Small Company Coalition

White Paper: Proper Funding of the Federal High Cost Programs

June 2017

EXECUTIVE SUMMARY

The Small Company Coalition (SCC) presents this White Paper to address the pressing need to fully fund the federal universal service high-cost programs applicable to rate-of-return (RoR) regulated carriers. The Federal Communications Commission (FCC) has, through several means, constrained the amount of support available to RoR carriers, none of which relate to the actual need of support for the purpose of building and maintaining world-class broadband networks. Instead, the FCC has adopted an artificial budget, based on the historical use and need of federal high-cost programs, to limit the overall amount of support available. As such, the mechanisms available to RoR carriers to foster broadband deployment and maintenance—i.e. the Alternative Connect America Model (ACAM) and the Connect America Fund Broadband Loop Support (CAF BLS), as well as High Cost Loop Support (HCLS) and Alaska Plan support – are insufficient to meet the needs expressed by the Commission-adopted calculations.

This SCC-sponsored review demonstrates that the artificial constraints placed on the RoR high cost mechanisms are needlessly harming the ability of carriers to deploy broadband, especially considering the collection and maintenance of significant CAF reserves. Such reserves could help reduce costs associated with maintaining integrity in the USF and the savings could be better used to help fund the RoR mechanisms. Consequently, the SCC concludes that the FCC must move towards fully funding the RoR high cost mechanisms through the steps outlined in this report.

About The Small Company Coalition. The SCC is an alliance of rural telecommunications and broadband providers as well as supporting vendor companies, formed to educate and empower small rural ILECs to work with regulators and legislators to eliminate or modify harmful laws or regulations. We endeavor to influence and revise regulations and legislation that impede our ability to provide advanced telecommunications service to the customers and communities we serve. The SCC, which is an initiative led by small company executives, strives to ensure that the voice of small companies is heard by those who have a genuine interest in protecting and enhancing the communication service needs of rural Americans.

I. THE STATE OF THE RATE OF RETURN HIGH COST SUPPORT MECHANISMS

The federal high cost support mechanisms available to RoR carriers are: (1) the ACAM program, which is based on an already-awarded fixed amount of support paid out over ten years; (2) the "legacy" mechanisms, consisting of CAF BLS and HCLS; and (3) Alaska Plan support. Currently, the federal programs' budgets are as follows[1]:

Table 1 – High Cost Support

[1] Source: USAC 3Q2017 Filing

Program	3Q17 Budget (Millions)	Annualized (Millions)
HCLS	$ 125.65	$ 502.60
CAF BLS	$ 186.12	$ 744.48
ACAM	$ 138.95	$ 555.80
AK Plan*	$ 13.50	$ 54.00
Total	$ 464.22	$ 1,856.88

* RLEC portion only

The amounts shown in Table 1 reflect capped amounts for each of the programs. In the HCLS program, there are multiple capping mechanisms: (1) the indexed cap; and (2) the overall budget control mechanism adopted by the FCC. The CAF BLS is also limited by the FCC's overall budget control mechanism. ACAM support was limited by operation of parameters within the model itself, such as lowering the per-location limit on support. In total, the SCC estimates these budget constraints result in $1.460 billion of reduced support, broken down as follows:

Table 2 – Federal High Cost Support Limitations[2]

Program	Capped	Uncapped	Reduction	Annualized
HCLS - Indexed Cap	$ 704.12	$ 1,922.12	$ 1,218.00	$ 1,218.00
CAF BLS/HCLS Budget Control	$ 799.78	$ 879.52	$ 79.74	$ 159.48
ACAM	$ 555.80	$ 638.00	$ 82.20	$ 82.20
Total	$ 2,059.70	$ 3,439.64	$ 1,379.94	$ 1,459.68

The Commission established an overall budget for the RoR high cost support mechanisms at $2 billion, which is based on support levels paid to such carriers in 2011.[3] This support level does not take into account more recent Commission decisions to, for example, increase the minimum broadband speeds (10/1 mbps) or change the definition of advanced services (to 25/3 mbps). It also fails to take into account any increase that would be needed as a result of inflation. The legacy support level also includes a now non-existent mechanism, Interstate Common Line Support or ICLS, but not the mechanism the Commission adopted to directly address the provision of broadband services (CAF BLS). To the SCC's knowledge, no effort has been made to perform a bottom-up calculation of support requirements, and instead the fate of broadband availability in rural America rests on a top-down allocation of already inadequate resources.

