probably deservedly so. There were many stories about \$200 million in fraud. Can you explain briefly how much money USAC paid to IBM? How many questionable applications were stopped? How did USAC handle the questionable applicants, Mr. McDonald? I am not finished.

In your judgment as the Program Administrator, will the accounting change to require cash on hand for commitment letters help protect schools from aggressive vendors and potential fraud?

Final question to Mr. Gumper: Can you briefly explain the process between the FCC and USAC regarding the management of the Universal Service Fund? I want to know how the FCC, quote, "undercollected" \$550 million for the E-rate earlier this year.

Mr. Chairman, you understand we are being assaulted you wireless and the Universal Service Fund is getting clobbered in all directions. In other words, the FCC undercollected \$550 million earlier this year for E-rate, and then within a few weeks suspended the program, citing lack of cash on hand. This seems like a flip-flop—a term these days.

Second, is it true that the FCC approved investments in government-backed securities in July, then reversed itself in September, requiring the liquidation of the investment at the cost of millions of dollars? How much did this cost? What are the long-term ramifications for all aspects of the funding of E-rate, High Cost, Low Income, and Rural Health Care, which nobody has mentioned this morning?

That is it.

Mr. McDONALD. Sir, I believe your first question was how many schools are awaiting commitment letters that we could issue today. There are about 4,200 applicants who would be getting funding commitment decision letters today if we were able to issue them, for about \$300 million.

Senator ROCKEFELLER. My question was, what will be the demand for the program by November 1.

Mr. McDONALD. I do not have an estimate of the number of applicants by November 1.

Senator ROCKEFELLER. Can you get that to me?

Mr. McDONALD. Yes, sir.

Senator ROCKEFELLER. IBM was the second one.

Mr. McDONALD. IBM, we have funded IBM, we have disbursed about \$770 million over the life of the program to IBM, and I believe most of that was properly committed and disbursed.

In 2002 we got a whistleblower letter alleging abuses in El Paso, Texas, with 2001 money. That led us to have a special investigations team of certified fraud examiners who conducted an investigation and made site visits to El Paso and to Isletta, Texas, who had filed an application for 2002 with IBM, and uncovered a procurement pattern that—basically, IBM was selected as a, quote, “strategic technology partner” with no prices on the table. After they were selected, with an agreement that their service provider identification number would be on every funding request for that applicant, they sat down with the applicant to figure out what did they really need and what would it cost the applicant. When the prices were settled, nobody was at the table but IBM.

The fundamental concept of the rules is competition over prices for eligible goods and services. That did not occur. We concluded that was not consistent with the rules, denied those applications—

Senator ROCKEFELLER. Understood. You have answered that well.

The accounting change to require cash on hand for commitment letters to help protect schools from aggressive vendors and potential fraud?

Mr. McDONALD. I do not see a relationship between the two, sir. To have cash on hand in terms of the commitments? You have to have unobligated cash to make commitments?

Senator ROCKEFELLER. Yes.

Mr. McDONALD. I do not see a connection between that and protecting the schools. That is just a question of when we can issue the funding commitment letters. We still have to do the same scrutiny of those applications to determine whether there is abuse by the service provider or the applicant.

Senator ROCKEFELLER. Mr. Gumper, this thing I mentioned, the undercollection of \$550 million, then within a few weeks suspending the program, citing lack of cash on hand.

Mr. GUMPER. Because of the way USAC collects money; we collect money at the start of the school year. We make commitments, hopefully before the school year starts. But the reality is that there is a fairly long lead time between when we make a commitment to a school or a library and they actually come back and say, OK, the work has been done, here is the bill, pay it.

As such, over the course of the last few years the USAC cash balance that we manage has increased significantly, to the point where at the beginning of this year it was close to \$3 billion. At that time our treasurer looked at the balance sheet, the cash flow needed, and suggested, because the fact that we had such a large balance of cash had been noted by the auditors in several audits, questioning why was USAC maintaining this huge cash balance and what was it growing. So as a result of that, in discussions with the FCC and on the advice of USAC, our finance people, it was de-

terminated that we, for cash management purposes, could use some of the money to keep down the contribution factor for a period of time.

