

WRITTEN STATEMENT

of

Jeffrey Carlisle

Chief

**Wireline Competition Bureau
Federal Communications Commission**

Before the

**Subcommittee on Oversight and Investigations
of the Committee on Energy and Commerce
United States House of Representatives**

September 22, 2004

Executive Summary of the Statement of Jeffrey Carlisle

Good morning, Mr. Chairman and distinguished members of the Subcommittee. I was named Chief of the Wireline Competition Bureau on August 4, 2004. As such, many of the incidents that are the subject of this hearing occurred before my tenure and I do not have first-hand knowledge of them. I am here, however, to relate the facts to you as I have ascertained them. More importantly, I am here to communicate to the Subcommittee that, with respect to the E-rate Program, I am working hard to achieve three main goals: first, to acquaint myself with the program and learn about its functioning in detail; second, to get up to speed with the current status of pending audits and enforcement actions, including the IBM case which the Commission concluded at the end of last year; and third to continue and advance the work already started to improve functioning and oversight of the program, and thereby eliminate waste, fraud and abuse.

Since the program's inception, and increasingly so since the 2002 launch of the Schools and Libraries rulemaking proceeding, the Commission has sought to improve the effectiveness, fairness, and efficiency of the E-rate program, while preventing waste, fraud, and abuse.

- Debarment Rules: In April 2003, the Commission adopted rules to bar participation in the program of any individuals and companies that have been found criminally or civilly liable for actions that violate our rules.
- Limits on Use of Internal Connections & Clarification of Eligible Services: In December 2003, the Commission adopted rules to prevent program applicants from making repeated, uneconomical upgrades or transferring their purchases to other entities, except in special circumstances. The Commission also endorsed an initiative to publicize specific lists of services and equipment that are eligible for E-rate discounts.
- Recovery of Funds for Violations: In July of this year, the Commission adopted rules to revise our recovery approach such that recovery actions are no longer limited to instances in which service providers have violated our rules, but instead recovery is directed against any party or parties (including service providers and E-rate applicants) that have committed rule or statutory violations.
- Strengthened Audit and Investigation Processes: Last month, the Commission adopted rules to strengthen the process for conducting audits and investigations of the E-rate program, including the establishment of a framework for heightened scrutiny for applicants and service providers that have violated our rules in the past and requirements for new certifications as a prerequisite to funding.
- Discount Matrix: We are also making recommendations to the Commission on revising the schedule of discounts schools and libraries are accorded under the program, as they purchase equipment and services. We believe that adjusting the discounts so that applicants are required to increase their contribution to those purchases will encourage schools and libraries to make better economic choices, and further minimize the opportunities for abuse.
- Vigilant Monitoring of Competitive Bidding Process: We also continue to tighten and

monitor the competitive bidding process in the E-rate program to minimize opportunities for waste, fraud, and abuse.

The potential weaknesses in a competitive bidding system were highlighted by the facts in the various 2002 IBM applications. Under the E-rate program rules for competitive bidding, after developing a technology plan, applicants are required to seek competitive bids on goods and services eligible for E-rate discounts by completing and posting an FCC Form 470 on the USAC website. Applicants also must satisfy applicable state procurement rules, wait at least 28 days after posting before committing to a contract, and in selecting their service providers, make price the primary consideration. Competitive bidding is a cornerstone of the E-rate program because it limits waste, ensures program integrity, and assists applicants in receiving the best value for their limited funds.

In the IBM cases, the applicants submitted a broad, generic version of the Form 470 indicating that they were seeking virtually every product and service eligible for E-rate discounts, rather than developing a list of services actually desired, based on their technology plans, with sufficient specificity to enable bidders to submit realistic bids with prices for specified services.

This was coupled with the applicants posting an RFP for a systems integrator; something they did not disclose on their Form 470s. IBM, in responding to these RFPs, did not provide specific prices for specific facilities and services, nor were such responses requested. Rather, the RFPs sought general information and prices for acting as a systems integrator, and IBM responded with hourly rates ranging from \$394 per hour for a Project Executive to \$49 per hour for a Project Administrator. Subsequently, the school districts selected IBM subject to the condition that a satisfactory contract could be negotiated with IBM over the scope of work and the prices of E-rate-eligible products and services. In the principal IBM case, Ysleta, IBM and Ysleta engaged in those negotiations and completed them on January 17, 2002. The final contract included five statements of work, ranging from just under \$1 million to more than \$12 million, each with detailed specifications, prices, and terms.

