

**Before the  
Federal Communications Commission  
Washington, D.C. 20554**

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

**Notice of Proposed Rulemaking**

**Reply Comments of AARP—Reverse Auctions**

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### **About AARP**

AARP is a nonprofit, nonpartisan organization with more than 39 million members. As the largest membership organization representing the interests of Americans aged 50 and older, AARP is greatly concerned about the health, safety and financial security of older Americans, including those living on low and fixed incomes. AARP advocates for affordable and accessible telecommunications services at both the state and federal level.

## Reply Comments of AARP

AARP respectfully submits these Reply Comments for the FCC’s consideration, and thanks the Commission for the opportunity to participate in this important docket regarding universal service in the broadband era. These Reply Comments will focus on reverse auctions, as raised by the FCC in its *Reverse Auction* NPRM,<sup>1</sup> and in Comments filed by various parties.

### **Reverse Auctions Add Unnecessary Complexity to an Already Complex Process**

The FCC’s NPRMs represent an ambitious attempt to address needed reform of supported services and to contain rising support levels. There is no question that universal service reform is a complex process. As noted by AARP in its April 17, 2008 Comments,<sup>2</sup> there are multiple overlapping issues, some of which are being addressed in separate FCC dockets, that have an impact on universal service reform. The resolution of these intertwined issues will require significant focus and consistency on the FCC’s part.

As noted by AARP in its opening Comments, the current universal service funding approach fails to account for the impact of technological change on service provision, and the resulting beneficial impact on incumbent local exchange carriers’ (ILECs’) revenue streams and costs of providing voice and broadband services. AARP noted that the path to achieve reform must proceed through audits of the operations of supported carriers, and the development of a cost foundation to identify the level of subsidy needed. Until the costs and revenues associated with supported companies’ operations are quantified, no amount of experimentation with reverse auctions will lead to successful reform of the program. Furthermore, as pointed out in the Comments of some parties, accurate cost information from traditional cost methods may be a prerequisite of auction implementation.<sup>3</sup> For reasons that will be discussed in more detail below,

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<sup>1</sup> *In the Matter of High-Cost Universal Service Support; Federal-State Joint Board on Universal Service*, WC Docket No. 05-337, CC Docket No. 96-45, Notice of Proposed Rulemaking, FCC 08-5 January 29, 2008. Hereinafter *Reverse Auction* NPRM.

<sup>2</sup> Hereinafter “opening Comments.”

<sup>3</sup> *Reverse Auction* Comments of the Public Utilities Commission of Ohio, p. 10.

adding reverse auctions into the mix of issues associated with universal service reform introduces substantial risk and offers highly uncertain rewards.

### **The Comments Do Not Present a Clear Path Forward for Reverse Auctions**

Some Comments lend support to the auction process.<sup>4</sup> Other Comments raise significant doubts about the viability of reverse auctions, or point to the need for a more thorough evaluation to identify and address complex issues.<sup>5</sup> What is abundantly clear from a review of the Comments is that no party has pointed to any example of the successful application of reverse auctions to reform universal service funding. The lack of a track record of auctions points to the need for restraint when considering this alternative.

While auctions for universal service funding have been applied abroad, that experience is unlikely to be of much help to the FCC. Most auctions overseas have been used to assist with the deployment of payphone service to previously unserved areas, such as those in Latin America,<sup>6</sup> or similar programs pursued in Uganda and Nigeria.<sup>7</sup> Subsidization of the deployment of pay telephones in unserved areas is a very different proposition than funding a carrier of last resort (COLR) in an area already served by an incumbent. The lessons offered by these “green field” programs are unlikely to be of much use for implementing auctions in areas that are already served. In fact, auctions held abroad where an incumbent has been present, as was the

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<sup>4</sup> See, for example, the Comments of Verizon, p. 18; NCTH, Inc., p. 2; New York Public Service Commission, p. 2.

