

Commission reminded E-rate applicants that they do not have to allocate out of their funding requests the value of the deals they get on bundled ineligible products or services – so long as the service provider that is offering the deal is currently offering the same one to the “public” or to another “designated class of subscribers.” Footnote 25 did not include anything new. Indeed, it simply reiterated and clarified further what has always been one of the Free Services Advisory’s basic principles:²

A cost allocation is not required when the free product or service is available to the public or a class of subscribers broader than just E-rate recipients. For example, many cell phones are free or available at discounted prices with the purchase of a two-year service contract. Applicants are free to take advantage of these deals without cost allocation, but cannot accept other equipment with service arrangements that are not otherwise available to some segment of the public or class of users.

In line with that, Footnote 25 says:

For example, many cell phones are free or available to the general public at a discounted price with the purchase of a two-year service contract. Schools and libraries are free to take advantage of these deals, without cost allocation, but cannot accept other equipment with service arrangements that are not otherwise available to some segment of the public or class of users. Therefore, a service provider may not offer free iPads to a school with the purchase of telecommunications or Internet access services eligible under E-rate, if such an arrangement is not currently available to the public or a designated class of subscribers.

Simply put and most notably, Footnote 25 prevents schools and libraries from being discriminated against in the marketplace because of their status as E-rate applicants. Companies occasionally bundle free or deeply discounted products or services that are not eligible for E-rate discounts with products or services that are and then market them to the public or to multiple classes of users. Not permitting E-rate applicants to take advantage of those kinds of money-saving opportunities makes no sense in our opinion, and the Commission obviously agrees. By clarifying what has always been an economically sound exception to the Commission’s free services rules, Footnote 25

² See <http://www.usac.org/sl/applicants/step02/free-services-advisory.aspx>

makes it perfectly clear that it is not the Commission's intention to relegate schools and libraries to the sidelines while non-E-rate organizations take advantage of great deals on *ineligible* products and services, simply because the former happen to be applying for E-rate discounts on *eligible* services at the same time from the same company.

We share SECA's concern that some unscrupulous vendors and applicants might try to use E-rate funds to subsidize the purchase of ineligible goods and services. However, we disagree with SECA that Footnote 25 has opened up a loophole in the rules that those kinds of participants in the program are bound to exploit. The "class of subscriber" requirement provides ample protection against the concerns expressed by SECA. For example, SECA says it has reason to believe that at least one vendor has already managed to bundle ineligible handsets with eligible VoIP services by deceptively claiming that the deal is available to a broad class of customers. We believe that the Commission has provided an adequate framework in which to address this claim without the need for additional regulation or clarification. Did the service provider actually make the free VoIP handset deal available to a broad class of customers besides E-rate applicants? This is the real issue.

Was this service provider's marketing effort to everyone else besides E-rate applicants a sham? Was there any evidence that the service provider employed a broad-based sales and marketing strategy? Did the service provider produce and distribute any advertising materials and, if so, into what markets did it distribute them? Did the service provider have inside or outside sales people who called on and made the same free VoIP handset offer to potential customers besides schools and libraries? If USAC concluded correctly that this particular service provider legitimately offered free handsets with VoIP service to a class of users besides E-rate applicants, then, quite frankly, there is no problem.

For argument's sake though, let's assume that USAC made a mistake by not requiring the applicant to do a free services cost allocation. Adding more and new layers of confusing free services regulations is not the remedy. That is not a fitting response to the problem, nor is it even necessary. If indeed USAC did make a mistake, there already

is a suitable remedy: first a Payment Quality Assurance (PQA) audit, then a Commitment Adjustment Decision, and finally, instructions to USAC to investigate this type of issue more carefully in the future.

Normally we agree with SECA on E-rate policy matters. On this matter, however, we must part ways. The policy that the Commission clarified in Footnote 25 has always made and continues to make perfect economic and regulatory sense. The Commission need not inquire about hypothetical marketing efforts. The important question is whether the policy that the Commission clarified in Footnote 25 actually works. That is, does it enable E-rate applicants to enjoy the same opportunities in the marketplace to save money on equipment and services as classes of subscribers who are not eligible for E-rate discounts, while at the same time reasonably protecting the E-rate subsidy system from inappropriate price manipulation? We believe that it does.

By allowing E-rate applicants to take advantage of only *bona fide* deals -- ones that service providers offer simultaneously to at least one other designated class of users (state and local government or higher education customers for example) -- Footnote 25 guarantees that companies will not be able to cook up suspicious offers exclusively for K-12 and public library customers.³ All it takes to guard against overly aggressive service providers who do not actually target anyone besides E-rate customers is a simple verification process. To verify the legitimacy of a company's offer, USAC can (1) ask questions like the ones we have already discussed and (2) request documentation sufficient to show that the company offered the same deal to at least one other class of users besides E-rate applicants. That should not be a difficult issue to audit.

