

Statement of

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SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

of the

COMMITTEE ON ENERGY AND COMMERCE

UNITED STATES HOUSE OF REPRESENTATIVES

On

Problems with the E-Rate Program: Waste, Fraud, and Abuse Concerns in the Wiring of

Our Nation's Schools to the Internet

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Executive Summary

- We first received allegations related to the investigation involving NEC-Business Network Solutions Inc. (NEC-BNS) in August 2001 and we have been working with federal law enforcement as part of an on-going federal investigation since that time.
- We received allegations of wrongdoing by IBM related to the receipt of E-rate funding in February 2002. We referred this matter to Federal law enforcement and provided support to their investigation of the allegations. In May 2004, we were advised that federal law enforcement had concluded their investigation and determined that there was no evidence of criminal activity by IBM.
- The NEC-BNS and IBM investigations highlight two concerns that we have with this program -- inadequacies in the competitive procurement requirements and reliance on applicant certifications regarding compliance with program requirements.
- The Commission has not fully implemented recommendations to address programmatic weaknesses highlighted by these investigations.

Introduction

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to appear before the subcommittee today to discuss concerns regarding waste, fraud, and abuse in the E-rate program. This is the second opportunity that I have had to testify before the subcommittee on these matters. In my comments and written testimony, I will discuss my office's involvement in the investigations of NEC-BNS and IBM and describe in more general terms the programmatic concerns raised by these investigations.

NEC-Business Network Solutions Inc. (NEC-BNS)

In this section of my testimony, I will briefly discuss my office's involvement in an on-going federal investigation involving NEC-BNS. I want to point out that there are aspects of this case that I am not at liberty to discuss because of the on-going nature of this investigation. In fact, the two audit staff in my office that are involved in this investigation are prohibited by law from disclosing information that they have been provided related to this case that was developed through the Grand Jury process.

In August 2001, my office was contacted by an Associate General Counsel with the Universal Service Administrative Company (USAC) regarding a request for information from an investigator from the Office of the City Attorney for the City and County of San Francisco. We obtained a copy of the request for information that was provided to USAC and a copy of the USAC response. In September 2001, we referred this matter to the

Governmental Fraud Unit of the Federal Bureau of Investigation (FBI) in accordance with the process that we had established with the FBI for centralized management of E-rate fraud cases.

In July 2002, my office established a working relationship with the Antitrust Division of the Department of Justice to investigate E-rate fraud. The Antitrust Division was interested in E-rate fraud because of the large number of cases that included allegations of bid rigging and other violations related to the Sherman Act. Information related to this case was provided to the E-rate fraud task force established by the Antitrust Division and my office has been involved in supporting this on-going investigation since that time. As part of our support for the investigation, my office has performed in-depth analyses of E-rate documents, testified before a federal grand jury, participated in the execution of a search warrant, evaluated seized electronic media, and participated in numerous witness interviews.

As part of the analysis that we performed for federal law enforcement, we examined NEC-BNS participation in the E-rate program with the purpose of identifying suspect activity. For the universe of NEC-BNS participation in the program from funding years 1998 through 2004, we identified fifty-three (53) E-rate applications at twenty (20) schools that we concluded were suspect. These fifty-three (53) applications represented approximately \$380 million in requested E-rate funding, over \$40 million in commitments, and \$29.7 million in disbursed funding. Although these applications represented only 27% of the E-rate applications during this period that included NEC-

BNS, they represented 93% of requested funds and 96% of disbursed funds. The results of our analysis was shared with federal law enforcement and served as the basis for the NEC-BNS portion of the overall investigation.

To date, there have been numerous indictments and plea agreements related to this case. In October 2002, Desmond McQuoid and US Machinery were indicted for mail fraud in the United States District Court for the Northern District of California. In March 2003, Mr. McQuoid entered into a plea agreement in which he agreed to plead guilty to mail fraud. In that plea agreement, Mr. McQuoid agreed to numerous facts regarding the matter including the following facts concerning E-rate fraud:

- Participating in a scheme to submit false and inflated funding requests to the USAC and SLD a part of the E-Rate program beginning in 1999 and continuing until 2000.
- Allowing the competitive bid process to be compromised by the consultants he was working with.
- Despite being aware that the contractors had submitted inflated bid price information to the School District and the USAC and SLD, not taking steps to correct the information provided.
- Attempting to obtain a 10 million dollar in-kind donation from the main contractor by having them purchase computer workstations from US Machinery and then donate these servers to the School District.

- Attempting to use the excess funds in the inflated bids to pay for these products even though I knew that the USAC and SLD had disallowed using their funds for these expenditures.