<sup>5</sup> For Comments opposing auctions, see, for example, the Comments of Time Warner, p. 15; NECA, p. 35; Sprint/Nextel, p. 12, and, OPATSCO, p. 16. For Comments offering conditional support, see, for example, Comcast, p. 7; Qwest, p. 8; Windstream, p. 24; Embarq, p. 19; and, AT&T, p. 34.

<sup>6</sup> See, “Leveraging Telecommunications Policies for Pro-Poor Growth—Universal Access Funds with Minimum-Subsidy Auctions,” OECD Document, October 22, 2004, p. 18.

<sup>7</sup> Ibid., and “Federal Republic of Nigeria Request for Proposal to Provide Universal Access Telecommunications Service,” May 8, 2006.  
<http://www.ncc.gov.ng/Headlines/RFP-%20UA%20Pilot%20Project%20Phase2.pdf#search=%22Nigeria%20telephone%20subsidy%20bid%22>

case in India (for payphone service),<sup>8</sup> and in Australia (for a more general universal service offering), did not fare well. Notably, the Australian regulatory authority identified the presence of the incumbent (Telstra) as the most likely reason for the lack of auction entry in an auction pilot project.<sup>9</sup>

The FCC's spectrum auctions provide a portent for the risks of reverse auctions. As the FCC is well aware, some spectrum auctions were characterized by collusion—bidders signaled one another regarding bidding strategies.<sup>10</sup> If collusion emerged in the spectrum auctions with relatively large numbers of bidders, the problem is likely to be even more pronounced in reverse auctions that will certainly be characterized by relatively few bidders.<sup>11</sup>

Another problem with spectrum auctions emerged surrounding the property rights associated with auction winners. As the FCC is also aware, some winning spectrum auction bidders eventually went bankrupt. The subsequent judicial review process, culminating in a U.S. Supreme Court decision,<sup>12</sup> determined that auction winners did not have to return spectrum licenses to the FCC. Similar concerns arise for reverse auctions for universal service support. If subsidy recipients should file for bankruptcy, other courts of competent jurisdiction can become involved, and it is possible that the regulatory agency administering the subsidy will lose control over the subsidy, just as the FCC lost control over some of its spectrum licenses. This is a

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<sup>8</sup> See, Noll, R. and Wallsten, S. "Universal Telecommunications Service in India," AEI-Brookings Joint Center for Regulatory Studies, Related Publication 05-25, October 2005, p. 10.  
<http://aei-brookings.org/admin/authorpdfs/redirect-safely.php?fname=../pdffiles/php97.pdf>

<sup>9</sup> "What Rules for Universal Service in an IP-Enabled NGN Environment?," International Telecommunication Union, April 15, 2006, p. 14.  
<http://www.itu.int/osg/csd/ngn/documents/Papers/Xavier-060323-Fin-v1.pdf>

<sup>10</sup> See, Crampton, P. and Schwartz, J. "Collusive Bidding: Lessons from the FCC Spectrum Auctions," *Journal of Regulatory Economics*, Volume 17, Number 3, May 2000, pp. 229-252.

<sup>11</sup> For additional discussion of collusion problems in auctions where a small number of bidders is present, see, Klemperer, Paul, "Using and Abusing Economic Theory," *2002 Alfred Marshall Lecture to the European Economic Association*, p. 9.  
<http://www.nuff.ox.ac.uk/economics/papers/2003/W2/usingandabusing.pdf>

<sup>12</sup> Supreme Court of the United States, *Federal Communications Commission, v. Nextwave Personal Communications, Inc., et al.* January 27, 2003.  
<http://www.supremecourtus.gov/opinions/02pdf/01-653.pdf>

substantial risk. The FCC indicates that it may need to develop rules on the bankruptcy issue.<sup>13</sup>

Whether FCC rules governing the disposition of subsidy assets in the event of bankruptcy would withstand judicial review is difficult to predict.

In summary, reverse auctions may introduce risks that could undermine the FCC’s ability to reform universal service funding. The discussion below highlights additional and difficult issues that the FCC will face should it pursue a reverse auction process.