After receiving a whistleblower's anonymous letter in May 2002, USAC investigated and ultimately denied Ysleta's request for funding on December 3, 2002, and then denied eight other applications that selected IBM as system integrator. On December 8, 2003, after *de novo* review of the facts of these multiple cases, the Commission upheld USAC's denial of eight of the nine funding requests totaling over \$250 million. The Commission found, in general, that the "two-step" bidding process (i.e., procurement of a system integrator followed by private negotiation with that integrator for the goods and services eligible for E-rate support) violated the Commission's competitive bidding requirements.

The Commission permitted the applicants denied funding to have a second chance to receive Funding Year 2002 support for services that they sought by seeking bona fide competitive bids. The eight school districts denied funding by the IBM decision have resubmitted funding requests seeking a total of \$40 million in services, an amount that is substantially less than the prior requests. IBM was permitted to bid again, but bid on only one of these applications, and was not successful.

The IBM case illustrates the importance of a robust competitive bidding mechanism in the E-rate program. It also shows the importance of having clear rules. We continue to be vigilant in pursuing both goals. The Commission acted decisively, in just over a year after USAC initially denied funding in the IBM cases, even as it was addressing numerous other cases and was engaged in general rulemakings to improve the E-rate program. In the course of the "IBM cases," USAC denied a quarter of a billion dollars in support, and also denied an additional quarter billion dollars of support for Funding Year 2002 to nine applicants in similar circumstances involving IBM. Thus, in the IBM cases, no funding was distributed, and no dollars had to be recovered.

We at the Commission are proud of this result. But I believe there is more that we can and should be doing. As I indicated at the beginning of my testimony, since the IBM case was concluded, the Commission has implemented further oversight requirements, and the Bureau has recommended changes to certification requirements to the Office of Management and Budget for approval. We are considering further steps. We believe these steps will continue to improve our oversight of the program, and we will continue to use adjudications, rulemakings, and audits to help us identify areas of E-rate program administration that are vulnerable to fraud or to confusion that leads to waste or abuse.

Thank you, Mr. Chairman, for the opportunity to participate in your review of the E-rate program. I look forward to your questions on this issue.

WRITTEN STATEMENT OF JEFFREY CARLISLE

Good morning, Mr. Chairman and distinguished members of the Subcommittee. I was named Chief of the Wireline Competition Bureau on August 4, 2004. As such, many of the incidents that are the subject of this hearing occurred before my tenure and I do not have first-hand knowledge of them. I am here, however, to relate the facts to you as I have ascertained them. More importantly, I am here to communicate to the Subcommittee that, with respect to the E-rate Program, I am working hard to achieve three main goals: first, to acquaint myself with the program and learn about its functioning in detail; second, to get up to speed with the current status of pending audits and enforcement actions, including the IBM case which the Commission concluded at the end of last year; and third to continue and advance the work already started to improve functioning and oversight of the program, and thereby eliminate waste, fraud and abuse.

I. The Commission Is Improving Program Oversight

As a program that benefits the public, the E-rate program has matured to such a level that it has attracted bad actors that bend and violate the public trust. We began to detect these individuals and entities, in some cases schools or libraries, as early as 2001, in reviewing audits completed in the year 2000. These individuals and entities have either gamed the system and exploited loopholes in our rules, or they have committed outright fraud, and engaged in deceptive practices in an effort to thwart our system of internal checks and audits. Some turn out to be honest mistakes, but some have also resulted in civil and criminal prosecutions. The sheer gall of some of these deceptions -- bid rigging, failure to deliver services already paid for, falsified forms and kickbacks -- is disappointing, given that this is a program to benefit children

and library patrons, but it is not surprising. We are dealing with elements in some instances that acknowledge no moral limits, regardless of the purposes of the program.

