

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

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

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**I. INTRODUCTION AND SUMMARY**

The Joint Board and the Commission should move toward an appropriate system of competitive bidding for high cost distributions from the Universal Service Fund. Rapid changes in the telecommunications marketplace are challenging all market participants to adapt. At the same time, in their present form high cost subsidies provide carriers with the wrong incentives and discourage innovation. The Joint Board's consideration of "reverse auctions" to determine high cost support offers a meaningful opportunity to help transform the High Cost Fund into an efficient, market-oriented system that advances core universal service objectives.

The remarkable rise of intermodal competition has fundamentally changed the telecommunications marketplace since Congress passed the 1996 Act. Consumers may choose from numerous providers and multiple technologies in nearly every market. Wireless, cable, and voice over internet protocol ("VoIP") services are providing consumers with new and different voice options. Still, the Universal Service Fund continues to grow at a record pace. The high

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<sup>1</sup> The Verizon companies participating in this filing are the regulated, wholly owned subsidiaries of Verizon Communications Inc.

cost portion of the fund is now more than \$4 billion annually, more than double its size from just six years ago, and is projected to grow even larger in the next few years. Significant reform of the High Cost Fund is critical to better reflect the changing competitive environment and technological advances.

The core goal of universal service support is to provide “access to” telephone service in all regions of the country at “affordable rates.” 47 U.S.C. § 254(b). This is an important goal, and today virtually all Americans have affordable access. Such service is provided by both traditional telephone companies and carriers offering wireless services or next-generation technologies. Current universal service subsidies do not reflect these market changes. Reverse auctions can help target support to the carriers that are able to provide service with the lowest amount of subsidy in the areas where high cost subsidies are needed. If they are properly structured, reverse auctions have potential, and, for reasons explained more fully below, are entirely consistent with the 1996 Act. Implementing an auction mechanism need not be done as a flash cut, but rather could be done over time to allow incumbent carriers that receive support a reasonable adjustment period.

The right competitive bidding process will impose appropriate market force controls over high cost subsidies. Any competitive bidding process will require careful attention to important details and cooperation from many participants. But reverse auctions themselves need not be complex. Indeed, the ability to devise a simple system that provides carriers with the proper incentive to bid for subsidies in amounts no greater than what they need to provide supported services is competitive bidding’s most compelling attribute. Similar to the impact of the Commission’s spectrum auctions, with the right design a simple system of reverse auctions for high cost support could provide consumers, carriers, and regulators with substantial benefits.

**II. THE VIABILITY OF THE HIGH COST FUND IS THREATENED BY THE ABSENCE OF MARKET FORCE CONTROLS OVER SUBSIDIES AND THE UNCHECKED GROWTH OF THE FUND.**

The High Cost Fund is not sustainable in its present form. Current high cost subsidies are based on the incumbent LEC's per-line operating costs without regard to whether another competing carrier could provide supported services with a smaller (or no) subsidy. Duplicative support to competitive eligible telecommunications carriers ("CETCs") compounds the problem by distributing the same amount of per-line support paid to incumbents to other carriers, regardless of whether they need a subsidy to provide service.<sup>2</sup> And in any areas where service would not be provided absent a subsidy, it makes no sense to subsidize multiple providers, rather than the one that could provide service with the lowest amount of subsidy.

**A. Competition Reduces The Need For Universal Service Subsidies In Many Areas.**

When consumers have access to quality services provided at affordable rates by one – or in many cases a number of competing providers – the on-going need for universal service subsidies must be questioned. The Joint Board and the Commission can no longer simply assume that "access to telecommunications and information services" is only available from traditional wireline LECs. 47 U.S.C. § 254(b)(3).

**1. The Current High Cost Subsidy Mechanism Does Not Take Into Account The Benefits Of New Competition.**

Most consumers now have access to telephone services from cable companies, wireless carriers, and/or VoIP providers. Cable companies are providing consumers with access to telecommunications services over their own networks. Cable companies are expected to offer telephony services (IP-based or circuit-switched) to some 84 percent of households by the end of

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<sup>2</sup> 47 C.F.R. § 54.307.

this year, up from 32 percent at the end of 2004, and are projected to offer service to 94 percent of U.S. households by the end of 2008.<sup>3</sup> Some major cable operators, including Time Warner Cable and Cablevision, already offer telephony services in every area within their footprints, while Cox plans to reach that milestone by year-end 2006.<sup>4</sup> Comcast plans to market its voice service to 80 percent of its footprint by the end of 2006.<sup>5</sup> Collectively, cable companies are expected to serve more than 8.5 million voice lines by the end of 2006 and more than 13 million lines by year-end 2007.<sup>6</sup> Analysts expect that cable companies will achieve an overall telephony penetration rate of 15-20 percent by 2010.<sup>7</sup>

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<sup>3</sup> Craig Moffett, et al., Bernstein Research, *Quarterly VoIP Monitor: Six Million and Counting*, at Ex. 17 (June 12, 2006).

<sup>4</sup> See Thomson StreetEvents, TWX – Q4 2004 Time Warner Inc. Earnings Conference Call, Conference Call Transcript (Feb. 4, 2005) (statement of Time Warner Inc. CFO Wayne Pace); Cablevision News Release, *Cablevision Completes Network Rebuild* (Dec. 3, 2003), <http://www.prnewswire.com/cgi-bin/stories.pl?Acct=104&story=/www/story/12-03-2003/0002069072&date=>; Cox News Release, *Cox Digital Telephone To Be Available in All Cox Markets by End of Year* (July 13, 2006), <http://www.coxenterprises.com/corp/presscenter/viewpressrelease.asp?articleid=836>.