### **Auction Entry**

A key element in the success of any auction is its ability to attract bidders.<sup>14</sup> When considering a reverse auction for universal service funding, the Commission must hold realistic expectations. As AARP noted in its opening Comments, the “entry” that the FCC has witnessed in rural markets is almost exclusively from wireless carriers (that the FCC now acknowledges are serving a separate mobility market).<sup>15</sup> Thus, it seems doubtful that robust rivalry for wireline voice or broadband subsidies will emerge in rural markets across the board.

The lack of entry, or uneven entry, will present problems with the efficiency of auction outcomes. While some areas might attract multiple entrants, others certainly will not. If some auctions fail, or if auctions are conducted with few bidders, the auction mechanism will not produce an efficient outcome. The FCC should carefully consider what it already knows when evaluating the potential for reverse auctions—wireline competition has not been robust in rural areas. It is unreasonable to believe that creating an auction will change this fact.

The reason for the lack of promise regarding entry in auctions is exactly the same as that associated with entry in the local exchange market in general—the industry continues to be

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<sup>13</sup> *Reverse Auction*, NPRM, ¶25.

<sup>14</sup> Klemperer, Paul. *Auctions: Theory and Practice*. Princeton University Press, 2004, p. 25.

<sup>15</sup> *In the Matter of High-Cost Universal Service Support; Federal-State Joint Board on Universal Service*; WC Docket No. 05-337; CC Docket No. 96-45, Notice of Proposed Rulemaking, FCC 08-4, January 29, 2008, ¶9.

characterized by high fixed and sunk costs.<sup>16</sup> There is no reason to expect that auctions will generate any new entry from wireline carriers in high cost areas as auctions do nothing to change the underlying structure of technology—the entry barriers associated with last-mile facilities will persist in the face of auctions. Furthermore, aspects of the auction process itself may discourage entry. For example, implementing a subsidy grant with a limited term<sup>17</sup> will increase risk associated with capital investment. Increased investment risk will discourage auction entry.

In summary, unless the FCC plans on moving in two contradictory directions at once—discouraging the expansion of wireless eligible telecommunications carriers (ETCs) through the cap on support, while also relying on wireless ETCs to provide the “competition” in the auction process—the FCC cannot reasonably expect the auction process to generate widespread competitive bidding.

### **Reserve Price**

The FCC must carefully consider the impact of multiple, overlapping dockets on an attempt to implement reverse auctions. For example, as pointed out by the Joint Board, one critical outstanding issue is the Tenth Circuit Court of Appeals in the *Qwest II* remand.<sup>18</sup> According to the Joint Board, the resolution of this remand may result in increases in funding.<sup>19</sup> Absent a resolution of this issue, use of existing funding levels as the reserve price, as suggested by the NPRM,<sup>20</sup> could transfer unresolved legal questions from *Qwest II* to the reserve and the auction process.<sup>21</sup> Thus, to establish a reserve, the FCC may be faced with the prospect of

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<sup>16</sup> Time Warner Comment, p. 14; Comcast Comments, p. 7.

<sup>17</sup> *Reverse Auction* NPRM, ¶47.

<sup>18</sup> *In the Matter of High-Cost Universal Service Support; Federal-State Joint Board on Universal Service*, WC Docket No. 05-337, CC Docket No. 96-45, Recommended Decision, November 20, 2007, ¶33.

<sup>19</sup> *Ibid.*, ¶42.

<sup>20</sup> *Reverse Auction* NPRM, ¶37.

<sup>21</sup> AT&T Comments, p. 36, Qwest Comments, pp. 5–6.

developing a new cost basis, either through the use of embedded costs, or through the use of cost modeling.<sup>22</sup> If the FCC were to apply updated cost estimation methodology for the purpose of setting a reserve, the FCC will have established a foundation for funding reform. The incremental benefits that might emerge from then conducting an auction are likely to be limited, especially if the number of bidders is small. Updated cost information, combined with the acknowledgment of revenues from sources other than basic voice, provides a more certain path to the establishment of rational universal service support.