Understanding this, the Commission has redoubled its efforts to deter and detect all forms of waste, fraud and abuse in the E-rate program, and we believe we can demonstrate good progress toward this goal.

Since the program's inception, and more recently with the 2002 launch of the Schools and Libraries Universal Support Mechanism rulemaking, the Commission has sought to improve the effectiveness, fairness, and efficiency of the E-rate program, while preventing waste, fraud and abuse.

In April 2003, the Commission adopted rules to bar participation in the program of any individuals and companies that have been found criminally or civilly liable for actions that violate our rules. We already have applied these procedures in three instances, and we have sought comment on whether to expand the reach of our debarment rules.

In December 2003, the Commission emphasized that our rules have always prohibited funding of duplicative equipment and services. To prevent entities from exploiting discounts on internal connections, the Commission adopted rules to prevent program applicants from making repeated, uneconomical upgrades or transferring their purchases to other entities, except in special circumstances. The Commission also endorsed an initiative to publicize specific lists of services and equipment that are eligible for E-rate discounts, both to help applicants more easily avoid ineligible ones and to clarify the scope of the program.

In July of this year, the Commission adopted rules to revise our recovery approach such that recovery actions are no longer limited to instances in which service providers have violated our rules, but instead recovery is directed against any party or parties (including service providers

and E-rate applicants) that have committed rule or statutory violations.

Last month, the Commission adopted the Schools and Libraries Fifth Report and Order, in which it addressed a number of issues that have surfaced as a result of audits conducted during the Commission's oversight of the E-rate program. The Schools and Libraries Fifth Report and Order strengthens the Commission's current process for conducting audits and investigations of the E-rate program in a timely and efficient fashion. Specifically, the order establishes a framework for determining the appropriate amount to be recovered when funds are disbursed in violation of the statute and our rules. In addition, the order sets forth a framework for heightened scrutiny for applicants and service providers that have violated our rules in the past. The order also extends the "red light" rule of the FCC's existing Debt Collection rules to bar fund recipients from receiving additional program benefits if they have yet to repay the fund for past erroneous disbursements. Our "red light" rule provides that the Commission shall withhold action on any application or request for benefits made by an entity that is delinquent in its non-tax debts owed to the Commission, and dismiss all such applications or requests if the delinquent debt is not resolved. The Fifth Report and Order also responds to recommendations made by the Commission's Office of Inspector General (OIG), including codifying USAC procedures into our rules and strengthening the program's document retention requirements, so that any misdeeds can be more easily detected and prosecuted. Consistent with the OIG's recommendations, the order also modifies technology plan requirements to require applicants to have an approved plan that follows the U.S. Department of Education technology plan guidelines, subject to an additional requirement that an applicant show that it has the necessary resources to achieve its technology aims.

In response to recommendations from the U.S. Department of Justice, the Fifth Report and Order also requires applicants to make important new certifications as a prerequisite to funding. For example, applicants must now certify that price will be the primary factor in bid selection, and, as a guard against gold-plating, that they will select the most cost-effective means to achieve goals of their technology plans. Finally, the order establishes a process to codify USAC procedures and update those requirements as necessary to protect against waste, fraud and abuse.

This Fall, we will make recommendations to the Commission on revising the schedule of discounts schools and libraries are accorded under the program, as they purchase equipment and services. We believe that adjusting the discounts so that applicants are required to increase their contribution to those purchases will encourage schools and libraries to make better economic choices, and further minimize the opportunities for abuse. We also continue to tighten and monitor the competitive bidding process to minimize opportunities for waste, fraud and abuse. The potential weaknesses in a competitive bidding system were highlighted by the facts in the various 2002 IBM applications.

II. The IBM Cases Illustrate the Need for Continuing Reform and Vigilance

Under the E-rate program rules for competitive bidding, after developing a technology plan, applicants are required to seek competitive bids on goods and services eligible for E-rate discounts by completing and posting an FCC Form 470 on the USAC website. Applicants also must satisfy applicable state procurement rules, wait at least 28 days after posting before committing to a contract, and in selecting their service providers, make price the primary consideration. Competitive bidding is a cornerstone of the E-rate program because it limits

waste, ensures program integrity, and assists applicants in receiving the best value for their limited funds.