At that point in time there was no correlation between when we issued commitment letters and the cash balance we had. This looked like just prudent cash management.

As mentioned in reply to one of your questions, a year ago the Commission told us that we would have to go to government accounting standards effective October 1, of this year. In the process of training for that and modifying our systems, the question came up from our people, because in government accounting, unlike what we were doing in GAAP. In GAAP we were booking an obligation in the program when we received an invoice for payment from a service provider and in effect processed it, adjudicated that it was correct, they followed the rules, it was within their commitment. At that point in time, we booked an obligation on our books.

But in government accounting, you talk about the point of obligation. The question was raised, was the point of obligation when we sent out the commitment letter? That issue was discussed throughout the first part of this year, and toward the summer it looked like we were going to be told that this was a possibility, that commitments could be obligations.

At that time we thought this would just be an accounting issue as to how we closed our books on October 1 and transferred to government accounting. In June the question was raised, though, might not USAC and the USF be subject to the Anti-Deficiency Act? And if we were subject to the Anti-Deficiency Act, then the question is, if these commitments were obligations, did we have the correct appropriation from OMB to cover it?

Because of the concerns of potentially violating the Anti-Deficiency Act, it was in August 3 that, in the interest of being conservative until we could actually verify whether or not, A, we were subject, whether these commitments were going to be treated as obligations, that we suspended the issuing of new commitments, because this is our very busy time. As we approached the school year, we had already committed over \$700 million and were on the verge of committing a lot more. And suddenly this issue came up, well, you might be in violation of the Anti-Deficiency Act.

So that is why we suspended the things at that time, sir.

Senator ROCKEFELLER. My time is up. I thank the witnesses and the Chairman.

The CHAIRMAN. Senator Snowe.

Senator SNOWE. Thank you, Mr. Chairman.

To follow up on that, Mr. Gumper. So you obviously were not certain as to whether or not these rules would apply. I mean, you knew they had been under discussion for a considerable period of time, is that correct?

Mr. GUMPER. We did not receive more certainty until the meeting early in September between the FCC, OMB, and USAC. At that point in time we were sort of given verbal direction that we should probably be thinking of treating these things as obligations when we closed our books. And for the very first time it was raised that under government accounting the investments that we had are invested in funds that were backed by government securities, but

they were operated by private companies. This is where we got somewhat better return of interest.

It was raised at that point in time, though, that those funds were counted as obligations also. So even though we considered them cash to balance against the commitment letters, they said: No, no, those are obligations.

Senator SNOWE. That is why you were forced to liquidate those assets at a loss?

Mr. GUMPER. That is why we were forced to liquidate. And when staff informed me at this meeting, I basically said we were not going to take such drastic action on a verbal OK, and I sent a letter to the Commissioner, Chairman Powell, saying we wanted written direction and the answers to some very specific questions as to how we should treat commitments, how we should basically handle this liquidation. And we got an answer back on September 27.

Senator SNOWE. And that is this letter that indicated you basically were compelled to take those steps?

Mr. GUMPER. Those steps. And we were also told not to inform anybody, because over the period of a short 2 days we sold and bought several billion dollars worth of government bonds and we did not want to disrupt the bond market.

Senator SNOWE. So is it correct that it becomes a loss to you in terms of having to liquidate those bonds?

Mr. GUMPER. We lost \$4.6 million because of the interest rates. That number is higher than we had anticipated when we first wrote to the Chairman of the FCC. One of the reasons was in between the Fed raised the short-term interest rates, and we keep our investments in basically what are short-term. We call them long-term; they are 2 years. But most of it is short-term, money market, or maturities of 2 years or so, and those are short-term, so they were somewhat affected by the increase in the Fed rate.

