Testimony of Thomas A. Gerke
CEO, Embarq
before the
Subcommittee on Communications, Technology and the Internet
March 12, 2009

High Cost Support and the Universal Service Fund

Good morning Chairman Boucher, Ranking Member Stearns and members of the Committee. Thank you for the opportunity to testify today on issues relating to high-cost support and the Universal Service Fund. I am Tom Gerke, Chief Executive Officer of Embarq.

Embarq is primarily a rural provider of voice, Internet, video and other services with approximately 6 million customers spread across 18 states. We were created in May 2006 when Sprint Nextel spun off its Local Telephone Division into a separate and independent company. Our service territory extends from the Pacific Northwest to the Florida Everglades, and from Northern Minnesota to the plains of Texas. Additionally, we are a carrier-of-last-resort in all of our service areas, which means we provide reliable, affordable service to numerous outlying rural areas with low population density and challenging terrain, even when it is not profitable to serve those areas. On January 27, 2009, our shareholders voted to merge with another rural carrier, CenturyTel; a move we believe will create an even stronger, more stable and innovative rural voice and broadband provider serving nearly 8 million access lines in 33 states. The new company will also be considerably more rural, serving areas with lower average population densities.

Today's hearing is timely and addresses a topic that is vitally important to the economic development of rural America. Reforming the federal Universal Service Fund ("USF") offers an opportunity to accelerate broadband deployment to unserved areas while maintaining affordable access to critical voice connectivity for those people that cannot or choose not to become broadband customers. Intelligent and effective reform of the federal USF is essential to both goals. Congress, and this subcommittee in particular, have taken a strong role in overseeing USF, and we appreciate your leadership.

Embarq commends Chairman Boucher and Congressman Terry for the universal service reform legislation they introduced last year. HR 2054, the Universal Service Reform Act, introduced many important changes to USF, including a transition to a broadband-focused fund and a more targeted support mechanism that would provide funding for customers living in high-cost areas served primarily by midsize rural telecom providers. Notably, the bill also ensured that identical carrier-of-last-resort ("COLR") obligations would be applied to all USF recipients, which is essential for competitive neutrality and preserving the long-run stability of the program. Since then, numerous regulatory actions have occurred, including the imposition of the competitive eligible

telecommunications carrier (CETC) cap, the passage of an ambitious broadband stimulus package and enactment of the Broadband Data Improvement Act. We look forward to working with both members and the rest of the Committee on the next version of USF reform.

We also commend Congressmen Barton and Stearns on some key provisions in HR 6356, the Universal Service Reform, Accountability and Efficiency Act, which sought to more precisely and narrowly direct USF support to the truly high-cost areas where it is most needed, and also tie USF support more directly to the carrier-of-last-resort obligation.

We believe the fundamental policy challenges facing the federal Universal Service Fund boil down to two simple things:

- Supporting rural broadband access while still maintaining the reliable, affordable voice service that rural customers expect and depend upon, and;
- Adapting the Universal Service Fund to a competitive telecommunications market by targeting support on a granular basis to better align support with cost.

Broadband and COLR (Carrier of Last Resort)

Policymakers, stakeholders and providers are increasingly coming to the conclusion that the Universal Service Fund is ready to take on a new explicit mission: expanding and supporting broadband availability in rural America. After all, broadband is increasingly seen as an essential service, important in keeping people connected, enhancing public safety, enabling education and telemedicine, and spurring economic development. More and more, the presence of broadband in a community is a key factor every business considers when deciding where to locate facilities.

But of course, there are important questions to consider as you contemplate this new mission, such as:

a. How to ensure that the current mission of ensuring reliable, affordable voice service from a carrier of last resort is not abandoned in the process;

b. How to manage the cost of supporting broadband and ensure that such support is complementary to similar missions now being undertaken by the NTIA and the Rural Utilities Service, as authorized in the ARRA.

c. How to target such support to places where the market would not otherwise deliver broadband, especially in a competitive market where broadband could come from different types of providers.

