USAC

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Federal Communications Commission
Office of the Secretary

Via Electronic and First Class Mail

August 19, 2009

WC 06-122
WC 05-337

Ms. Julie Veach
Acting Chief, Wireline Competition Bureau
Federal Communications Commission
445 12th St., S.W.
Washington, D.C. 20554

Re: Policy Guidance Regarding Universal Service Fund Matters Previously Submitted to Commission Staff

Dear Ms. Veach:

In response to a request from Wireline Competition Bureau (WCB) and Office of Managing Director (OMD) staff, the Universal Service Administrative Company (USAC) hereby provides this non-confidential summary of policy guidance requests previously presented to Federal Communications Commission (FCC or Commission) staff regarding Universal Service Fund (USF) matters. The letter lists six outstanding matters for which USAC has requested guidance.

1. USF Contributions: Reporting of Prepaid Telephone Card Revenue on FCC Form 499-A.

   (a) The FCC Form 499-A Instructions require carriers to report as telecommunications revenue the amount the customer paid for the calling card. The FCC Form 499-A, however, requires carriers to report the face value of the card as revenue. USAC has requested guidance to clarify these seemingly conflicting requirements. In cases where carriers sell prepaid calling cards to a third-party distributor or wholesaler not affiliated with the carrier, the selling carrier may not be aware of what the end-user customer paid. Further, when a prepaid card does not have a face value, or the customer paid less than face value because of discounting, then carriers are using alternative methods for calculating calling card sales. Reporting requirements need to be clarified to assist carriers with an alternative method that can be used to determine the revenue amount that should be reported on Line 411 of the FCC Form 499-A when the face value or the amount paid by the customer is not known by the original selling carrier.

(b) Audits of prepaid calling card revenue reporting indicate that the FCC Form 499-A and corresponding instructions do not address the question of how carriers should report revenue related to prepaid calling cards that measure units of time rather than dollar amounts. Commission guidance on appropriate treatment of revenue related to such cards is requested with the outcome potentially impacting USF collections.

(c) The FCC Form 499-A and corresponding instructions do not address the question of when prepaid calling card revenue should be recognized and reported by a carrier. If the carrier cannot determine when a prepaid telephone calling card is sold to an end-user customer, when should the carrier report the revenue associated with the card on the FCC Form 499-A?

Impact on the Universal Service Fund

These issues create both a reporting issue for the carrier and an audit problem for USAC when determining an adequate method for calculating the revenue impact to the USF. Until these issues are clarified by the Commission, USF collections by carriers may be overstated or understated.

2. USF Contributions: Classification of ATM/Frame Relay Revenue.

USAC's Internal Audit Division (IAD) audit activities revealed reporting issues concerning Asynchronous Transfer Mode (ATM) and Frame Relay products. USAC IAD identified instances where ATM revenue was classified as non-telecommunications revenue and reported on Line 418 of the FCC Form 499-A. Carrier responses to audit inquiries indicate such revenue is considered derived from an "information service." USAC is seeking policy guidance concerning the proper categorization of ATM/Frame Relay revenue.

Impact on the Universal Service Fund

Audits indicate a substantial amount in potential underreporting of revenues subject to USF contributions.

3. USF Contributions: Classification of Virtual Private Network and Dedicated Internet Protocol Revenue.

Audit findings for multiple carriers require Commission guidance on the proper classification of Virtual Private Network (VPN) and Dedicated Internet Protocol telecommunication services. VPN service provides the functions and features of a private network without the need for dedicated private lines. Through the use of an encrypt-transmit-decrypt process, the VPN customers have a solution that is the same as dedicated point-to-point connections. Carriers have classified VPN service revenues, as related to circuit charges and flat fee charges, and dedicated Internet Protocol (IP) revenues as non-telecommunications revenue on Line 418 of the FCC Form 499-A.

Further inquiry disclosed that the dedicated IP revenue amount was primarily related to data transport using IP. This product is similar to Private Line/Frame Relay, which is to be entered on Line 415, per the 2006 FCC Form 499-A Instructions.[1] The product contains encryption and processing that is transparent to the customer and is used in the operation of the system.

Impact on the Universal Service Fund

Potential USF contribution recovery from two audited carriers is substantial. Other carriers offering similar services not reporting revenues from these services will further cause an understatement of revenues.

4. High Cost Program: Document Retention Requirements Prior to Rule Change.

The Commission established explicit High Cost Program document retention rules[2] effective March 1, 2008 that require carriers retain for five years from receipt of funding all records necessary to demonstrate to auditors that support received was consistent with High Cost Program rules. When the Commission established this rule, it did not address what, if any, remedial actions should be initiated against carriers that did not maintain documentation for periods being audited prior to the establishment of the High Cost Program documentation rules.