<sup>5</sup> CMCSA – Comcast Corporation at Sanford C. Bernstein & Co., *Strategic Decisions Conference*, Thomson StreetEvents, at 5 (June 2, 2006) (statement of Brian Roberts). This does not include systems Comcast recently acquired from Adelphia and Time Warner.

<sup>6</sup> Jeffrey Halpern, et al., Bernstein Research Call, *Quarterly VoIP Monitor: Six Million and Counting*, at Ex.18 (June 12, 2006).

<sup>7</sup> See, e.g., Douglas S. Shapiro, et al., Banc of America Securities Research Brief, *Battle for the Bundle: Mapping the Battlefield, Our First Report from the Front 2* (June 14, 2005) (“Cable should have 19.8 million telephony subs by 2010, or 18% penetration of homes passed.”); Jeffrey Halpern, et al., Bernstein Research Call, *Quarterly VoIP Monitor: Six Million and Counting*, at Ex. 18 (June 12, 2006) (estimating an 18 percent penetration of U.S. homes); Kate Griffin, Yankee Group, *The VoIP Evolution Continues: Forecasting Broadband VoIP and Cable Telephony* at 11 (Aug. 2006) (“By 2010, we forecast [cable companies] will provide telephone service to more than 18% of US households.”); see also Richard Klugman, et al., Prudential Equity Group, LLC, *The Dust Has Settled: We Think It’s O.K. To Own Telecom Stocks Again*, at Figure 28 (July 20, 2006) (“Cable and VoIP market Penetration Should Reach 20% by 2010.”); Michael Rollins, et al., Citigroup, *Vonage Holdings Corp (VG)* at 7 (July 3, 2006) (“We believe VoIP services, including Cable MSOs, can capture 23% of homes by 2010.”); Jonathan Chaplin, et al., JPMorgan, *State of the Industry: Consumer*, at 4 (Jan. 13, 2006) (“We expect cable and other VoIP providers to increase share of primary residential voice lines . . . to 28.0% by 2010.”); Frank G. Louthan IV, Raymond James Equity Research, *Reassessment of Access Lines and Wireline Carriers*, at 3 (July 5, 2006) (“[C]able and stand

Wireless companies are also providing consumers with access to telephone service in both rural and urban areas. According to the Commission's most recent report, 98 percent of the total U.S. population already has access to three or more different wireless providers in counties in which they live.<sup>8</sup> In fact, wireless service has grown so spectacularly that of the 379 million voice lines counted by the Commission at the end of 2005, approximately 204 million – more than 50 percent – were wireless.<sup>9</sup> Moreover, in many instances wireless carriers are providing a competitive alternative in historically difficult to serve rural areas. In surveying the wireless landscape, the Commission recently concluded that “CMRS providers are competing effectively in rural areas,” and noted that “some analysts report that wireless competition is increasing in rural areas, particularly as a wireline substitute.”<sup>10</sup>

Independent VoIP providers also provide any consumer with broadband access – which is now available to more than 90 percent of U.S. households from a provider *other than* the incumbent LEC<sup>11</sup> – with access to telephony service. According to the Commission's most

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alone VoIP will become a primary factor in terms of taking share away from incumbent voice providers, with these competitors' share expected to exceed 30% of U.S. households by year end 2010.”).

<sup>8</sup> See *Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services*, Eleventh Report, WT Docket No. 06-17, FCC 06-142, ¶ 41 (Sept. 29, 2006) (proceeding terminated) (“*Eleventh Report*”). According to the same report, “94 percent of the U.S. population, live[s] in counties with four or more mobile telephone operators competing to offer service...51 percent of the U.S. population, live[s] in counties with five or more mobile telephone operators competing to offer service, and 18 percent of the population, live[s] in counties with six or more mobile telephone operators competing to offer service.” *Id.*

<sup>9</sup> See FCC, Industry Analysis & Technical Division, Wireline Competition Bureau, *Local Telephone Competition: Status as of December 31, 2005*, at Tables 1 & 14 (July 26, 2006).

<sup>10</sup> *Eleventh Report* ¶ 88.

<sup>11</sup> See, e.g., NCTA, *Cable Broadband Availability*, <http://www.ncta.com/ContentView.aspx?contentId=60> (116.1 million homes passed by cable modem service as of 2005); NCTA, *2006 Industry Overview*, at 11 & Chart 6 (cable modem service is available to approximately 93 percent of homes passed by cable as of year-end 2005) (citing Morgan Stanley).

recent report on high-speed Internet access, cable broadband is available to 93 percent of households to which cable operators can provide cable TV service.<sup>12</sup> In addition, the number of NECA traffic-sensitive pool members offering DSL services has grown from 151 providers in 1999, to 1,044 providers (94 percent of pool members) in 2006.<sup>13</sup> The actual provision of VoIP services to consumers throughout the country is also expanding rapidly. Vonage, for example, provides service to more than two million customers and reports that it is adding an average of more than 22,000 subscribers each week.<sup>14</sup> Skype, a service that allows customers to make free computer-to-computer calls, was acquired by eBay; Skype gained 100 million users in just two-and-a-half years and is adding more than 200,000 users daily.<sup>15</sup>

Moreover, consumers increasingly view cable telephony, VoIP, and wireless as viable alternatives to wireline service. Industry experts forecast that cable and VoIP will have more than 11 million domestic voice subscribers by year-end, and that by the end of 2010 approximately 45 percent of U.S. households will either be wireless only or will use VoIP to make their calls.<sup>16</sup> More specifically, a Yankee Group survey found that approximately 10

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<sup>12</sup> See FCC, Industry Analysis & Technical Division, Wireline Competition Bureau, *High-Speed Services for Internet Access: Status as of December 31, 2005*, at Table 14 (July 26, 2006).