As a starting point, it's important to understand that incumbent phone providers have a very specific mandate associated with universal service. State and federal carrier-of-last-resort mandates require us to provide serve to all the homes in our service territory, even where it is uneconomic to do so. This carrier of last resort mandate is generally paired with exacting service quality standards and retail rate mandates that require us to

charge similar rates in the high-cost rural areas to those in the low-cost urban and suburban areas. With few exceptions, a carrier of last resort is required to build and maintain voice service availability to all the homes in a community, even if they are receiving voice service from a competing source or foregoing it altogether.

In addition, while rural high-cost consumers are very interested in broadband availability, they continue to expect reliable voice service as well. These are the consumers least likely to have other options from cable, wireless or some other source, and not all of them actually order broadband when it is made available. In other words, the challenge is how to layer on expanding availability of broadband throughout a rural area while still maintaining the voice network that is already there.

Broadband Stimulus

This mission will undoubtedly be enhanced by the far-reaching economic recovery legislation that was enacted last month, allocating $7.2 billion to increase broadband availability and adoption through the National Telecommunications and Information Administration (NTIA) and the Rural Utilities Service (RUS), especially to the extent such support is focused on unserved areas. By providing an infusion of one-time capital costs, both agencies can expand the areas where broadband is available and bring more communities and constituents onto to the network. Embarq is urging both agencies to act quickly with a sharp focus on unserved areas, an approach that would maximize both immediate job creation and the long-term economic health of those communities.

Adapting to competition.

Universal service was originally conceived to bring and maintain reliable, affordable service to the places where market forces alone would not otherwise provide it. The Universal Service Fund was created in 1996 because Congress realized that as competition emerged, service providers in high cost rural areas would no longer be able to maintain implicit urban-to-rural subsidies and would need to replace those subsidies with explicit support from the Universal Service Fund. That competition is a reality today.

Unfortunately, in the case of many midsize rural providers, Universal Service support has been calculated and distributed on the basis of broad geographic "study areas" that could stretch across a carrier's entire service area for a state, averaging together cities, towns and rural areas that could be hundreds of miles away from each other. The assumption, for example, was that Embarq could offset the high cost of serving places like the Everglades by cross-subsidizing from Tallahassee or the Orlando suburbs, and as a result, no universal service support was necessary in Florida.

This policy produced an unfair result for the people who lived in those rural areas. To give you an example of how competitive our markets are, Embarq has lost 18 percent of its overall customers in just the three years since May 2006, when we spun off from Sprint Nextel. Embarq loses more than 1,000 lines each day, and the lost customers are mostly in the low-cost areas. If reliable, affordable service to homes and small businesses depends on a cross-subsidy that simply can't be sustained any more, then

those homes and businesses will be out of luck in an economy where being connected to the network has become a prerequisite to competing effectively.

At the same time, averaging USF support across a carrier's entire service area in a state results in support flowing to numerous town centers that are perfectly economical to serve – leading to arbitrage opportunities for competitive carriers to apply for universal service support in those areas too. We have seen this over the past several years in cases where five or more competitive providers were receiving support to serve the same geographic area.

All these results were at odds with the realities on the ground. The simple fact is that many town centers are economical to serve, while the need for support occurs in the outlying areas where the population density is lowest and the return on investment drops off sharply the further you move away from town. The dysfunctional result of the current system is that it "over invests" in town centers and "under invests" in the surrounding rural areas – to the detriment of those who live in those rural areas.

[See diagrams 1 and 2]

We believe the ultimate solution is to eliminate cross-subsidies and misallocation of resources by calculating and targeting universal service support on a much more granular basis, either at a wire center level or perhaps even more granular. While this sort of granular calculation and targeting may have been impractical thirteen years ago when the Universal Service Fund was first created, modern GIS mapping technologies have made it much more practical. Many of these technologies will be employed in the broadband mapping efforts initiated by Congress last year in the Broadband Data Improvement Act (and more recently funded in the American Recovery and Reinvestment Act).