In March 2003, US Machinery entered into a plea agreement in which they agreed to plead guilty to mail fraud. In that plea agreement, US Machinery agreed to numerous facts regarding the matter including the following facts regarding E-rate fraud:

- US Machinery bid to supply computer servers as part of an E-Rate application submitted by and on behalf of the San Francisco Unified School District.
- US Machinery learned during the process that some of the contractors had submitted inflated bids to the School District and to the USAC and SLD.
- US Machinery brought this fact to Dennis McQuoid's attention and failed correct the misstatements in the bid documents.
- Dennis McQuoid arranged a meeting with the principal contractor ... and tried to obtain a concession from the contractor to purchase computers from US Machine.
- As a result, the contractor was then supposed to donate these computers to the School District.

In May 2004, NEC-BNS entered into a plea agreement as a result of this investigation. In that agreement, NEC-BNS agreed to plead guilty to one count of wire fraud in violation of 18 U.S.C. § 1343 and one count of conspiracy to suppress and eliminate competition in

violation of the Sherman Antitrust Act, 15 U.S.C. § 1. As part of the settlement, NEC-BNS agreed to pay \$20,685,263 in criminal fines, civil settlement, and restitution.

IBM Global Services

In this section of my testimony, I will briefly discuss my office's involvement in an investigation involving participation in the E-rate program by IBM Global Services (IBM).

In February 2002, my office was contacted by the General Counsel of the Universal Service Administrative Company (USAC) regarding a letter they had received alleging wrongdoing by IBM related to their involvement in providing E-rate support to the El Paso Independent School District (EPISD). The letter, signed "Concerned Tax Payer", outlined three areas of concern: (1) the need for the program and IBM's role in driving that need; (2) apparent violations of Federal and state rules governing the procurement process; and (3) the lack of project information for the EPISD board and the public. The letter provided a great deal of detail regarding the project and IBM's involvement and clearly raised legitimate questions about whether or not program rules were followed.

As a result of the allegations raised in the "Concerned Tax Payer" letter, USAC initiated a special investigation of IBM's involvement as a service provider with EPISD for funding years 2001 and 2002 and with the Ysleta Independent School District (Ysleta ISD) for funding year 2002. Based on the results of their analysis, USAC concluded that

Ysleta ISD failed to comply with program requirements and that those Ysleta funding requests associated with IBM should be denied. USAC further recommended that SLD deny funding requests associated with IBM when those requests fit the pattern of Ysleta ISD and EPISD.

As I discussed earlier in my testimony, we established a working relationship with the Antitrust Division of the Department of Justice in June 2002. We referred this matter to the Antitrust Division shortly after they established an E-rate fraud task force in July 2002. In September 2002, representatives from my office visited with representatives on the Antitrust task force to review case material. In October 2002, the Antitrust attorney directing the investigation requested authority within the Antitrust Division to conduct a preliminary inquiry “to pursue a possible bid rigging scheme in which competing telecommunication providers may have colluded with each other, with school districts, or through representatives, on contracts for communications equipment sold to El Paso ISD in El Paso, Texas, Ysleta ISD in Ysleta, Texas, and potentially other districts nationwide.” Authority to conduct a preliminary inquiry was granted.

In September 2002, we received additional allegations regarding IBM participation in the E-rate program. These allegations were provided following a Train-the-Trainers workshop provided by the Schools and Libraries Division of USAC during which SLD trainers encouraged participants to provide any information highlighting serious violations of program rules. The allegations address IBM’s “over-involvement in the competitive bidding process.” The allegations provided information detailing a pattern of

virtually identical “cookie-cutter” or “laundry list-type” form 470s posted by applicants around the country and provided detailed information on a number of these schools issuing “strikingly similar” requests for proposals around the same time as the form 470s were posted seeking essentially the same thing – “a strategic technology partner ... to assist the district in securing E-rate funds.” We forwarded this additional information to the Antitrust attorney directing the investigation.

In April 2004, we were advised that the Department of Justice had closed their preliminary inquiry of the IBM matter. We discussed this case with representatives from the Antitrust Division and were informed that they did not identify any evidence of criminal activity based on the material that they reviewed as part of the preliminary inquiry. After receiving this information, my office closed their case file on this matter.

Programmatic Concerns Highlighted by NEC-BNS and IBM Investigations

The NEC-BNS and IBM investigations highlight two general concerns that my office has with the design of the E-rate program: (1) weaknesses in the rules governing the competitive procurement of goods and service; and (2) over-reliance on self certification.

Competitive Procurement

Program rules require that applicants use a competitive procurement process to select service providers. In establishing this requirement, the Commission recognized that “(c)ompetitive bidding is the most efficient means for ensuring that eligible schools and libraries are informed about all of the choices available to them” and that “(a)bsent

competitive bidding, prices charged to schools and libraries may be needlessly high, with the result that fewer eligible schools and libraries would be able to participate in the program or the demand on universal service support mechanisms would be needlessly great.”