<sup>13</sup> NECA, *Trends 2006: Making Progress with Broadband*, at 12 (Figure 5), 15 (Sept. 2006), [http://www.neca.org/media/trends\\_brochure\\_website.pdf](http://www.neca.org/media/trends_brochure_website.pdf).

<sup>14</sup> See Vonage Press Release, *Vonage Crosses 2 Million Line Mark* (Sept. 5, 2006), <http://pr.vonage.com/releasedetail.cfm?releaseID=209823>; Vonage Holdings Corp., (Form 10-Q), at 14 (Aug. 4, 2006). More than 95 percent of Vonage subscribers are in the U.S. See Vonage Holdings Corp., (Form S-1/A), at 1 (May 23, 2006).

<sup>15</sup> See Richard Klugman, et al., Prudential Equity, *The Dust Has Settled: We Think It's O.K. To Own Telecom Stocks Again*, at 40 (July 20, 2006).

<sup>16</sup> See Craig Moffett, et al., Bernstein Research Call, *Quarterly VoIP Monitor: Six Million and Counting*, at Ex. 18 (June 12, 2006) (estimating more than 8.5 million cable lines by year-end 2006); John Hodulik, et al., UBS, *Vonage Holding Corp.* at Chart 7 (July 5, 2006) (estimating nearly three million independent VoIP subscribers by year-end 2006); Frank G. Louthan, IV, Raymond James & Associates, Inc., *Reassessing the Impact of Access on Wireline*

percent of wireless users currently do not have a landline phone.<sup>17</sup> Lehman Brothers estimates that 20 million wireline access lines have been lost to wireless since 1999, and that wireless substitution will continue to add more than six million new wireless subscribers each year.<sup>18</sup>

The new intermodal voice service providers can, and in many cases do, operate without the help of *any* universal service support.<sup>19</sup> In areas where there are carriers willing and able to offer service without high cost subsidies, subsidies should be eliminated or vastly reduced as part of market-oriented reforms to high cost distributions.

In fact, telephone services are far *more affordable* than they were even 10 years ago when the 1996 Act was adopted. Wireless prices specifically have declined by more than 50 percent since 2001.<sup>20</sup> And prices charged by wireless and other intermodal competitors have constrained

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*Carriers*, at 2 (July 11, 2005) (estimating wireless-only households with a 25 percent market share, and residential cable and standalone VoIP with a market share of more than 20 percent).

<sup>17</sup> Keith Mallison, Yankee Group, *Wireless Substitutions of Wireline Increases Choice and Competition in Voice Services*, at 5 (July 27, 2005); see also J. Armstrong, et al., Goldman Sachs, *2006 Outlook – Stuck in Neutral*, at 31 (Jan. 13, 2006) (wireless-only customers represent a 12.5 percent share of the residential market).

<sup>18</sup> Blake Bath, Lehman Brothers, *Telecom Services – Wireline*, at Figure 11 (July 7, 2005); see also Timothy Horan, et al., CIBC World Markets, *3Q05 Communications and Cable Services Review*, at Ex. 12 (Nov. 23, 2005) (estimating wireless substitution at 20 million lines as of year-end 2005, increasing by 5-6 million lines each year through 2007).

<sup>19</sup> For example, Alltel served 162,949 lines in Alabama the quarter before it received high-cost support. Compare USAC, *Federal Universal Service Support Mechanisms Fund Size Projections for the First Quarter 2005*, App. HC20 (2004), <http://www.universalservice.org/about/governance/fcc-filings/2005/> with USAC, *Federal Universal Service Support Mechanisms Fund Size Projections for the Second Quarter 2005*, App. HC21(2005), [http://www.universalservice.org/about/governance/fcc-filings/2005](http://www.universalservice.org/about/governance/fcc-filings/2005/). Similarly, Sprint served 55,786 lines in Alabama prior to receiving high-cost support. Compare USAC, *Federal Universal Service Support Mechanisms Fund Size Projections for the Second Quarter 2005*, App. HC21 (2005), [http://www.universalservice.org/about/governance/fcc-filings/2005](http://www.universalservice.org/about/governance/fcc-filings/2005/) with USAC, *Federal Universal Service Support Mechanisms Fund Size Projections for the Third Quarter 2005*, App. HC21 (2005), [http://www.universalservice.org/about/governance/fcc-filings/2005](http://www.universalservice.org/about/governance/fcc-filings/2005/).

<sup>20</sup> See Kate Griffin, Yankee Group, *Pervasive Substitution Precedes Displacement and Fixed-Mobile Convergence in Latest Wireless Trends* at Exhibit 2 (December 2005).

the rates ILECs can charge because the services are highly cross-elastic.<sup>21</sup> Moreover, according to the 2004/2005 edition of the Commission's Statistics of Communications Common Carriers, from 1996 to 2005, the change in the consumer price index for local residential services generally was in-line with movement of the consumer price index for all consumer items.<sup>22</sup> However, as a result of competition generally, and the increase in bundled offerings, customers' *overall* bill for telephone services, which were already widely affordable, has been getting even more affordable. The prices for total telephone service *decreased* 5.8 percent from 1998 to 2005; at the same time, the cost of all consumer items was *increasing* by 15.3 percent.<sup>23</sup> On average, in 1998, consumers spent two percent of their income on telephone services; today, that

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<sup>21</sup> See, e.g., Marguerite Reardon, *Verizon Plays Hardball on Pricing*, News.com, Nov. 9, 2005, [http://news.com.com/Verizon+plays+hardball+on+pricing/2100-1037\\_3-5942158.html](http://news.com.com/Verizon+plays+hardball+on+pricing/2100-1037_3-5942158.html) ("Verizon Communications has reduced rates on its traditional telephony service to new lows as it tries to compete with cable companies who are now offering telephony as part of their own packages."); Jeffrey Halpern, Sanford C. Bernstein & Co., Inc., *The State of the US Telecom Market and a Preference for Verizon*, at 4 (June 16, 2006) ("Steep Declines in Consumer Voice ARPU: RBOCs discount voice pricing to compete with cable VoIP, Verizon Freedom now priced at parity with some VoIP offers; AT&T not far behind.").