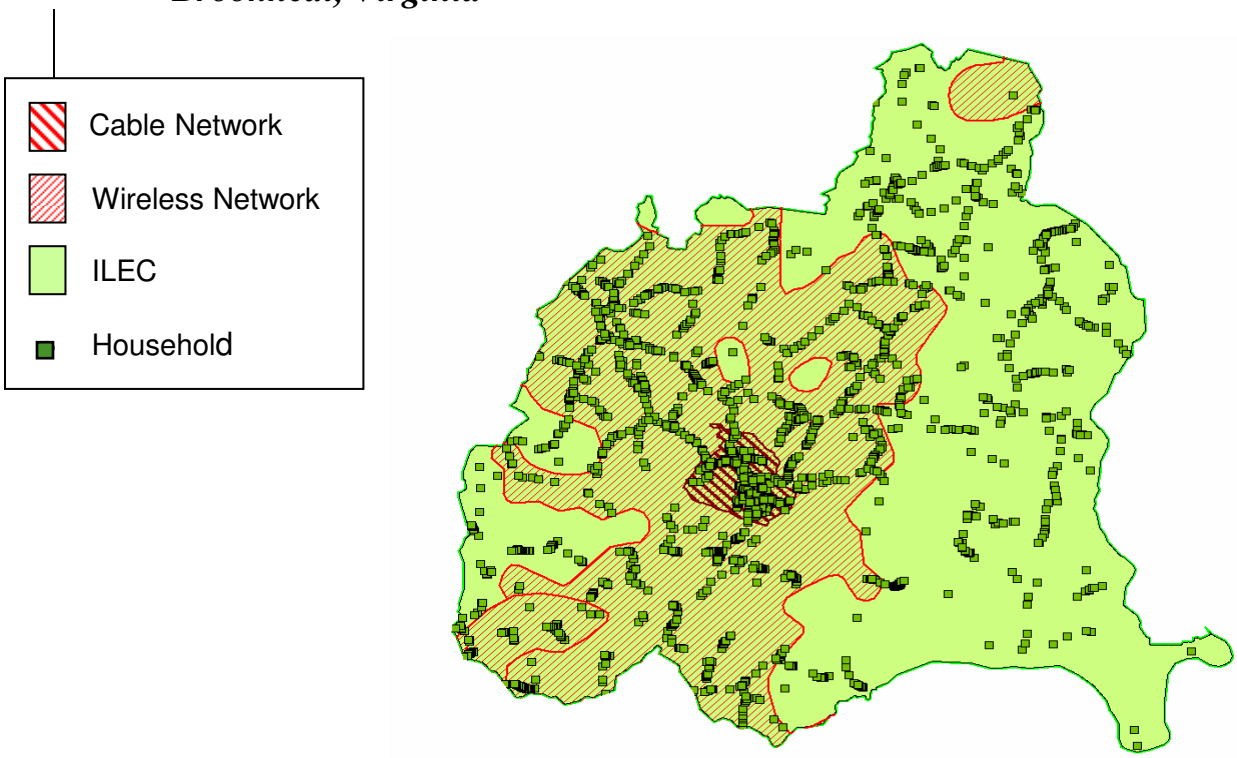
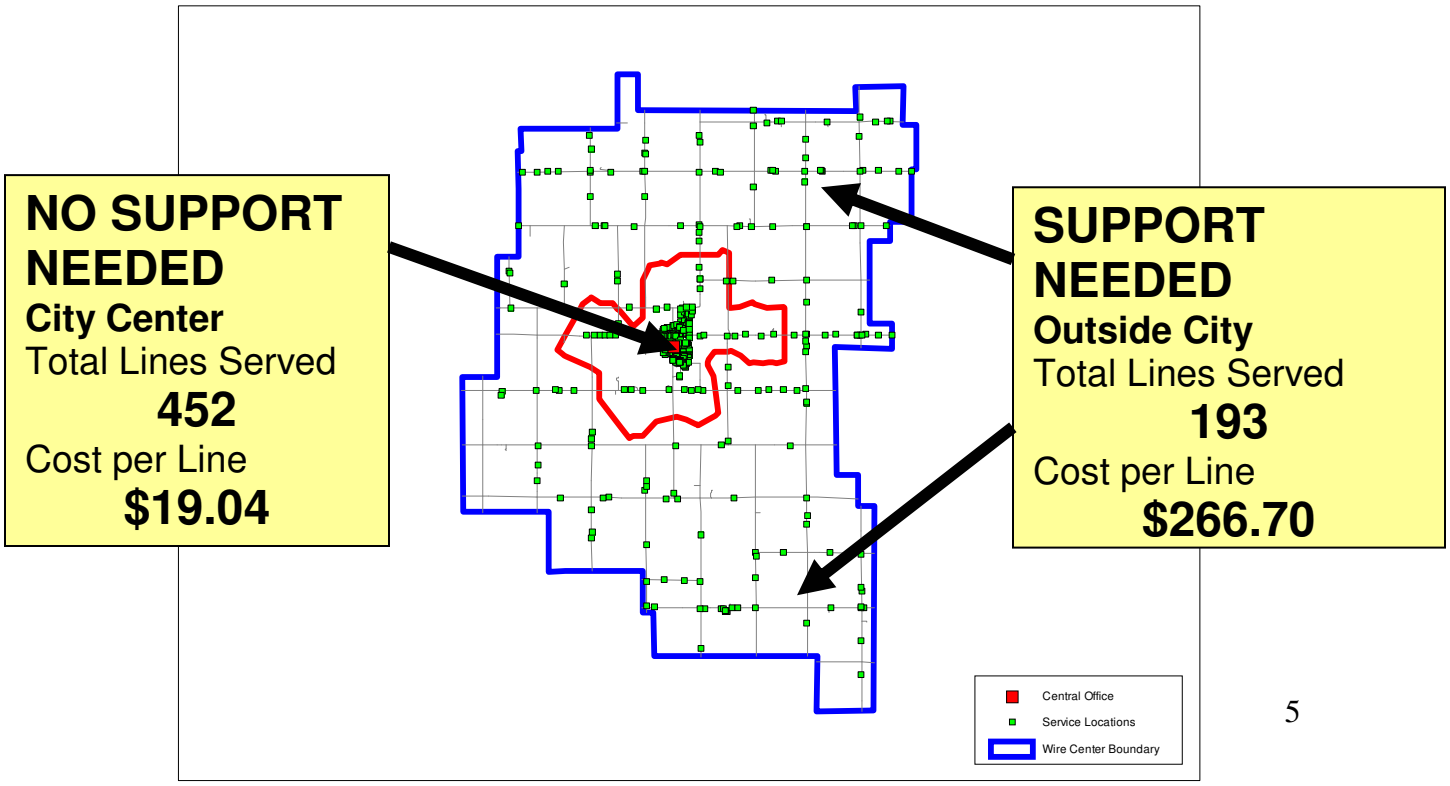
This would ultimately ensure that support was directed to the rural areas that need it most, and not to the places where competitive and incumbent providers *both* find it economical to provide service – and compete – without federal USF support. It would also mean that a rural community with similar population density would be treated fairly regardless of which state it was in, or what type of carrier it was served by.

Targeting support accurately and on a granular basis is especially important now as Congress considers a move toward a broadband-focused USF. After all, an inequitable distribution system based on statewide study areas could end up leaving many rural communities and outlying areas behind, no matter how much funding was pumped through the program, unless the calculation and distribution formulas are adjusted.

Conclusion

Reforming universal service is a daunting challenge, but a great amount of groundwork has already been done by the members of this Committee, through legislation and oversight. We look forward to working with you to reform universal service in a way that is precisely targeted to the places where it is needed, achieves the twin goals of expanding broadband availability and supporting the carrier-of-last-sort mandate, while maintaining appropriate stewardship and integrity of the program.

<u>Diagram 1</u>: Comparison of network coverage
Brookneal, Virginia



<u>Diagram 2</u>: Targeted USF – support where it is needed:
Goodland, Indiana