II. THE ROR SUPPORT MECHANISMS SHOULD BE FULLY FUNDED

As stated above, the current overall RoR carrier high cost support budget of $2 billion is based on support levels that existed in 2011 with the adoption of the *USF/ICC Transformation Order*. At that time, HCLS, ICLS, and local switching support (LSS) made up the bulk of the RoR mechanism. Since then, LSS has been eliminated and replaced by CAF Intercarrier Compensation support (CAF ICC), and ICLS has been replaced and in most ways enhanced by CAF BLS. However, with the release of the *USF/ICC Transformation Order* and subsequent decisions, the Commission's focus has been almost entirely on the availability and affordability of broadband services.

[2] HCLS Indexed Cap – NECA Overview and Analysis of 2016 USF Data Submission, September 30, 2016; CAF BLS/HCLS Budget Control – USAC 3Q2017 FCC Filing, Appendix HC15; ACAM – USAC 3Q2017 FCC Filing, Appendix M02 and Comments of WTA – Advocates for Rural Broadband, filed February 13, 2017 in WC Docket No. 10-90 at p. 5

[3] *USF/ICC Transformation Order*, FCC 11-161 (rel. Nov. 18, 2011) at 126

As stated above, the FCC has increased the threshold broadband speed to be provided for support eligibility, and has increased the speed related to the definition of advanced telecommunications services pursuant to Section 706 of the Act. Even with these changes, and the fact that the total RoR support level is based on USF distributed in 2011, the overall budget has not increased. This has, in part, led to the unfunded support mechanisms noted above in *Table 2*.

While RoR RLECs have done an admirable job in building and maintaining state-of-the-art broadband networks, more effort, investment, operations, and maintenance are necessary to reach the FCC's current 25/3 mbps goal for the United States. Table 3, from the FCC's most recent Broadband Progress Report, shows that 39% of Americans living in rural areas do not have access to 25/3 mbps broadband internet access services (BIAS). This ratio increases dramatically, to 68%, for Americans living in rural Tribal areas.

Table 3 – Americans Without Access to Fixed Advanced Telecommunications Capability (25/3 mbps)

	Population (millions)	Percentage of Population
United States	33.982	10%
Rural Areas	23.430	39%
Urban Areas	10.552	4%
Tribal Lands	1.574	41%
Rural Areas	1.291	68%
Urban Areas	0.283	14%
U.S. Territories	2.628	66%
Rural Areas	1.078	98%
Urban Areas	1.550	54%

Typically, the last customers to receive BIAS of 25/3 mbps magnitude are the most expensive to serve, a fact recognized by the FCC in numerus instances.[4] Thus, it makes little to no sense to (1) establish a budget based on 2011 support payouts, and (2) not determine, from the bottom up, exactly what it will cost to reach the FCC's goals for universal broadband services.

Compounding this problem is the FCC's refusal to fully fund the need for support identified by its own current formulas. As shown above, each of the FCC's high cost support mechanisms for RoR carriers is in some way constrained. The SCC suggests a necessary start to this process is for the FCC to fully fund the RoR high cost support mechanisms currently in place. The formulas inherent in these mechanisms have undergone substantial public scrutiny, FCC adoptions, and in many cases legal reviews. It is now time to trust that the calculations adopted via the FCC's process work and are worthy of full funding.

III. CURRENT UNIVERSAL SERVICE FUND RESERVES

The SCC has reviewed publicly-available data regarding the financial status of the FCC's universal service fund programs. This data includes Universal Service Administrative Company (USAC) annual reports, FCC filings, and other information; National Exchange Carrier Association (NECA) data; and information generated by the FCC, including various reports, orders, and comments filed in proceedings. From this data, the SCC concludes that ample resources

[4] *See e.g.*, *RoR USF Reform Order* (FCC 16-33, rel Mar. 30, 2016) at 172

exist to at least better fund the RoR high cost mechanisms, if not fully fund them as the SCC recommends.