In the IBM cases, the applicants submitted a broad, generic version of the Form 470 indicating that they were seeking virtually every product and service eligible for E-rate discounts, rather than developing a list of services actually desired, based on their technology plans, with sufficient specificity to enable bidders to submit realistic bids with prices for specified services. While the Form 470 offered applicants the chance to inform potential bidders if there was a more specific request for proposal (RFP) that they could consult, the applicants in the IBM cases generally indicated that one was not available, even though they posted such an RFP only five days after filing their respective Form 470s with USAC.

In the principal IBM case, involving Ysleta Schools District (Ysleta), the applicant indicated that it was seeking a “Technology Implementation and Systems Implementation Partner” to “assist the District in preparing applications on the District’s behalf for E-rate funding . . .” Five firms responded to Ysleta’s RFP. IBM submitted a 147-page response that addressed each category in the RFP. In that response, the only prices that IBM quoted were hourly rates for Systems Integration, ranging from \$394 per hour for a Project Executive to \$49 per hour for a Project Administrator. A “systems integrator” operates in the role of a prime contractor for coordinating services actually delivered by subcontractors. Our rules, however, contemplate a direct relationship between the applicants and the service providers, not an indirect relationship through an intermediary subcontracting unit.

In its response to the RFP, IBM did not place bids on the specific products and services that were eligible for E-rate discounts, as required by our rules. Ysleta selected IBM subject to the condition that a satisfactory contract could be negotiated between IBM and Ysleta over the

scope of work and the prices of E-rate-eligible products and services. IBM and Ysleta engaged in those negotiations and completed them on January 17, 2002. The final contract included five statements of work, ranging from just under \$1 million to more than \$12 million, each with detailed specifications, prices, and terms.

Triggered by a whistleblower's anonymous letter in May 2002, USAC sent a special investigator to do a site visit and collect documentation from Ysleta concerning whether it had the resources to effectively use the services it had purchased. After reviewing Ysleta's application and supporting documents, USAC denied Ysleta's request for funding on December 3, 2002, based on violations of the Commission's competitive bidding rules, and provided Ysleta and IBM with a detailed explanation for that denial. Soon thereafter, USAC also denied eight other applications that selected IBM as system integrator. On January 30, 2003, Ysleta and IBM sought Commission review of USAC's decision, and the eight other applicants associated with IBM filed similar appeals.

On December 8, 2003, after a *de novo* review of the facts of Ysleta and similar cases, the Commission upheld USAC's denial of eight of the nine funding requests totaling over \$250 million, for Ysleta, Donna, El Paso, and Galena Park in Texas; the Navajo Education Technology Consortium and Albuquerque in New Mexico; Oklahoma City, Oklahoma; and Memphis, Tennessee. The Commission found, in general, that the so-called "two-step" bidding process (i.e., procurement of a system integrator followed by private negotiation with that integrator for the goods and services eligible for E-rate support) that IBM had participated in with Ysleta and others had violated the Commission's competitive bidding requirements.

Specifically, the Commission found in Ysleta that:

1. Ysleta did not attempt to select the products and services that represented the most

cost-effective offerings, with price as the primary consideration. The only prices that IBM presented were hourly rates for systems integration. No bids were for prices for any E-rate supported offerings. Ysleta did not request or obtain sufficient data about the prices of IBM's competitors for E-rate services to know if IBM's prices represented the most cost-effective option. Ysleta's internal assessment of cost-effectiveness was not sufficient;

2. The manner in which Ysleta and other schools used Form 470 had the effect of eliminating competitive bidding for the products and services eligible for discounts under the E-rate program, because Ysleta's form failed to describe the services that it sought to purchase in sufficient detail to enable potential providers to formulate bids. Specifically, the structure and content of the RFP meant that potential vendors of specific services would be unlikely to respond in a meaningful way to the all-inclusive FCC Form 470;

3. Because Ysleta's two-step system integration approach was inconsistent with our competitive bidding requirements and Ysleta failed to demonstrate that it selected IBM with price as the primary factor, it failed to submit a *bona fide* request for service, contrary to section 254(h)(1)(B) of the Communications Act; and

4. Compliance with state and local procurement processes did not exempt Ysleta from complying with the Commission's competitive bidding rules.