<sup>22</sup> See FCC, Statistics of Communications Common Carriers, Table 5.10 (2004/2005 ed.) ("Statistics of Communications Common Carriers"). Much of the change in local residential services was not from the monthly rate, but from increases in the SLC, taxes, 911 and other charges. For example, while the average monthly charge increased 10.2 percent from 1994 to 2004 (\$13.19 to \$14.53), during the same time period the SLC increased 63.7 percent (\$3.55 to \$5.81) and the cost of taxes, 911, and other charges on average grew 71.9 percent (\$2.31 to \$3.97). See *id.*, Table 5.11 – Average Residential Rates for Local Service in Urban Areas, 1994-2004. The SLC increases were largely due to implementation of the CALLS plan and the Multi-Association Group Plan, which increased the end user charge, but decreased per-minute access charges. See *Access Charge Reform*, Sixth Report and Order, 15 FCC Rcd 12962 (2000); *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, 16 FCC Rcd 11244, ¶ 30 (2001).

<sup>23</sup> See Statistics of Communications Common Carriers, Table 5.10. The first year with available statistics for total telecommunications service expenditures was 1998.

number is only 1.8 percent.<sup>24</sup> Thus, voice service has been getting more affordable, both in real terms and compared to the costs of other services.

The trend toward more affordable traditional and non-traditional voice services appears to be consistent in both rural and urban areas and coincides with offerings by cable, wireless, and VoIP providers that increasingly include nationwide calling plans with unlimited minutes of use.<sup>25</sup> Available data even indicates that high cost subsidies generally exceed statutory objectives in that rural consumers often pay *less* than urban consumers for the same wireline services.<sup>26</sup>

The dynamics of current market forces – *i.e.*, competitive growth resulting in substantial price reductions – have advanced universal service goals tremendously over the last several years. As these market forces thrive, the need for high cost support should decrease. Ironically,

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<sup>24</sup> Compare U.S. Department of Labor, Bureau of Labor Statistics, *Consumer Expenditure Survey* Table 3 (1998) (showing consumer unit income of \$41,622 (before taxes) and \$830 of expenditures for telephone services), available at <http://www.bls.gov/cex/1998/Standard/age.pdf>, with U.S. Department of Labor, Bureau of Labor Statistics, *Consumer Expenditure Survey* Table 3 (2004) (listing consumer unit income (before taxes) as \$54,453 and \$990 worth telephone services expenditures), available at <http://www.bls.gov/cex/2004/Standard/age.pdf>.

<sup>25</sup> See, e.g., Verizon Wireless, *Calling Plans*, <http://www.verizonwireless.com/b2c/store/controller?item=planFirst&action=viewPlanOverview> (offering nationwide wireless calling plans and unlimited minutes of use); Vonage, <http://www.vonage.com/> (a VoIP provider offering nationwide calling plans and unlimited minutes of use); Net2Phone, <http://web.net2phone.com/consumer/voiceline/plans.asp> (a VoIP provider offering nationwide calling plans and unlimited minutes of use).

<sup>26</sup> See, e.g., Comments of Sprint Nextel Corporation, CC Docket No. 96-45, WC Docket No. 05-337 (March 27, 2006) (indicating that rates in rural areas for various non-rural carriers are well below the national average urban benchmark); see also Declaration of Patrick Garzillo attached to the Comments of Verizon, CC Docket No. 96-45, WC Docket No. 05-337 (March 27, 2006) (describing analysis of rural rates in six states and rates reported in GAO reports; analysis indicates that rural rates are reasonably comparable to urban rates and in some cases lower than urban rates); Comments of BellSouth Corporation, CC Docket No. 96-45, WC Docket No. 05-337 (March 27, 2006) (indicating same); Comments of NASUCA, CC Docket No. 96-45, WC Docket No. 05-337 (March 27, 2006) (indicating same); Comments of General Communication, Inc., CC Docket No. 96-45, WC Docket No. 05-337 (March 27, 2006) (indicating same); and Comments of Qwest Communications International, Inc., CC Docket No. 96-45, WC Docket No. 05-337 (March 27, 2006) (indicating same).

that is not the case today. High cost support to ETCs is on the rise.<sup>27</sup> This is a trend that must be reversed if consumers are to fully realize all of the benefits of new competition.

**2. Future High Cost Subsidies Should Be Narrowly Targeted To Areas That Truly Need Support.**

Concurrent with the implementation of a competitive bidding process, the Joint Board and the Commission should re-evaluate the high cost landscape and target future support to areas in which customers would not be served without federal subsidies. In analyzing individual service areas, the Joint Board and the Commission should first determine if rates in a particular area would be affordable and reasonably comparable to urban rates without any high cost funding.

As discussed above, it is often the case that customers in rural areas actually pay less than customers in urban areas for the same voice services. The presence of competitive carriers operating in high cost areas without any support should indicate that subsidies may not be needed in those areas to ensure affordable access. Further, if rates in high cost areas would be affordable and reasonably comparable to rates for the same services in urban areas without any high cost support, then the presumption should be that subsidies ought to be eliminated or substantially reduced in those areas. Where high cost funding is determined to still be necessary to ensure affordable access, even after factoring all the efficiencies of new intermodal competitors, the Joint Board and the Commission should turn to a properly structured competitive bidding mechanism. Reverse auctions in those areas could be used to select the carrier(s) to be funded and to set subsidy amounts that are market-oriented.