A. CAF Reserves

In the *USF/ICC Transformation Order*, the Commission adopted changes to the way the USF is funded. First, the way excess contributions (i.e., USF contributions in excess of USF demand) were handled was changed to allow, in addition to requiring USAC to carry such excess contributions forward, the FCC to utilize them in other ways.[5] Second, and in recognition of the newly established $4.5 billion overall budget for the high-cost support programs, the FCC established the CAF Reserve, where USAC is required to forecast no less than $1.125 billion in quarterly USF demand (1/4 of the annual budget). In quarters where demand is less than $1.125 billion, the difference is added to the CAF Reserve. In quarters where demand is greater than $1.125 billion, the CAF Reserve is to be utilized in order to keep the USF contribution percentage from wildly fluctuating.[6] The FCC later ordered the CAF Reserve to be transferred to the high cost account.[7]

USAC has aggregated nearly $2 billion in CAF Reserves since 2012, and has obligated $200 million per year for the voluntary model-based support path for RoR carriers ($2.0 billion over 10 years). The annual breakdown is as follows:

Table 4 – CAF Reserves[8]

CAF Reserves ($millions)				
Period	Beginning Balance	Additions	Disbursements	Ending Balance
2012	$ 524.32	$ 467.70	$ (105.20)	$ 886.82
2013	$ 886.82	$ 680.56	$ (365.06)	$ 1,202.32
2014	$ 1,202.32	$ 780.90	$ (34.80)	$ 1,948.42
2015	$ 1,948.42	$ 657.02	$ (593.67)	$ 2,011.77
2016	$ 2,011.77	$ 489.54	$ (477.83)	$ 2,023.48
1Q2017	$ 2,023.48	$ 85.47	$ (103.36)	$ 2,005.59
2Q2017	$ 2,005.59	$ 36.87	$ (136.69)	$ 1,905.77
3Q2017	$ 1,905.77	$ 33.04	$ (96.02)	$ 1,842.79

B. USAC Financials

USAC issues a financial report each year that shows the activity undertaken regarding its responsibility in overseeing the federal universal service programs. The reports provide an overview of USAC's activity during the year and include certain financial statements, statistics, a management discussion of results, and an independent auditor's report.

According to the SCC's analysis, USAC's financials show substantial accumulated assets that appear to largely be attributable and/or assigned to the Schools and Libraries program. Of the total "Assets Held for the Federal USF" amount shown on USAC's schedule of assets, 60% is assigned to the Schools and Libraries program. Following is a brief summary:

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[5] *USF/ICC Transformation Order* at 548

[6] *Id.*, at 559-563

[7] *RoR USF Reform Order*

[8] USAC 3Q2017 quarterly filing to the FCC, Fund Size Projection Summary, p. 11-12

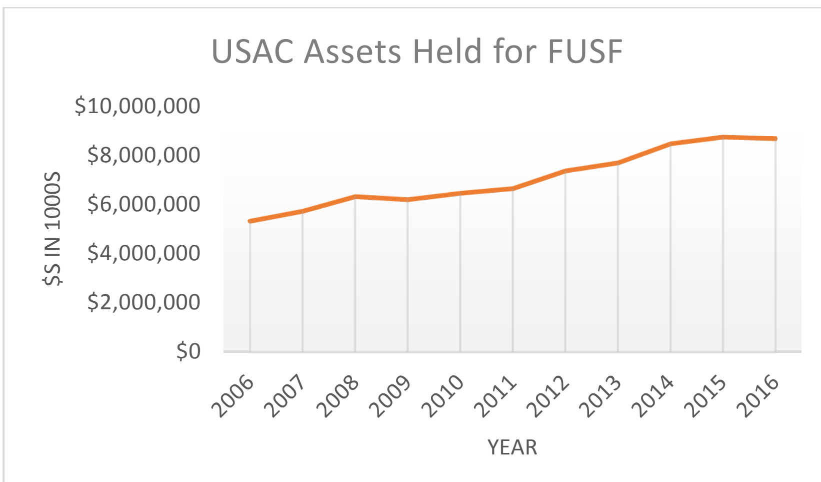
Table 5 – USAC 2016 Schedule of Assets ($ in 1000s)[9]