SECA has expressed concern that, should the Commission not act quickly to rewrite Footnote 25, service providers are going to start offering never-before-seen deals on bundles of Priority One services and ineligible products and services. "If the FCC does agree that such VoIP and other end-user equipment bundles (e.g., tablets) are E-rate

³ For the record and contrary to the policy underlying the free services rules, it is important to note that not all deals that companies craft solely for the K-12 market are designed with an eye toward artificially inflating prices on eligible services. With that in mind, we urge the Commission to revisit the free services rules sometime soon.

eligible,”⁴ SECA asks, “is there a line where the Commission would deem such bundles as too extreme?”

We wonder how legitimate offers, ones that enable E-rate applicants to enjoy the same substantial savings on equipment and services that business, non-profit and government sector organizations are able to enjoy, can ever be “too extreme.” If a company is willing to give something away for free to win market share, and it makes the exact same legitimate offer to multiple groups of users, including schools and libraries, how can that kind of offer ever be “too extreme”? Drawing an objective line between offers that are “okay” and one that are “too extreme,” we submit, is impossible.

If a deal appears too good to be true, USAC simply needs to investigate it more closely. A few simple questions can address a multitude of circumstances. Is the service provider inflating its standard rates? Did the applicant meet the competitive bidding requirements? Is the applicant overpaying for services that could be delivered with similar quality and reliability at a lower cost? There are sufficient safeguards within the current regulatory framework to respond to questions of this nature without weighing down the program with additional regulation.

SECA says it is concerned, for example, that Web hosting companies might try to take advantage of the Footnote 25 “cell phone” policy by changing the way they price their services. Instead of quoting a single price for a tightly integrated package of eligible Web hosting services and ineligible Web tools, as they do now, SECA suggests that the companies that sell those kinds of packages might start pricing their Web hosting services separately and throwing in Website tools for free. Presumably, SECA is concerned that those companies will start charging more for Web hosting to cover the cost of the free Website tools. This is an unlikely scenario. It is our observation that this particular segment of the Web hosting industry focuses almost entirely if not exclusively on the K-12 market, thus rendering SECA’s concern in this regard completely moot.

⁴ SECA comment in this regard is somewhat misleading. Bundles of eligible and ineligible services are never going to be entirely eligible for E-rate discounts, unless ancillary services are involved. Free services in a bundle, whether eligible or ineligible, cannot, for obvious reasons, receive E-rate discounts.

It is worth noting too that the price of Website tools, as evidenced by USAC-approved cost allocations, represents only a very small fraction of the total cost of the packages that these kinds of companies sell – typically less than 10%. As a practical matter, therefore, the likelihood of these companies deciding to upset a very delicate economic and political apple cart by radically changing the way they create, market and sell their services to schools and libraries is not very high.

Finally, we disagree with SECA that the demand for Priority One dollars will shoot through the roof if the Commission leaves Footnote 25 as is. The checks inherent in the E-rate rules – competitive bidding, cost of eligible services required to be the primary factor in contracting decisions, cost effectiveness requirements, lowest corresponding price requirement, and of course the free services rules – make it highly unlikely that allowing schools and libraries the equal opportunity to take advantage of special offers on ineligible end user and other equipment will wind up substantially increasing the price those schools and libraries pay for E-rate eligible services.

Moreover, the notion that Footnote 25 will lead directly to E-rate applicants contracting for significantly more Priority One services than they do now is nothing but conjecture. For argument's sake though, let's assume that it does. If demand increases because more schools and libraries choose to embrace advanced telecommunications technologies like VoIP, that is hardly a bad thing. To the contrary, it is a clear sign that the E-rate program is working, doing exactly what Congress and the Commission intended it to do in the first place. The steadily increasing demand for Priority One services is well documented. The answer to this higher demand is not to make it more expensive for schools and libraries to upgrade to new technologies; the answer is to move more funds into the E-rate program.⁵

⁵ See <http://www.fundsforlearning.com/blog/2012/08/2012-survey-part-4-how-should-e-rate-program-be-changed>. Almost 60% of the applicants who responded to our recent survey stated that the Commission should focus on increasing the amount of funding available in the E-rate program. When asked about potential solutions for a scenario where Priority 1 demand exceeds available funding, majority opinion was split between establishing a Priority 1 threshold (similar to the Priority 2 threshold system currently in place) or adjusting the discount matrix to lower the available discount on eligible services. Responses indicate that removing eligible services or placing limitations on the amount of funding for certain types of projects are believed to be of negligible impact.

Respectfully submitted,

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