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<sup>27</sup> The Progress & Freedom Found., *Digital Age Communications Act: Preliminary Proposal of the Universal Service Working Group*, at 9-10 (Rel. 1.0, Oct. 2005) (footnote omitted) ("Although the costs of providing telephone service have fallen significantly over time, [Universal Service Fund] spending has increased from \$15 per household in 1993 to \$52 per household in 2003.").

**B. The Fund Has Grown Dramatically Over Recent Years And Is Out Of Step With Statutory Goals.**

Beyond new competition, the need for high cost reform is evident from the size and growth of the fund itself. The Universal Service Administrative Company (“USAC”) predicts that the High Cost Fund requirements for 2006 will be over one billion dollars per quarter.<sup>28</sup> Between 1998 and 2005, approximately \$43.5 billion has been expended to implement Section 254, with nearly \$22 billion of this support spent on high cost subsidies.<sup>29</sup> Even if there were no additional growth in the High Cost Fund, by the end of this year the total High Cost Fund would be larger than \$4.183 billion per year<sup>30</sup> – more than double the size of the fund just seven years ago.<sup>31</sup>

In addition to incumbent LECs, new CETCs have been applying for and receiving high cost support with increasing frequency and in an increasing number of study areas. High cost support to CETCs more than doubled between 2003 and 2004 alone.<sup>32</sup> For a number of the high cost support programs, ILECs and CETCs receive support based on the ILEC’s embedded costs,

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<sup>28</sup> FCC, Industry Analysis & Technology Division, Wireline Competition Bureau, *Trends in Telephone Service, Table Compiled as of April 2005*, at Table 19.3 (June 21, 2005) (“*Trends in Telephone Service*”); see also USAC, *Federal Universal Support Mechanisms Fund Size Projections for the Fourth Quarter 2006*, App. HC02 (2006)(Unaudited) (“*USAC 4th Quarter 2006 Projections*”) (projecting annualized high-cost support funding to be \$4.183 billion), <http://www.universalservice.org/about/governance/fcc-filings/2005/>; USAC, *2005 Annual Report* at 7 (total high-cost disbursements of \$3.824 billion for 2005 (Unaudited)), <http://www.universalservice.org/about/governance/annual-report/2005>.

<sup>29</sup> See USAC, *Universal Service Fund Facts*, <http://www.universalservice.org/about/universal-service/fund-facts/fund-facts.aspx>.

<sup>30</sup> See *USAC 4th Quarter 2006 Projections*, at App. HC02.

<sup>31</sup> See USAC, *Universal Service Fund Facts-High Cost Program Data, 1998-2005 Disbursements by Calendar Year (2005)(Unaudited)*, <http://www.universalservice.org/about/universal-service/fund-facts/fund-facts-high-cost-program-data.aspx#calendar>.

<sup>32</sup> *Trends in Telephone Service*, at Table 19.5.

rather than on a basis that reflects the cost of efficiently providing the service with today's technology. In almost every case, these new subsidies are entirely duplicative, often many times over, of high cost subsidies already paid to the ILEC.<sup>33</sup> In less than five years, the share of high cost funds spent to subsidize CETCs in high cost areas increased from 0.1 percent to 9.5 percent.<sup>34</sup> As discussed below, affordable access and competitive neutrality do not require support of multiple ETCs in a service area.

The size (and continued growth) of the fund is unsustainable. This undermines the statutory goal of a "specific, predictable and sufficient" universal service mechanism. 47 U.S.C. § 254(b)(5). As market forces have reduced telephone rates and made them more affordable over time, the growth of the fund has meant that the universal service assessment has become a larger proportion of consumer bills for voice telephone service. Indeed, the Universal Service Fund contribution factor has risen dramatically in recent years. In 1998, the contribution factor averaged 3.16 percent and has trended upward since, peaking near 11 percent – nearly 3.5 times greater than it was just eight years ago.<sup>35</sup>

The current universal service assessment also jeopardizes the statutory goal that all rates remain "just, reasonable, and affordable." 47 U.S.C. § 254(b)(1). As the Tenth Circuit recently recognized, "excessive subsidization may affect the affordability of telecommunications

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<sup>33</sup> McLean & Brown, *Universal Service: Rural Infrastructure at Risk*, at 39 (Rel. 2.0, Apr. 2006) (noting that 58 percent of study areas with a CETC have two or more CETCs, and that 29 percent of such study areas have three or more CETCs).

<sup>34</sup> *Trends in Telephony Service*, at Table 19.5; see also Comments of OPASTCO, CC Docket No. 96-45 (Sept. 30, 2005) (indicating that CETCs are the primary drivers of growth in the rural high cost program).

<sup>35</sup> See *Trends in Telephone Service*, at Table 19.16; see also *Proposed Second Quarter 2006 Contribution Factor*, Public Notice, 21 FCC Rcd 2379 (2006). The contribution factor recently dropped to 9.1 percent. Such fluctuations are to be expected, and temporary decreases in the factor do not change the overall trend.

services, thus violating the principle in § 254(b)(1).” *Qwest Communications International v. FCC*, 398 F.3d 1222, 1234 (10th Cir. 2005). This concern is widely accepted. *See, e.g., Alenco Communications v. FCC*, 201 F.3d 608, 620 (5th Cir. 2000) (“[E]xcess subsidization in some cases may detract from universal service by causing rates unnecessarily to rise, thereby pricing some consumers out of the market.”).