### **Geographic Bidding Areas**

There is no easy answer on bidding geography, and preexisting infrastructure raises problems that are likely to undermine the effectiveness of a reverse auction. The FCC reached the tentative conclusion that the study area of the wireline ILEC is the appropriate geographic area on which to base reverse auctions.<sup>23</sup> The FCC indicates a willingness to consider disaggregation of study areas, but only if a method can be developed to cap the subsidy distribution at the study area total. The FCC has received alternative proposals for the geographic area to be used to define auction areas. Some parties have proposed areas ranging from Zip Code Areas<sup>24</sup> to wire centers or Census Block Groups.<sup>25</sup>

Geographic bidding areas pose a substantial challenge to the design of a reverse auction. The use of study areas orients the bidding geography to the ILEC's service area. Study areas have other disadvantages, such as the large size of some, and the gerrymandered nature of study

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<sup>22</sup> As noted in the *Reverse Auction* Comments of the Ohio Public Utilities Commission (p. 10), cost-based evaluation will be needed where auctions fail, or have few bidders. The *Reverse Auction* NPRM (¶ 38) describes a potential process of setting reserve prices based on forward-looking costs developed by the FCC's cost model. Whether the FCC's cost model is sufficient is questionable. The FCC's model is now dated, and may not reflect the costs of providing the services that the FCC proposes the auction winner provide (i.e., broadband). Significant revisions in cost modeling are needed to reflect current technology.

<sup>23</sup> Reverse Auction NPRM, ¶¶19–22.

<sup>24</sup> Alltel proposed pilot, February 17, 2007.

<sup>25</sup> Verizon proposal, Appendix, p. 4.

area boundaries. These factors may conflict with entrant business plans and deter entry. Wire centers, while smaller than study areas, retain the disadvantage of being based on the ILEC's service area, and conflict with a potential entrant's business plan. Linking the auction bidding area to the ILEC's service area will create a biased auction structure. However, use of "competitively neutral" geographies, such as Zip Code areas or Census Block Groups generates separate problems, as these geographies may not correspond to either ILEC service areas or entrant business plans. The past twelve years under the Telecom Act have witnessed little "out of area" ILEC entry. Whether an ILEC would be interested in placing a bid in an auction that required it to extend facilities outside of its current service area, which might be the case if Zip Code areas or Census Blocks were the basis for bidding geography, is questionable.

### **Single Winner? Multiple Winners?**

The FCC reached a tentative conclusion that a single auction winner was desirable, given the possibility of increased subsidy should multiple winners be allowed.<sup>26</sup> While a single winner may generate some advantages,<sup>27</sup> the FCC must keep in mind that a single-winner auction structure will favor incumbent providers. No other provider has the ability to immediately serve all relevant customers. The advantage handed to incumbents will be even more pronounced if the ILEC study area or wire center is utilized as the basic geographic unit because incumbents, unlike potential entrants, have ubiquitous facilities deployed. The likely outcome of the application of a single winner approach will be to discourage auction entry, thus undermining the level of competition that could emerge from the auction process. The single-winner framework may also work against bidding competition in future auctions. It is not clear whether bidders will participate in future auctions once an incumbent is established through the initial auction.

However, selection of multiple winners generates a separate set of incentive problems, as

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<sup>26</sup> *Reverse Auction* NPRM, ¶14.

<sup>27</sup> For example, see Verizon Comments, Appendix, p. 12.

aggressive bidding is unlikely under an “everybody wins” approach, or the “winner takes more” format that has been suggested.<sup>28</sup> If bidders share the overall amount of support available, they will have every incentive to keep overall support levels as high as possible.<sup>29</sup> Thus, both single winner and multiple winner frameworks have disadvantages and may impact auction outcomes through reduced entry or diminished incentives to bid aggressively.