The Commission found it in the public interest, however, to permit the applicants that were denied funding to have a second chance to receive Funding Year 2002 support for services that they sought by seeking *bona fide* competitive bids. In particular, the Commission found that there was "substantial and widespread reliance" on USAC's prior approval of applications that utilized two-step bidding. USAC could reasonably have been construed as sanctioning the

improper two-step bidding process by approving a 2001 application by El Paso, which involved IBM. The processing window for these rebid applications closed on June 9, 2004.

The eight school districts denied funding by the IBM decision have resubmitted funding requests seeking a total of \$40 million in services, an amount that is substantially less than the prior requests. IBM was permitted to bid again because, as stated in the order, the Commission believes that its rules were not as clear as we would have liked, and that IBM may not have realized that its aggressive interpretation of the rules actually crossed the line. As it turns out, IBM bid on only one of these applications, and it was not successful. As directed by the Commission, USAC is carefully scrutinizing these requests to ensure that they are consistent with the Commission rules as clarified in the Order. USAC is also investigating the circumstances surrounding El Paso's 2001 application.

III. The Lessons Learned From This Case

The IBM case illustrates the importance of a robust competitive bidding mechanism in the E-rate program. It also shows the importance of having clear rules. We continue to be vigilant in pursuing both goals.

The Commission acted unanimously in just over a year after USAC initially denied funding in the IBM cases. The Commission acted decisively and quickly, even as it was addressing numerous other cases and was engaged in general rulemakings to improve the E-rate program. In the course of the "IBM cases," USAC denied a quarter of a billion dollars in support, and also denied an additional quarter billion dollars of support for Funding Year 2002 to nine applicants in similar circumstances involving IBM. Thus, in the IBM cases, no funding was distributed, and no dollars had to be recovered.

Competitive bidding is critical to the success of the E-rate program. As long as vendors and suppliers are subject to competition from others who are also eager to gain a customer, they have a strong incentive to offer a competitive, cost-based price for E-rate eligible goods and services. Absent competitive pressures, service providers and applicants may inflate prices to maximize their gains.

Clear rules are also crucial. Private firms and E-rate applicants have incentives to interpret unclear rules to their benefit, even at the expense of the nation's students, library patrons, and all Americans – the true beneficiaries of the E-rate program. The Commission is committed to enforcing, explaining, and, when necessary, changing its rules to minimize potential for their abuse. Through the ongoing rulemaking process, we are revising and adjusting the program rules to minimize abuse, as we have done in the recent Fifth Schools Order, while we continue to grant support to those in need.

Finally, the IBM decisions are an example of the system working. The inquiry into Ysleta began with an anonymous letter alleging rule violations by IBM. Pursuant to its normal practices, USAC sent a special investigator to do a site visit and collect documentation, and USAC denied the funding request consistent with our rules. The Commission followed its normal process by reviewing the record *de novo*, and it largely affirmed USAC's decision, seizing the opportunity to clarify its rules.

We at the Commission are proud of this result. But I believe there is more we can and should be doing. As I indicated at the beginning of my testimony, since the IBM case was concluded, the Commission has implemented further oversight requirements, and the Bureau has recommended changes to certification requirements to the Office of Management and Budget for approval. We are considering further steps. We believe these steps will continue to improve our

oversight of the program, and we will continue to use adjudications, rulemakings, and audits to help us identify areas of E-rate program administration that are vulnerable to fraud or to confusion that leads to waste or abuse.

The Commission and its staff remain absolutely committed to making necessary improvements in the E-rate program. We are happy to provide any assistance to the Subcommittee and stand ready to offer our technical and subject area expertise as you move forward. Thank you, Mr. Chairman, for the opportunity to participate in your review of the universal service fund's schools and libraries support mechanism, and I look forward to your questions on these issues.