STATEMENT OF BRIAN L. TALBOTT, Ph.D.

Universal Service Administrative Company

Chairman

of the

Board of Directors

Before the

SENATE COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION

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Good afternoon, Mr. Chairman and Members of the Committee. My name is Brian Talbott. I am the Chairman of the Board of Directors of the Universal Service Administrative Company (USAC). It is my privilege to be here today to speak with you about USAC and its administration of the Universal Service Fund (USF). The USF provides approximately $6.5 billion annually to support access to telecommunications and other services by rural and low-income consumers, schools, libraries and rural health care providers. On behalf of all USF stakeholders, I would like to thank this Committee for its role in the passage of the Universal Service Antideficiency Temporary Suspension Act last December. This Act provided much-needed relief to schools, libraries, and rural health care providers, as well as to the companies serving them.

Overview

USAC is the not-for-profit corporation designated by the Federal Communications Commission (FCC) to administer the High Cost, Low Income, Rural Health Care, and Schools and Libraries (E-rate) universal service support mechanisms created by the Telecommunications Act of 1996 and FCC regulations adopted pursuant to the Act. USAC is governed by a Board of Directors, each of whom is appointed by the Chairman of the FCC. I have served on the Board since USAC's creation in 1997 and was elected Chairman in January 2005.

Application of Government Accounting Principles (GovGAAP) to the USF

From 1998 through 2004, USAC, pursuant to FCC regulations, accounted for the financial transactions of the USF in accordance with Generally Accepted Accounting Principles (GAAP). The extensive annual audits conducted under strict FCC oversight as required by Part

54 of the FCC's rules resulted in no material findings from 1998 through 2003. The 2004 audit has not yet been completed.

In October 2003, the FCC ordered USAC to change the USF accounting methodology from GAAP to federal government accounting principles, or GovGAAP. The FCC stated that the purpose of moving the USF to GovGAAP was "to ensure that the Commission can maintain its obligations under federal financial management and reporting statutes and directives of the Office of Management and Budget (OMB)" because the USF is a component of the FCC's financial statement. At the time, the USAC Board understood from FCC staff that the transition to GovGAAP would have no impact on the manner in which USAC administers the programs themselves.

Throughout the last quarter of 2003 and during 2004, USAC undertook the necessary steps to train our financial staff in and conform our systems to GovGAAP in order to meet the October 1, 2004 implementation deadline. As USAC worked with FCC staff to transition to GovGAAP, USAC staff raised the question whether GovGAAP should be interpreted to mandate treating commitment letters USAC sends to beneficiaries in the E-rate and Rural Health Care programs as "obligations" for purposes of government accounting. USAC staff raised a similar question as to the treatment of the projections USAC files with the FCC regarding High Cost and Low Income program payments.

In late September 2004, USAC received the answer to one of these questions. FCC staff directed USAC to treat the E-rate and Rural Health Care commitment letters as government obligations. This new requirement fundamentally changed the manner in which USAC had administered the USF since 1997 in accordance with the Telecommunications Act of 1996, FCC regulations, close FCC oversight, and substantial audit review. With regard to the High Cost and

Low Income program projections, USAC was informed that a request had been made to OMB for an opinion concerning whether those projections are government obligations as well. We have not received an answer to that question.

Impact of the Antideficiency Act on the USF

During the process of transitioning to GovGAAP, USAC was verbally informed by FCC staff that the USF might be subject to the federal Antideficiency Act (ADA). In late September 2004, FCC staff, after consulting with OMB, informed USAC for the first time that the ADA applied to the USF. At the same time, FCC staff informed USAC that under GovGAAP, USF investments in government-backed mutual funds, government agency securities, and money market funds were also considered "obligations" for government accounting purposes and had to be liquidated to ensure compliance with the ADA.

Application of the ADA to the USF, combined with the accounting determination that E-rate and Rural Health Care funding commitments constitute budgetary obligations, had a number of dramatic consequences:

- Between August and November 2004, USAC suspended new funding commitments in the E-rate and Rural Health Care programs, leaving schools, libraries and rural health care providers without needed support.
- Suspension of issuing commitments resulted in delays in making the most effective use of services. For example, in one case in Alaska, while the school district's service provider continued to provide service under a multi-year contract despite the lack of a commitment from USAC, the school board became anxious that the amount of debt accumulating could lead to bankruptcy. The district began to plan for the

abrogation of its contract and to turn off the services when it received a commitment in January. In another case, a library would not allow a service provider to proceed to install internal connections without a commitment from USAC because the library viewed the discounted share as an unfunded liability for which the city could be sued.

- The late determination that the ADA applied to the USF required USAC to move more than $3 billion in safe government-backed money market investments to Treasury securities, resulting in a $4.6 million loss.

Reapplication of the ADA to the USF will result in significant uncertainty and instability to the detriment of the USF and its many stakeholders. I will provide a few examples here:

- USAC makes commitments to schools for each school year under FCC rules. If USAC is unable to make commitments before the start of the school year, the significant uncertainty for the schools will adversely affect their planning processes and achievement of educational goals.
- Rural health care providers already strapped for funds will have to wait even longer for funding required to serve critical patient medical needs.
- Because High Cost support payments to rural telephone companies in many cases constitute a significant portion of their revenues, any suspension or delay in disbursement of funds will disrupt their revenue flow and may delay network maintenance and improvements.
- To the extent that USF investments are limited to Treasury securities, USAC's ability to use safe investments with higher yields to offset increases in the contribution factor will be severely limited.

