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Using Competitive Bidding to Reform the Universal Service High Cost Fund

Before the

Committee on Energy and Commerce, Subcommittee on Communications, Technology,
and the Internet

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Mr. Chairman and members of the committee, thank you for giving me the opportunity to testify here today.

The current universal service program high cost fund is inefficient, inequitable, and growing at an alarming rate, having increased from \$1.7 billion in 1999 to about \$4.5 billion in 2008. Especially because the program is funded by taxes on telecommunications services paid by all users, including low-income people, the program is in urgent need of reform.

The good news is that we have the tools to increase buildout, increase penetration, and reduce costs. We can do it by eliminating the current system and replacing it with competitive procurement.

The current high-cost mechanism is not only expensive, but also discourages competition and does little to benefit consumers. A study by Gregory Rosston and Bradley Wimmer, for example, concluded that completely eliminating the high-cost fund would decrease telephone penetration by only about one-half of one percent.² This result is consistent with nearly every other economics study published in peer-reviewed journals. Since

¹ Contact information: scott@wallsten.net. My testimony represents my opinions alone, and not necessarily those of any organization with which I am affiliated.

² GREGORY ROSSTON & BRADLEY WIMMER, *The 'State' of Universal Service*, 12 Information Economics and Policy, (2000).

then, the proliferation of wireless alternatives means that the effect on connections would probably be even less.

The 1996 Telecommunications Act tried to address the competition problem by opening up the system to entrants, called competitive eligible telecommunications carriers or CETCs.

Some contend that we can control growth by eliminating the rule under which CETCs receive the same subsidy as the incumbents.³ After all, they say, most of the increase in the fund is from subsidies to competitive entrants, most of which are wireless companies that have lower costs.

That's partly correct. It makes no economic sense to pay entrants with lower costs the high subsidies that incumbents currently get. But it also makes no sense to subsidize a firm's high costs when a lower-cost option is available. Thus, rather than eliminating the identical support rule we should rewrite it so that all firms—including the incumbent—get the smallest, not the biggest, subsidy required for a firm to provide service. So, for example, if a wireless entrant can provide service in the area for only half the subsidy the incumbent receives, then all eligible carriers in the area, including the incumbent, should receive only that smaller subsidy.

But we can do even better than that.

An efficient program would provide just enough of a subsidy to make it profitable to provide the service. The problem is how to determine what that subsidy should be or even whether a subsidy is really necessary.

Fortunately, the government has a tried and true method for getting the biggest bang for its buck.

When the government wants a good or a service it asks for bids and generally awards the contract to the lowest bidder, all else equal. The government uses competitive bidding for buying products as simple as paper to those as complex as weapons systems like the Joint Strike Fighter.

Everyone understands this concept and recognizes the importance of getting multiple bids, whether it's for work on your car or for providing services to the U.S. military in Iraq. This everyday common-sense approach is sometimes called a "reverse auction."

Universal service is just another type of government procurement. In this case, the government is buying some minimum set of telecommunications services that society believes everyone should have at a specific price.

The current system, however, is akin to awarding no-bid contracts that last forever. We know that no-bid contracts are more costly and less transparent than are contracts awarded in a more open and competitive manner. For that reason we generally don't

³ <http://www.ntca.org/images/stories/Documents/Advocacy/PositionPapers/2009/IssueIdenticalSupport.pdf>

tolerate no-bid contracts, yet they have become so accepted in universal service that anything else is considered radical.

But there's no reason for the no-bid perpetual contract approach to continue. The high-cost fund could begin procuring universal service using the same competitive bidding approach that the government uses for almost everything else.

In a reverse auction for universal service firms tell the government how much of a subsidy they would need to provide particular telecom services in particular areas. The government then chooses the firm that can provide the service for the smallest subsidy.

Reverse auctions are not a new idea. Aside from the U.S. government using them for nearly all procurement, other countries have already used this method to provide telecommunications services in rural areas. This experience, which I review in a paper forthcoming in the *Federal Communications Law Journal* and that I am submitting as part of my testimony, has important lessons.

In particular, reverse auctions for universal service are feasible and typically lead to much smaller subsidies than the incumbent beneficiaries previously said was necessary, thus using less taxpayer money to provide more service. In some cases the auctions revealed that firms were willing to provide service with no subsidy at all. And the worst outcome from using reverse auctions was one that ended up with the incumbents winning everything. In other words, the worst outcome from using reverse auctions in universal service was what we accept as the status quo.

I do not, however, want to give the impression that just because reverse auctions are feasible they would be easy. The details of the auction matter a lot. For example, would you want to allow multiple winners in any given area? Allowing multiple winners would facilitate service competition, but could actually increase universal service obligations, at least in the short run.

Another issue is how to handle the incumbent. On the one hand, the incumbent may have an advantage in an auction because it already has facilities in the area, potentially discouraging other firms from bidding. On the other hand, if the incumbent loses could it, or should it, still be the carrier of last resort?

These problems, however, can be solved. Auctions for spectrum, too, were once widely considered impractical. Yet, the FCC successfully implemented spectrum auctions and they are now used routinely around the world.

Moving from no-bid perpetual contracts to competitive bidding for universal service provision would help bring the high cost fund under control. Reducing the high cost fund would, in turn, go a long way towards facilitating an efficient and fair universal service program.

Thank you. I look forward to answering your questions.