Description	S&L	High Cost	Lifeline	RHC	Common	Total
Cash and Equiv.	$ (1,041,006)	$ 2,216,210	$ 65,833	$ 443,489	$ -	$ 1,684,526
Investments	$ 6,249,790	$ -	$ -	$ -	$ -	$ 6,249,790
Receivables	$ 134,424	$ 37,424	$ 35,748	$ 578	$ 881,873	$ 1,090,047
Allowance	$ (130,543)	$ (36,710)	$ (14,149)	$ (570)	$ (175,317)	$ (357,289)
Interest Rec.	$ -	$ -	$ -	$ -	$ 14,499	$ 14,499
Total	$ 5,212,665	$ 2,216,924	$ 87,432	$ 443,497	$ 721,055	$ 8,681,573
Percent of Total	60%	26%	1%	5%	8%	100%

The audit report, Note 3, provides the following explanation for these assets:

> 3. *Activities Related to the Federal USF.* As described in Note 1, the cash and other financial assets of the USF, which USAC administers and acts as an intermediary for, are reported at fair value in the Statements of Financial Position as assets held for the Federal USF, with an equal amount recorded as liabilities related to assets held for the Federal USF. The summary of assets applicable to the USF included below provides additional detail with respect to these amounts.

Over time, as shown in the chart below, the balance in total assets held for the Federal USF has grown substantially.[10]



The SCC is aware of the Antideficiency Act (ADA) and its possible impacts on the federal USF.[11] The ADA helps ensure that the United States government does not incur obligations in excess of the ability to meet those obligations in terms of available appropriations or funds, and the USF has been determined to be subject to the ADA.[12] For example, in the E-Rate program the issuance of Funding Commitment Decision Letters (FCDL) consists of obligations under the ADA and thus must be accounted for consistently with governmental generally accepted accounting principles.[13] However, the USF was exempted from the ADA's requirement by Congress through

[9] 2016 USAC Annual Report, at p. 28
[10] USAC Annual Reports
[11] Pub.L. 97–258, 96 Stat. 923
[12] *See e.g.*, United States Government Accountability Office "Application of the Antideficiency Act and Other Fiscal Controls to FCC's E-Rate Program", GAO-05-546T (April 11, 2005)
[13] See *In the Matter of Application of Generally Accepted Accounting Principles for Federal Agencies and Generally Accepted Government Auditing Standards to the Universal Service Fund*, Order, CC Docket No. 96-45 (rel. Oct. 3, 2003; FCC 03-232)

December 31, 2017.[14] Assuming the assets held for the USF are related to USAC's efforts to comply with possible future application of the ADA, but given the growth reflected above and the fact that the USF has been exempted until the end of 2017, the SCC believes a detailed review of these investment amounts is warranted.

C. Excess Resources Should be Used to Fully Fund RoR USF Programs

Based on the above discussion, the SCC strongly urges the FCC to review USAC's financial position, especially as they relate to the "Assets Held for Federal USF," and determine whether, as the SCC suspects, this represents a severe overfunding of the USF program. Should the FCC find that the investments held for federal USF represent an excess reserve, then the SCC recommends the FCC expeditiously move to reallocate those funds to either (1) reduce the federal universal service charge, or (2) more fully fund the RoR USF mechanisms. Furthermore, the SCC recommends the FCC utilize all or a portion of the uncommitted CAF Reserves to help fully fund the RoR USF mechanisms.[15]

IV. UNIVERSAL SERVICE PROGRAM-RELATED AUDITS

The FCC, with assistance from USAC, has enacted various audit and review processes in relation to payments made from the federal universal service programs. These processes include the FCC's Office of Inspector General (OIG) audits, USAC's Beneficiary and Contributor Audit Program (BCAP), and USAC's Payment Quality Assurance (PQA) program. The SCC's members and numerous other RoR carriers have been subject to one or more of these reviews, and the overall experience has been one of inefficiency, repetition, frustration, and sometimes interminable length.