Applicants are required to submit a form 470 identifying the products and services needed to implement the technology plan. The form 470 is posted to the USAC web page to notify service providers that the applicant is seeking the products and services identified. Applicants must wait at least 28 days after the form 470 is posted to the web site and consider all bids they receive before selecting the service provider to provide the services desired. In addition, applicants must comply with all applicable state and local procurement rules and regulations and competitive bidding requirements. The form 470 cannot be completed by a service provider who will participate in the competitive process as a bidder and the applicant is responsible for ensuring an open, fair competitive process and selecting the most cost-effective provider of the desired services. Further, although no program rule establishes this requirement, applicants are encouraged by USAC to save all competing bids for services to be able to demonstrate that the bid chosen is the most cost-effective, with price being the primary consideration.

In the case of IBM, it seems clear that the practices followed by several of the school districts that selected IBM as their service provider for participation in the E-rate program for the funding years reviewed did not follow program requirements for the competitive procurement of goods and services. Although the Department of Justice did not find evidence of criminal activity, USAC denied numerous applications involving IBM as a

result of their investigation and the Commission affirmed USAC decisions regarding these applications in the order they adopted in December 2003.

On June 5, 2002, USAC prepared a preliminary special investigation report summarizing the results of that review. In that preliminary report, USAC concluded that both EPISD and Ysleta ISD utilized a Request for Proposal (RFP) format that did not make price the major factor in the selection of the service provider in violation of program rules. In October 2002, USAC prepared a preliminary draft analysis of issues identified in the EPISD and Ysleta ISD funding requests, determined that funding requests for the two school districts followed the same basic pattern, and presented the results of their legal analysis focusing on the Ysleta ISD funding requests. In that document, USAC concluded that:

- Ysleta selected IBM as its service provider by a process other than the FCC Form 470 posting process and without defining the specific services that would be provided;
- Ysleta selected IBM as its service provider without complying with the requirements that the applicant select the most cost-effective provider of service with low cost being the primary factor;
- Compliance with FCC Form 470 posting requirement is necessary in addition to applicable state and local procurement requirements;
- IBM's proposal specifies a range of services that it will provide as the Strategic Technology Partner. Many of these services are not eligible for funding.

- IBM's proposal emphasizes developing the technology plan and structuring funding requests in order to maximize funding requests; and
- Requests for Proposal contain similar language and raise significant questions as to whether IBM was improperly involved in the selection process.

In the case of NEC-BNS, wrongdoing rose to the level of criminal activity. In the plea agreement that NEC-BNS accepted, NEC-BNS admitted to the following facts regarding this case:

- NEC "participated in a conspiracy with one or more vendors of equipment and services related to telecommunications, Internet access, and/or internal connections, a purpose of which was to suppress and eliminate competition for E-Rate program projects".
- In furtherance of the conspiracy, NEC "reached an agreement with its co-conspirators to frustrate the competitive process on the E-Rate projects by allocating contracts and submitting fraudulent and non-competitive bids" and, to carry out this conspiracy, NEC "discussed with these co-conspirators prospective bids for the E-Rate projects; agreed with these co-conspirators who would be the lead contractor on the project and who would participate on the project as subcontractors to the designated lead contractors; submitted fraudulent and non-competitive bids in accordance with the conspiratorial agreement." Further, NEC engaged two consultants who "took steps to ensure the success of the conspiracy by eliminating and disqualifying bids from non-conspirators and either directly

awarding the contracts or using their best efforts to persuade the school district officials to award contracts to the designated lead contractors.

Reliance on Applicant Certifications

The E-rate program is heavily reliant on applicant and service provider certifications. For example, on the form 470, applicants certify that the support received is conditional upon the ability of an applicant to secure access to all of the resources, including computers, training, software, maintenance, and electrical connections, necessary to use effectively the services that will be purchased under this mechanism. On the form 471, applicants make several important certifications. Applicants certify that they have “complied with all applicable state and local laws regarding procurement of services for which support is being sought” and that “the services that the applicant purchases ... will not be sold, resold, or transferred in consideration for money or any other thing of value.” Other certifications are required on various program forms.

Reliance on applicant and service provider certifications has been an area of concern in my office for some time. We have two concerns regarding certifications. The first concern deals with over-reliance on certifications in lieu of USAC verification and validation of applicant and service provider assurances as part of USAC’s normal review processes. The significance of this concern has been diminished somewhat by steps that USAC has taken, and is proposing to take, to strengthen the Program Integrity Assurance (PIA) process.