- If the ADA is permanently applied to the USF, and High Cost and Low Income projections are deemed to be budgetary obligations, a significant increase in the contribution factor could occur.
- USAC will be required to keep separate accounts for monies collected, committed and disbursed in 2005 for years to come if a permanent exemption is not forthcoming. This increases administrative costs and complexity. Because USAC's administrative costs come from the USF, increasing administrative costs in turn increases the burden on those who contribute to the USF.

Although USAC was able to make some limited E-rate commitments in November and December 2004, as the end of the year approached, USAC was holding back on issuing some $500 million in commitments due to a lack of unobligated monies as defined by GovGAAP and the application of the ADA to the USF. Then, at the end of last year, Congress enacted the Universal Service Antideficiency Temporary Suspension Act. This allowed USAC to quickly resume its normal course of operations and continue issuing funding commitments in the E-rate and Rural Health Care Programs. I would like to thank all of you for your leadership in that effort. The temporary exemption, which allows the USF to incur obligations for a limited period without regard to the ADA or the apportionment limitations otherwise imposed on the expenditure of federal appropriations, offers the USF some administrative relief for 2005. Many of the deleterious consequences experienced in late 2004, however, could very well return upon expiration of the statute. Consequently, without a permanent exemption, there will be significant uncertainty as to how the universal service programs will operate in the future, which could lead to instability in the programs. We know that the unanticipated consequences of the changes mandated by GovGAAP and the application of the ADA to the USF created serious administrative issues that harmed the programs without evident benefits. USAC recognizes the need for appropriate mechanisms to ensure effective oversight of USF programs. Just as imposition of the ADA created damaging uncertainty in the administration of the USF programs, however, the rolling application of additional federal statutes and regulations to the USF and its administrative structure, without careful consideration of their need and their impact on the programs, could lead to similar difficulties.

Effect of the Application of the ADA on USF Investments

The design of the universal service programs requires USAC to maintain a significant USF balance. Since its inception, USAC has managed the USF prudently, investing funds on hand in different safe vehicles, including government-backed mutual funds, government agency securities, and money market funds, all of which—despite their proven safety and high liquidity—are now considered budgetary obligations under GovGAAP. OMB rules mandate that in order for funds to be considered "unobligated" such funds must be invested only in United States Treasury securities or in cash.

If the ADA applies to the USF as of January 1, 2006, USAC's ability to invest the USF in a manner that safely optimizes interest income will be severely curtailed, because investments in essentially anything other than cash and direct Treasury or federal agency instruments—no matter how safe or liquid—are considered "obligations" for purposes of GovGAAP accounting. At best, USAC might be able to invest a very small amount of the funds in accounts that would be considered obligated. Right now, all USF investments are in cash accounts or Treasury instruments.

In three days last year, at the direction of FCC staff, USAC sold approximately $3 billion in safe investments and placed those funds in cash and Treasury instruments, resulting in a $4.6

million loss. This reallocation of the USF investment portfolio resulted in an immediate 20 percent decrease in investment returns. That is, fourth quarter 2004 interest income was $9.7 million, compared to $12 million in interest income in the third quarter of 2004. Because investment returns help keep the contribution factor as low as possible, a decrease in interest income will increase the funding burden on all Americans.

The Transition to GovGAAP and Application of the ADA to the USF Have No Impact On USAC's Ability to Deter, Prevent, and Detect Waste, Fraud, and Abuse and Are Not Required to Limit USF Expenditures

Not only has the application of GovGAAP and the ADA to the USF created instability in the E-rate program, these measures do not enhance USAC's or the FCC's ability to address waste, fraud, or abuse of the USF. They are simply rules governing the accounting treatment of the USF. USAC strongly supports the application of effective accounting rules to the financial transactions of the USF. Accounting under GAAP between 1998 and 2004 did not have the effect of creating the collection and disbursement problems USAC has encountered under GovGAAP.

USAC is committed to doing all it can to prevent waste, fraud, and abuse in the universal service support mechanisms and devotes substantial resources toward achieving that objective. Since it began administering the USF, USAC has denied millions of dollars in funding requests from ineligible entities and entities seeking ineligible services. None of the measures that USAC takes to prevent waste, fraud, and abuse—extensive data validation procedures, close scrutiny of invoices, and beneficiary audits, to name just a few examples—are related to GovGAAP or the application of the ADA to the USF.

There may be some concern regarding whether application of the ADA to the USF is necessary to contain USF spending. The answer is no. There are extensive statutory and regulatory constraints on the USF and no issues regarding USF spending in excess of applicable laws have been raised. These constraints are unaffected by the ADA. Application of the ADA could, however, create unpredictability and uncertainty regarding the timing and amount of USF payments that beneficiaries could expect to receive.

Conclusion

Mr. Chairman, thank you for providing me with the opportunity to address the Committee. On behalf of all of the many USF stakeholders, I again applaud the Congress for passage of the Universal Service Antideficiency Temporary Suspension Act last December, and USAC welcomes your consideration of a permanent ADA exemption for the reasons I have discussed. USAC looks forward to continuing to work with Congress and I would be happy to respond to any questions you may have.