### **III. COMPETITIVE BIDDING FOR HIGH COST SUBSIDIES WOULD HELP CURB THE FUND’S GROWTH AND APPROPRIATELY TARGET SUBSIDIES TO THE MOST EFFICIENT PROVIDERS.**

Paradoxically, new competition has contributed to the fund’s growth. But this same competition could now be relied upon to help fix the problem by supplying requisite participants in a process of competitive bidding for high cost subsidies. Reverse auctions for high cost dollars would help target support to the carriers that are able to provide service with the lowest amount of subsidy.

Reverse auctions would allow ETCs to compete for high cost subsidies in exchange for providing supported services in defined service areas. Pre-qualified ETCs could “bid down” from current aggregate support levels in high cost areas for subsidies. Similar to almost any competitive bidding process for government contracts, the reverse auction “winner” would be the ETC that submits the lowest bid. That ETC would be subsidized, for a period of time, in the amount of its bid. Such a system would subsidize only the most efficient ETC capable of providing supported services in a defined service area with the lowest amount of subsidy. Moreover, a system of reverse auctions that ultimately funds no more than one ETC in a high cost area would eliminate funding of multiple networks that are unnecessary to ensure affordable access.

The Commission itself now has over a decade of experience with spectrum auctions. Auctions are used to assign spectrum licenses to bidders who will put the spectrum to its highest

and best use. Wireless service providers and rural incumbent LECs, perhaps the two most critical players in any competitive bidding process for high cost funds, have been primary participants in spectrum auctions. Indeed, in the recently completed Auction No. 66, 73 applicants self-identified as rural telephone companies.<sup>36</sup>

Congress first authorized the Commission in 1993 to issue mutually exclusive spectrum licenses via auction or competitive bidding.<sup>37</sup> Since then, the Commission has conducted more than 60 auctions, granted more than 56,000 licenses through these auctions, and raised over \$14 billion in revenue.<sup>38</sup> In 2004, the Commercial Spectrum Enhancement Act required the Government Accountability Office (“GAO”) to examine the Commission’s commercial licensing process and report its findings to Congress. In its subsequent report to Congress, GAO found that domestic spectrum auctions encourage investment and innovation and have little or no effect on end-user pricing.<sup>39</sup> Moreover, GAO found that spectrum auctions addressed many of the problems associated with previous methods used to assign mutually exclusive licenses and

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<sup>36</sup> See Federal Communications Commission website, *Wireless Auctions, Auction Application Search*, available at [https://auctionfiling.fcc.gov/form175/search175/search\\_results.htm?searchLevel=B&PStart=21&increment=20](https://auctionfiling.fcc.gov/form175/search175/search_results.htm?searchLevel=B&PStart=21&increment=20).

<sup>37</sup> The Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66, § 6002, 107 Stat. 312, 387-392) added Section 309(j) to the Communications Act. Section 309(j) authorizes the Commission to use competitive bidding to determine initial license grant where there are mutually exclusive applications for the spectrum.

<sup>38</sup> See Federal Communications Commission website, *Auctions Home/About Auctions*, available at [http://wireless.fcc.gov/auctions/default.htm?job=about\\_auctions](http://wireless.fcc.gov/auctions/default.htm?job=about_auctions); see also, *Strong Support for Extending FCC’s Auction Authority Exists, but Little Agreement on Other Options to Improve Efficient Use of Spectrum*, General Accountability Office, GAO 06-236 (December 2006) (“GAO Report”) at 2. These figures do not include the 1,087 licenses won in the recently concluded AWS auction, with bids close to \$14 billion.

<sup>39</sup> GAO Report at 4, 17-19.

concluded that the competitive bidding process for assigning licenses for commercial entities appeared very effective.<sup>40</sup> In particular, GAO found that auctions are:

- relatively quick, reducing the average time for granting a license to less than a year from the initial application date;
- less costly than previous methods;
- transparent;
- effective in assigning licenses to entities that value them the most; and
- effective in recovering for the public a portion of the value of national resources used for commercial purposes.<sup>41</sup>

Beyond the communications industry, competitive bidding is often used to successfully determine market rates. In the Canadian timber industry, for example, the government owns the vast majority of all forest land in the province of British Columbia and uses auctions to set timber prices by awarding cutting rights to the highest bidders.<sup>42</sup> This system was adopted by government officials in British Columbia in 2002 in response to criticism from the United States and others that Canadian mills were able to buy unfairly subsidized timber at below market rates. The goal of the timber auctions in British Columbia was to establish a system that lets market forces determine timber prices. “The market pricing system (MPS) is based on the auction of timber. . .to establish the price for Crown timber. . .The new pricing system and other elements of the revitalization plan will result in public timber going to the highest and best use within B.C.”<sup>43</sup>

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<sup>40</sup> In particular, GAO found widespread support among its expert panelists for extending the Commission’s spectrum auction authority. *Id.* at 23.

<sup>41</sup> *Id.* at 20-21.

<sup>42</sup> British Columbia Ministry of Forests and Range, British Columbia Timber Sales, *Market Pricing System & BCTS, Frequently Asked Questions – Fall 2004*, available at <http://www.for.gov.bc.ca/bcts/faq/#Marketing>.

<sup>43</sup> *Id.*

Closer to home and to public utilities, auctions were also used by the Texas Public Utilities Commission to calculate stranded costs as part of the state's electric utilities deregulation plan. In 2001, electric utility companies in Texas were required to auction off 15 percent of their generating capacity.<sup>44</sup> The auction prices were then used to determine the value of the remaining 85 percent of capacity.

Reverse auctions have the same potential to help transition the High Cost Fund to a system where subsidies are provided only to those carriers that can provide service with the least amount of subsidy and ensure the "highest and best use" of high cost support. Indeed, if auctions can work to successfully determine market rates for electromagnetic spectrum, timber prices, and electric power capacity, then there is every reason to believe that competitive bidding can also bring market forces to bear on high cost support.