### **Impact on COLR Obligations**

The FCC raises the issue of whether carrier of last resort obligations must be addressed in the context of reverse auctions.<sup>30</sup> Applying an auction to select a COLR raises a number of substantial issues. COLR obligations are likely to be defined by state commissions (or state statutes). The obligations of COLRs as defined by the states should not be undermined by funding new COLRs, such as wireless carriers, that are incapable of offering services that are consistent with state definitions,<sup>31</sup> or the functionality that consumers have come to rely on, such as flat-rate local calling, reliable 911, or access to directory listings. Furthermore, if a single-winner auction mechanism is used to support a COLR, the COLR may gain substantial leverage in the renewal of support. If the auction winner decides that it does not want to serve as a COLR after the initial term, and other firms are unwilling to enter, the FCC (or state commissions) could be faced with take-it-or-leave-it demands for increased funding.

### **Auctions and Rate Regulation**

AARP noted in its opening Comments that some states are lifting rate regulation for basic service. The elimination of rate regulation may pose significant problems for the reverse auction

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<sup>28</sup> CTIA Presentation to the Federal State Joint Board, February 20, 2007, p. 10.

<sup>29</sup> As noted by Laffont and Tirole, when it comes to multiple reverse auction winners, “there is no free lunch.” Laffont, J. and Tirole, J. *Competition in Telecommunications*, MIT Press, 2000, p. 254.

<sup>30</sup> *Reverse Auction NPRM*, ¶24.

<sup>31</sup> For example, the California Commission defines basic service to include the ability to choose either flat or measured rate service, equal access, and access to a directory listing. It appears unlikely that these functions would be provided by a wireless carrier.

process. Implicit in the FCC's proposed auction framework is the assumption that prices in high cost areas are constrained to achieve universal service objectives, and there is no question that subsidized rates charged by a COLR must be constrained. Within the context of universal service support, constrained basic service prices provide incentives for service providers to view the subsidy available as the best option to carry out operations in the high-cost geographic areas. However, if pricing constraints on basic service are lifted by state policies once the ILEC is no longer a COLR, the ILEC might decline to bid, or it might submit bids that were at or near the reserve price to ensure that its bid would not be the winner.<sup>32</sup> If an ILEC does not find COLR obligations desirable, which might be the case if it could eliminate pricing constraints by no longer serving as COLR, the auction process could provide a means for ILECs to escape COLR obligations, thus reducing incentives for aggressive bidding. The FCC cannot ignore the interplay between basic rate deregulation and the viability of an auction.

### **Compliance Costs Must Be Addressed When Evaluating Reverse Auctions**

Should the FCC pursue reverse auctions, conducting the auction is only the beginning of the process. Following the auction, the FCC (or state commission) must ensure that the subsidy recipient is performing as expected, and does not act on natural incentives to cut costs or increase prices once the subsidy right has been awarded. Follow-up and audit is a natural part of the use of reverse auctions. The costs of policing subsidy contracts must be considered when evaluating the viability of reverse auctions.

### **Conclusion**

The use of reverse auctions as a vehicle for reforming universal service funding levels raises a number of serious concerns. Adding reverse auctions to an already complex funding environment will likely lead to unintended consequences, opening the risk of additional

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<sup>32</sup> The issue of the elimination of rate caps for ILECs that are no longer COLRs is raised in AT&T's Comments (p. 35). AT&T proposes (p. 22) that state-level price regulation be eliminated, and basic service rates be allowed to "market-based" levels that would obviate the need for subsidy.

problems with the universal service program. As AARP discussed in detail in its opening Comments, the FCC must implement reform to the universal service program that aligns funding with the cost and revenue structures that reflect the business model of today's subsidy recipients. If this critical first step is not taken, a reverse auction process will only perpetuate existing inefficiency, as the reverse auction mechanism will be cobbled atop the existing inefficient funding structure. Implementing this proposed "regulatory innovation" on top of a broken foundation is unlikely to lead to successful reform.