Impact on the Universal Service Fund

Although the Commission established High Cost Program documentation retention rules applicable on a prospective basis, the Commission did not address audits and the result of audits prior to the establishment of the documentation rules. USAC is not able to take action on these findings until the Commission provides policy guidance. There are approximately 100 audits that have a finding related to documentation for periods prior to the establishment of the High Cost Program document retention rules. Although USAC is performing additional reviews for all disclaimed and adverse audits, there are still outstanding audits with documentation issues from audits performed by USAC IAD for 2003 to 2005 and audits that received a qualified opinion from Rounds 1 and 2 of the FCC OIG

[1] 2006 FCC Form 499-A Instructions at 24.
[2] *See* 47 C.F.R § 54.202(e).

USF audit program. The potential recovery of support paid to beneficiaries is significant, if the support is deemed improper and recoverable due to carrier failure to comply with the document retention requirements of Section 54.202(e), even though this rule was not in effect for the time period being audited. This issue will also become a common finding in Round 3 of the FCC OIG USF audit program audits, because the time period being audited includes transactions that occurred prior to Section 54.202(e) going into effect.

5. High Cost Program: Income Tax for S-Corporations.

USAC has requested clarification on whether income taxes attributable to S-corporation shareholders as a result of their ownership of the corporation's equity are includable in the carrier's revenue requirement and, therefore, recoverable through USF. Current industry practice allows carriers formed as S-corporations to impute the taxes on income paid by the shareholders for purposes of determining the corporation's reportable interstate revenue. This practice makes S-corporation and C-corporation treatment consistent by recognizing the taxable income of a regulated carrier as recoverable regardless of corporate form.

S-corporation carriers believe that shareholder income taxes may be included in carrier's revenue requirement because:

(a) this is standard industry practice recognized by the National Exchange Carrier (NECA) (*see* Section 3.1 of its Cost Issues Manual);[3]
(b) a Policy Statement from the Federal Energy Regulatory Commission providing for an income tax allowance for partnerships owning interest in a regulated public utility;[4] and
(c) an FCC position allowing cable companies to recover such income taxes.[5]

In addition, NECA allows S-Corporations to include shareholder income taxes for NECA common line pool purposes. While historical practice has been for carriers to include income taxes attributable to S-Corporation shareholders in determining the telephone company's interstate revenue reporting requirement, it has been an audit finding in over 20 High Cost Program beneficiary audits because the auditors do not agree with the industry practice. As the rules are silent on this issue, USAC is not able to take action on these findings until the Commission has provided policy guidance.

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[3] *See generally*, NECA Cost Issues Manual, Section 3.1, Income Tax Treatment of Subchapter S Corporations, Partnerships and Certain Limited Liability Companies, 12/90 (Revised 4/99, 03/07).
[4] 111 FERC ¶ 61,139 (2005) at ¶ 32.
[5] *See* Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation and Adoption of a Uniform Accounting System for Provision of Regulated Cable Service, 9 FCC Rcd 4527 (1994).

Impact on Universal Service Fund

During Rounds 1 and 2 of the FCC OIG USF audit program audits, this finding was identified in over 20 audits and recovery of High Cost Program support would be significant if the S-corporation carriers are not permitted to impute shareholder income tax in determining the company's interstate revenue requirement. The resolution of this finding will impact multiple years.

6. High Cost Program: Applicability of the CETC Industry-Wide Interim Cap to Company Specific Caps for AT&T and Alltel.

The Commission established the CETC industry-wide cap effective as of August 1, 2008 (FCC 08-122, rel. May 1, 2008). Prior to release of this order, the Commission also established two company specific High Cost caps for AT&T (FCC 07-196, rel. Nov. 19, 2007) and Alltel (FCC 07-185, rel. October 26, 2007). USAC believes that it is required to implement the orders for AT&T and Alltel company-specific caps for the time period each respective order was in effect until the date it was superseded by FCC 08-122, because the CETC industry-wide cap was effective prospectively and did not state that it superseded the company-specific caps retroactively. The company specific caps were not implemented prior to the CETC industry-wide cap for administrative reasons only. USAC was ready to implement the company-specific caps in the June 2008 High Cost disbursement cycle. At the written direction of Commission staff, however, USAC did not implement the company-specific caps. Had Commission staff agreed to the implementation methodology for the AT&T and Alltel company specific caps, these two individual caps would have been implemented prior to the effective date of the CETC industry-wide cap.

USAC is requesting written guidance as to whether the AT&T and Alltel company-specific cap orders should be implemented for the time periods each order was in effect, prior to the effective date of the industry-wide cap.

Impact on Universal Service Fund

If USAC were to implement the company specific caps for AT&T and Alltel, significant amounts of funding previously disbursed would be recovered from each carrier.

The determination of these matters will significantly impact USF collections, the USF contribution factor, USAC administrative and operational responsibilities, and the obligations of contributors and beneficiaries. USAC respectfully requests guidance regarding the matters set forth above. We are available to meet to discuss any of these issues. USAC appreciates your consideration of these matters.

Sincerely,

Richard A. Belden
Chief Operating Officer

cc: Steven VanRoekel, Managing Director, FCC
Mark Stephens, Chief Financial Officer, FCC
David Hunt, Acting Inspector General, FCC