Senator SNOWE. The letter to you from the FCC, the one that you referred to on September 27, it sounds to me like the Inspector General obviously knew for quite some time about this idea of conversion. I know it had been under consideration, but it seemed more emphatic in this letter to you from the FCC.

How long had the Inspector General realized that this was going to be inevitable for USAC to implement the government accounting rules? Because I think it really gets to the heart of the matter and how E-rate has been treated, how this program is treated. It is obviously not throughout the entire Universal Service Fund. It is not the High Cost programs.

Why is E-rate, why is this program being treated dissimilarly from other entities within the fund and also throughout government?

Mr. CLINE. I do not believe for financial management purposes and financial reporting that E-rate is being singled out differently for the requirement to, like for example, for USAC to move to gov-GAAP.

Senator SNOWE. Could you give me an example of another entity that has been treated similarly under these circumstances right now?

Mr. CLINE. All of the funding mechanisms are moving to government accounting standards.

Senator SNOWE. Did they get a lead time, that they have to act in such a time?

Mr. CLINE. My understanding would be they have the same lead time as E-rate.

I think the other funding mechanisms, the High Cost, Low Income, the impact on the immediate stop in funding I would suspect, although I do not know—that would be USAC's call. I do not believe anybody else had that stop that the E-rate has experienced.

Senator SNOWE. So why could it not have been done differently?

Mr. CLINE. Why it could be done differently, to be honest with you, we in OIG would have a hard time answering that. Our questions are actually very similar to yours. We have presented to the Commission that, we need you, the Commission, to make a determination how these requirements are going to be implemented and how they are going to be represented in the financial statements.

Our involvement in these issues are as part of the audit of the FCC's Fiscal Year 2004 financial statement audit. Numerous of the questions that you are asking we are asking, perhaps on a more mechanical level, but very similar questions. We are asking, how do you intend to gather this information, how do you intend to report it.

The impact on the flow of funding, I do not believe that OIG had insight into that any earlier than anyone else. To my knowledge, in relation to the audit of the financial statement, we did not foresee that. We in OIG would not foresee that because our interest is in the financial presentation of the information included in the financial statement.

Senator SNOWE. Right, and no one has any argument with that. I think it is the question of how this program has been treated under these circumstances. Have you received anything, has anybody received anything, from OMB with respect to this directive in writing?

Mr. CLINE. OIG has not.

Senator SNOWE. OIG. Has anybody?

Mr. GUMPER. We certainly have not. I know in the letter that was sent back to me by the FCC they indicated that they had gone to OMB and had asked for a written opinion and had not received it yet.

In terms of the question are we treating this program differently than the others, that is still an open issue with the High Cost, Low Income. We did raise the question in my letter to the Chairman as to whether or not the projections we make in the High Cost, Low Income program are in fact obligations. Prior to every quarter, we list every telephone company as to how much money we are going to pay them in the following quarter. We file that with the FCC. The FCC, after they approve it, basically then we go through with those payments.

They indicated back to me in the letter that that had been an issue that had just recently come up, that they had been referred to the OMB as to whether or not we should treat these programs the same. We are waiting for that answer. I can tell you that if we treat those projections as obligations we will add another approximately \$2 billion of obligations to our books, which at that time would put us in a deficient mode of operation.

Senator SNOWE. Well, I guess I think the question is, Mr. Bennett, why would the FCC force this kind of liquidation without a written directive. Is that unusual or is that a consistent manner of operation?

Mr. CLINE. Unfortunately, we in OIG do not have the answer to that question. You would have to place that to FCC management. That is not a decision that we are involved in.

Senator SNOWE. Thank you, Mr. Chairman. Thank you.

The CHAIRMAN. Thank you. I thank the witnesses.

Any more, Jay?

Senator ROCKEFELLER. No.

The CHAIRMAN. I thank the witnesses. This hearing is adjourned. [Whereupon, at 11:10 a.m., the hearing was adjourned.]