#### **IV. THE ACT SUPPORTS COMPETITIVE BIDDING FOR HIGH COST SUBSIDIES.**

A properly structured reverse auction mechanism would be consistent with the statutory framework.

##### **A. Reverse Auctions Are Consistent With ETC Designation Under Section 214.**

Section 254(e) admonishes that "only an eligible telecommunications carrier designated under section 214(e) shall be eligible to receive specific Federal universal service support." 47 U.S.C. § 254(e). The statutory language, structure, and legislative history make clear that designation as an ETC under Section 214 merely affords carriers the opportunity to receive universal service subsidies, not a guarantee that they will in fact receive subsidies in all areas.

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<sup>44</sup> 25 Tex. Admin. Code § 25.381(b) (2006), *available at* <http://www.puc.state.tx.us/rules/subrules/electric/25.381/25.381.pdf>.

The plain language of Section 254(e) establishes that ETC designation is a necessary but not a sufficient condition to receive universal service support. That is, an ETC designated pursuant to Section 214(e) is “eligible” for but not entitled to support. Words used in a statute are presumed to have their normal meaning.<sup>45</sup> The statutory term “eligible” is frequently understood to mean “fitted or qualified to be chosen or used.”<sup>46</sup> In *CTIA – The Wireless Association v. FCC*, No. 05-1008, 2006 WL 2728749, at \*11 (D.C. Cir. Sept. 26, 2006), a decision issued just a few weeks ago, the D.C. Circuit upheld this definition of “eligible” in a different context because it “fits comfortably within the common meaning” of the term.<sup>47</sup>

The term “eligible” does not connote a particular entitlement. When Congress intended to create an entitlement in the 1996 Act, it did so explicitly by using the term “entitled” rather than the term “eligible.” Compare 47 U.S.C. §214(e)(1) (carriers “shall be eligible to” receive universal service support in accordance with Section 254) with *id.* § 254(h)(1)(A) (carriers offering service to health care providers “shall be entitled to” the difference between rates to health care providers and other customers in comparable rural areas).

Additional analysis of Section 254(e) furthers the point. After indicating that only carriers designated as ETCs are “eligible” to receive support, this provision goes on to instruct “[a] carrier that receives such support shall use that support. . .” and requires that “[a]ny such

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<sup>45</sup> *Review of the Commission’s Rules and Policies Affecting the Conversion to Digital Television*, Third Memorandum Opinion and Order on Reconsideration, 17 FCC Rcd 18571, 18573, ¶ 6 (2002) (citing *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985)) (“Statutory construction must begin with the language employed by the statute and the assumption that the ordinary meaning of the language accurately expresses the legislative purpose.”).

<sup>46</sup> *CTIA – The Wireless Association v. FCC*, No. 05-1008, 2006 WL 2728749, at \*11 (D.C. Cir. Sept. 26, 2006) (quoting *Webster’s Third New International Dictionary of the English Language Unabridged* 736 (1981)).

<sup>47</sup> *Id.*

support should be explicit and sufficient.” *Id.* (emphasis added). Use of the word “that” is restrictive, indicating that not all carriers designated as ETCs necessarily will receive support.<sup>48</sup> Moreover, use of the word “any” indicates that subsidies will not be distributed in all instances.

Finally, the legislative history of the predecessor provision to Section 214(e) underscores Congress’s intent that ETC designation is not a guarantee of funding. The relevant Senate Report explains that ETC designation would “mak[e] that carrier eligible for support payments to preserve and advance universal service, *if any* such payments are established” by the Commission. S. Comm. on Commerce, Science, and Transportation, *Report on Telecommunications Competition and Deregulation Act of 1995*, at 42 (1995) (“*Senate Report*”) (emphasis added); *see also id.* at 39 (explaining that ETCs “shall be eligible to receive support payments, *if any*, established by the FCC or a State to preserve and advance universal service.”) (emphasis added). Thus, whether a carrier receives funding turns not on its ETC designation, but instead on whether it satisfies the criteria of whatever funding mechanism the Commission establishes pursuant to Section 254(e).

Consistent with the statutory language and legislative history, the Commission has never indicated that ETC designation constitutes an entitlement to support. The Commission has, however, tentatively recognized that it can create a reverse auction mechanism that complies with Section 214.<sup>49</sup> And the Joint Board properly has noted that Section 214(e) “provide[s] some

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<sup>48</sup> See, e.g., William Strunk, Jr. and E. B. White, *THE ELEMENTS OF STYLE* 59 (4<sup>th</sup> ed. 2000).

<sup>49</sup> See *Federal State Joint Board on Universal Service*, Further Notice of Proposed Rulemaking, 14 FCC Rcd 21177, 21217, ¶ 95 (1999) (“*Unserved Areas NPRM*”) (tentatively concluding to adopt a competitive bidding mechanism in unserved areas).

guidance about how competitive bidding should be structured.”<sup>50</sup> Specifically, the Joint Board has contemplated that the purpose of an ETC designation would be to *permit* a carrier to participate in the auction – not to designate a particular level of support. *First Recommended Decision* at 21219, ¶ 345.

**B. The Commission Is Not Required To Fund a Minimum Number Of ETCs.**

The Act does not require the Commission to fund any minimum number of ETCs in a service area. The Commission is required to ensure that universal service is preserved and advanced in accordance with the principles enumerated in Section 254(b), but that does not mean that multiple carriers, if any, in a service area must receive high cost funding. Funding multiple carriers in each area could undermine universal service goals by increasing the size of the fund and thereby adding to the burden on consumers.