According to the FCC's latest data, the review processes resulted in 158 audits with a total of $8,044,263 in estimated overpayment recovery. Below is the summary provided by the FCC for 2016:

Table 6 – FCC 2016 Payment Recovery[16]

Program or Activity	# Audits	# of Audits with Overpayments	Estimated Recovery
USF-HC	46	29	$1,456,833
USF-S&L	81	32	$6,503,946
USF-LL	16	4	$4,504
USF-RHC	15	3	$78,980
Total	**158**	**68**	**$8,044,263**

Based on the above data, the FCC's high cost program review processes resulted in a recovery of $50,913 in payment recovery per audit. The SCC asserts the cost of the audit programs is not worth the payments recovered. For example, recent information obtained by the SCC reveals a total contract award of $99.8 million for eight awardees to perform USAC's BCAP audits. The apparent term for this contract is four years, or approximately $25 million per year. Even if all of the 2016 estimated recovery reflected in Table 6 is attributed to the BCAP audits, the benefit related to this use of federal universal service funds is a difficult, if not impossible, case to make.

[14] USAC 3Q2017 Fund Size Projection Summary at p. 72
[15] In addition to the additional ACAM funding committed by the FCC, the SCC also recognizes the open issues surrounding the National Tribal Telecommunications Association's Tribal Broadband Factor (TBF) proposal. It is the SCC's understanding that NTTA is requesting funding from the CAF Reserves for the TBF.
[16] 2016 FCC Agency Financial Report

Instead of continuing an obviously inefficient and cost ineffective audit process, the SCC recommends the FCC heed its own advice and pay further attention to materiality concerns. In its recent Report and Order addressing the comprehensive review of the Part 32 Uniform System of Accounts, the FCC stated:

> "We also agree with Alexicon that 'it would be beneficial to NECA and its pool members if the Commission adopted a definition of materiality that provided guidance related to NECA's review procedures.' Indeed, more particular guidance may be especially important for carriers receiving legacy universal service support because federal support is tied to the reported cost of such carriers. We adopt the general materiality guidelines promulgated by the Auditing Standards Board."[17]

The SCC suggests a similar approach to ensuring the proper use of federal high cost support funds. For example, the FCC could rely on independent auditors for testing compliance with certain USF rules and reporting results. Furthermore, the FCC should make more efforts to identify high risk or known "bad actors" for audits and further review, instead of undergoing costly audits of the smallest companies with little or no chance for material recovery (due to the relatively small amount of support received, unless foul play is detected). To this end, the FCC and USAC must develop, via an orderly and public process, methods to identify the highest audit risks (in terms of likelihood of material repayment of funds) so that audit resources can be most efficiently expended.

CONCLUSION

The SCC appreciates the effort over the years that Congress, the FCC, and other stakeholders have expended in implementing, revising, and executing the federal universal service support programs. It is nothing less than a herculean effort on the part of all involved to maintain a functioning program, all while the industry changes at a rapid pace. However, the SCC suggests it is time for the FCC to recognize the very basic issues discussed in this report – that the high cost mechanisms identify support needed for broadband network deployment and maintenance in rural areas, but that artificial constraints are keeping these programs from full effectiveness.

The SCC strongly urges the FCC to consider steps to fully fund the RoR high cost support mechanisms by carefully reviewing, in a public fashion, the financial accounts maintained by USAC and to revisit the FCC's policies on fund reserves. Based on the SCC's analysis, substantial resources appear to exist to more fully fund the RoR high cost programs.

Finally, the SCC strongly urges the FCC to review and revise the audit and review process currently in place and executed by the OIG and USAC. The SCC believes there are substantial inefficiencies inherent in the process that lead to unnecessary costs being passed to the program, RoR carriers, and ultimately the customers themselves.

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[17] *In the Matter of Comprehensive Review of the Part 32 Uniform System of Accounts*, Report and Order (FCC 17-15), WC Docket No. 14-130 (rel. February 24, 2017) at 26