The second, and more serious, concern is related to the design of the certifications. Concerns about the design of program certifications were first brought to our attention by federal law enforcement. Numerous concerns about certification design were brought to our attention during our first meeting with the E-rate fraud task force established by the Antitrust division of the Department of Justice in July 2002. A representative from the Commission's Wireline Competition Bureau (WCB) was present during that discussion. At our request, task force members provided written comments on program certifications in December 2002. Some of the concerns expressed by task force members dealt with applicant certification to future events (i.e., on the form 470, applicants certify that they recognize that support is conditional upon the schools "securing access to all of the resources ...necessary to use the services purchased effectively").

In the case of IBM, the pattern that was observed at several applicants shows applicants reporting on the form 470 that they do not have Requests for Proposal for the specific internal connections being sought and certifying that the request has been examined and that "to the best of my knowledge, information, and belief, all statements of fact contained herein are true." Shortly after form 470s were posted, applicants would issue a separate RFP ("strikingly similar" in many cases) for a "Technology Implementation and Systems Integrator Partner." The RFP for the "Technology Implementation and Systems Integrator Partner" states that the "selected vendor will serve as the prime contractor for any projects funded through E-rate." Effectively, applicants provided assurance to the program that they have not sought proposals for E-rate projects at the same time that they clearly have.

In the case of NEC-BNS, there are numerous examples of fraudulent representations on program forms. In fact, it may be more challenging to identify certifications that were not fraudulent representations. Desmond McQuoid certified that he was authorized to submit requests on behalf of the San Francisco Unified School District when he was not. He further certified that the state and local procurement regulations were followed and that program rules were followed when neither of these statements was accurate.

Certification Weaknesses Have Not Been Fully Addressed

My office started to raise concerns about perceived weaknesses in the competitive procurement process and over reliance on certifications shortly after we became involved in program oversight. We first became concerned about the competitive procurement process as a result of our involvement in the Metropolitan Regional Education Service Agency (MRESA) investigation. During that investigation we observed how weaknesses in competitive bidding requirements and reliance on self certification were exploited resulting in, at a minimum, a significant amount of wasteful spending. We continued to express our concerns as we designed our oversight program, developed a program for auditing beneficiaries, and supported E-rate fraud investigations. In fact, we established a working relationship with the Antitrust Division of the Department of Justice in a large part because of the number of investigations that we were supporting that involved allegations regarding the competitive procurement process.

Our level of concern regarding both the competitive procurement process and reliance on self-certification was heightened as we started to work with the Antitrust Division.

During our discussions with Antitrust, they expressed a general concern with the lack of information regarding the competitive process and specific concerns regarding applicant and service provider certifications. Although we started to pursue these issues with Commission staff in the fall of 2002, the Commission has only recently started to address some of the recommendations from Antitrust, and none of these recommendations are fully implemented. We have been informed by WCB that several of the Antitrust suggestions have been incorporated into the appropriate E-rate forms and that those forms are now at the Office of Management and Budget for approval. Other recommended certifications, particularly regarding the competitive process, are still in the process of public comment, and we are as yet uncertain what the FCC may ultimately do with these recommendations. Numerous of the suggestions from Antitrust involved USAC obtaining and reviewing critical procurement documents during the application review process. The Commission's response to these suggestions was to include in the 5th Report and Order the requirement that the applicant retain these documents, but providing these documents for review along with an E-rate application was not required. And lastly, WCB has informed us that at this time they will not incorporate certain recommendations. I believe that the delay in implementing Antitrust's recommendations, and the exclusion of some of the recommendations from implementation, continues to place the program at risk.

Conclusion

The Office of Inspector General remains committed to meeting our responsibility for providing effective independent oversight of the Universal Service Fund program. As I have described in this testimony, we continue to have numerous concerns about this program. The results of audits that have been performed and the allegations under investigation lead us to believe the program may be subject to an unacceptably high risk of fraud, waste and abuse through noncompliance and program weaknesses. We are concerned with program rules governing the competitive procurement of goods and service and with the over reliance on certifications. In view of these concerns, I believe that it would be appropriate to conduct a broad based review of the program.

We believe we have made significant progress toward our goal of designing and implementing an effective, independent oversight program. However, primarily because of a lack of adequate resources, we have been unable to implement our oversight program. But some progress has been made. We have partnered with USAC to accomplish approximately 100 audits of E-rate beneficiaries using contracted resources available to them and the Commission has been actively furthering efforts for us to use the USF to accomplish more audits. But we believe direct access to the USF is the best manner with which to obtain the necessary resources and, as I have stated previously, until resources and funding are available to provide adequate independent oversight for the USF program, we are unable to give the Chairman, Congress and the public an appropriate level of assurance that the program is protected from fraud, waste and abuse.

Thank you and I will be happy to answer any of your questions.