In fact, as discussed above, in many currently designated high cost service areas there may be no need for any ETC to continue to receive subsidies in order for the Joint Board and the Commission to satisfy the requirements of Section 254, even in the absence of a competitive bidding mechanism. As the Senate Commerce Committee explained when addressing the predecessor language to Section 254(e):

In some areas of the country, particularly in areas that are already subject to competition in the provision of services included in the definition of universal service, the Committee expects that support payments would not be needed in order to provide universal service at just, reasonable, and affordable rates. The Committee intends this requirement to provide the flexibility for the FCC to reduce or eliminate support payments to areas where they are no longer needed... *Senate Report* at 39 (1995).

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<sup>50</sup> *Federal State Joint Board on Universal Service*, Recommended Decision, 12 FCC Rcd 87, 267, ¶ 345 (1996) (“*First Recommended Decision*”) (summarizing Joint Board finding); see *Unserved Areas NPRM* at 21219, ¶ 100.

Consequently, if universal service objectives can be achieved in a service area without any universal service subsidies, the Commission is under no obligation to provide such funding.

**C. A Properly Structured Reverse Auction Mechanism Would Meet the Objectives of Section 254.**

A properly structured reverse auction mechanism would satisfy the relevant principles in Section 254(b) for the preservation and advancement of universal service. *See, e.g., Federal State Joint Board on Universal Service, Report and Order, 12 FCC Rcd 8776, 8951 ¶ 325 (1997) (“First Report and Order”)* (“[W]e agree with the Joint Board that competitive bidding is consistent with section 254, and comports with the intent of the 1996 Act to rely on market forces and to minimize regulation. . .”). Generally, the Joint Board and the Commission have always been understood to have the authority to impose some limit on high cost subsidies and the overall size of the fund. For example, in upholding the Commission’s definition of “sufficient” support, the Tenth Circuit recognized that it may well be appropriate to “cap federal support at levels ‘only as large as necessary’ to meet the statutory goal. . .excessive subsidization arguably may affect the affordability of telecommunications services, thus violating the principle in § 254(b)(1).” *Qwest*, 398 F.3d at 1234 (citations omitted).

Competitive bidding would more closely align high cost support with subsidy levels actually required to provide supported services than the current “one size fits all” system of per-line subsidies based on the ILEC’s costs. Competitive bids for high cost dollars would benefit from the informed judgments of ETC bidders, which presumably have a better knowledge of their own costs and revenue requirements than regulators.

Moreover, reverse auctions would help provide for “just, reasonable, and affordable” rates. 47 U.S.C. § 254(b)(1). By tailoring high cost support to the most efficient level – *i.e.*, the lowest amount sufficient to meet objectives – in each service area, reverse auctions would likely

reduce what consumers must pay in universal service taxes for affordable telecommunication services. This is one of the primary advantages of competitive bidding, which the Commission has observed “may advance the goal of affordable rates because carriers would be able to pass-through any reductions [in the amount they contribute to the fund] to their subscribers.”

*Unserved Areas NPRM* at 21220, ¶ 101. The Joint Board has also appropriately rejected the suggestion that special standards are necessary to ensure quality of service in the auction context, concluding that “the question of quality standards is not unique to competitive bidding,” and “competition will give carriers the incentive to provide quality service.” *First Recommended Decision* at 267, ¶ 346.

In addition, competitive bidding offers the prospect of a “specific, predictable and sufficient” mechanism to “preserve and advance universal service.” 47 U.S.C. § 254(b)(5). Specificity could be achieved through careful attention to operational rules for the auction mechanism. Predictability could be achieved by establishing a set period of time between auctions for individual service areas during which support would be provided to the ETC that wins the bid. *See Alenco*, 201 F.3d at 622-23 (“specific” means explicit and “plainly stated,” and “predictable” means that there are “predictable *rules* that govern distribution of the subsidies”) (emphasis in original). The bidding process itself would assure that support was sufficient in that no rational ETC participant in a reverse auction would submit a bid for a level of support insufficient to actually provide the supported services. Similarly, the requirement of “explicit” support is not an impediment to implementing an auction mechanism. 47 U.S.C. § 254(e). An ETC that wins the bid for high cost subsidies in a service area would generally receive explicit support in the amount of its bid.

Another benefit to competitive bidding is that, if properly structured, the auction mechanism would by its nature disperse subsidies in a “competitively neutral” manner. *See First Report and Order* at 8801-03, ¶¶ 46-52 (adopting competitive neutrality as an additional universal service principle pursuant to Section 254(b)(7)). The current system funds all ETCs in a high cost area at the same per-line rate as the ILEC in a cost-benefit vacuum and without regard to the presence or absence of competition. Reverse auctions would allow all ETCs operating in a high cost service area, irrespective of the technological platforms of their voice products, to compete for high cost dollars. *First Recommended Decision* at 266, ¶ 342 (finding that “competitive bidding would put all prospective eligible carriers on an equal footing.”). The prospect, through competitive bidding, of gaining entry to a particular service area with exclusive high cost support for a period of time would also incent CETCs not currently operating in a service area to bid for high cost dollars.

ETCs currently receiving high cost funding are not entitled to indefinite support as markets and customer options change over time. As discussed above, new technologies have exploded in recent years and there is new, growing competition from non-traditional providers. If the same supported services can be provided by a more efficient technology in a high cost area, for a lower support amount, then a reallocation of support is entirely consistent with the Act. “‘Sufficient’ funding of the customer’s right to adequate telephone service can be achieved regardless of which carrier ultimately receives the subsidy.” *Alenco*, 201 F.3d at 621. The universal service envisioned by Congress in the Act “is to benefit the customer, not the carrier.” *Id.* More broadly, universal service subsidies are not tantamount to property rights of an ETC. “The Fifth Amendment protects against takings; it does not confer a constitutional right to government-subsidized profits.” *Id.* at 624. Congress expressly anticipated that universal