



**Before the
Federal Communications Commission
Washington, D.C. 20554**

_____)	
In the Matter of:)	CC Docket No. 02-6
Schools and Libraries Universal Service)	
Support Mechanism)	GN Docket No. 09-51
_____)	

**REPLY COMMENTS REGARDING PETITION FOR CLARIFICATION
PERTAINING TO THE ELIGIBILITY OF FREE VoIP HANDSETS
AND OTHER END-USER EQUIPMENT**

I. The Long Term Impact on the E-rate Program Must Be Considered When Deciding Whether to Expand Permitted Service Offerings Bundled with End User Equipment.

In filing its initial Petition and proposing four criteria for allowing bundled end user equipment to be included in eligible Priority 1 requests without cost allocation, the State E-rate Coordinators’ Alliance (SECA) tried to strike a balance among competing policies. One such policy, as explained by the FCC in Footnote 25 of the Sixth Report and Order, seeks to avoid penalizing applicants for receipt of free or nominally priced end user cellular devices that are available to the public at large, not just to schools and libraries or to some narrow subset of customers. Prior to the Sixth Report and Order, applicants were compelled to deduct the full retail value of cellular devices from the pre-discount price of monthly cellular service even though these free devices were available to the public at large. By requiring cost allocation in these circumstances, E-rate customers essentially had to “pay” the full retail value of the devices in foregone E-rate discounts.

The second policy is articulated by service providers seeking to expand this narrow exception to allow for bundling other end user devices such as VOIP handsets as part of eligible Priority 1 service. They maintain that E-rate applicants should be permitted to receive these free devices without requiring cost allocation because there is no difference between free cell phones and other end user devices.

SECA maintains that the bundling of end user equipment and marketing of the equipment as free is, in short, too good a deal to be true. We are concerned that these bundled services will raise the price of E-rate eligible services, because vendors will raise their monthly service fees to recoup the amortized costs of the equipment. This concern is based on several sensible principles: (1) E-rate vendors have the incentive to market their products and services in a manner that maximizes E-rate discounts so to minimize the out of pocket costs to the E-rate applicant/customer; (2) the vendor incurs a cost to provide this equipment that it has the economic incentive to recoup from its customer; (3) because E-rate regulations focus on the price of eligible services and not the underlying cost elements of those services, the vendor can raise the price of E-rate eligible services, claim that the equipment is free, and the vendor is able to recoup the costs of the equipment through E-rate.

On its face, some applicants may not support this position because bundled VOIP and other services bundled with end user equipment service would allow E-rate recipients to increase their receipt of E-rate discounts and obtain equipment that was paid for in part by E-rate funding rather than having to pay for the full costs of this equipment out of their own budgets. We think such an assumption would be short-sighted and counterproductive. We also believe it is our duty to consider not only short term gains, but also the long term implications of changes to E-rate rules to ensure that they will facilitate a sustainable program for years to come.

SECA believes that expanding the FCC's very specific eligible cellular service exception would prove harmful in the long term to the integrity and financial stability of the program. E-rate funding is already significantly oversubscribed where each year demand far outpaces available funding based on the current compilation of eligible services. But for the available rollover of funds in FY 2013 from prior years, there would not have been sufficient dollars to fund any Priority 2 eligible equipment. Given the pace of growth in demand, it we expect that in FY 2013, the demand for Priority 1 funding based on existing eligible services (that is, without

the addition of eligible end user equipment bundles) will exceed available funding (and there would not be enough rollover funds from prior years available to supplement FY 2013 dollars). By removing cost allocation principles for end user devices, the increase in demand would exacerbate the already severe funding shortage in the program. Applicants would no longer be assured that Priority 1 funding requests could be fully funded and pro-ration may be required. This, in turn, would require applicants to increase the non-discount share for E-rate services, and such additional funding may or may not be available from applicant's own budgets. Given the administrative complexities that would ensue, with canceled FRNs or partially funding FRNs, it would be nearly impossible to ensure that Applicants could timely receive and meaningfully use their E-rate discounts.

II. SECA's Concerns about Increased E-rate Demand Due to Bundled Service with End User Equipment is Well-Founded.

Several of the commenting parties challenged the legitimacy of SECA's financial concerns, claiming that they were speculative and unfounded. We disagree. Our concerns are legitimately founded and not conjectural.

SECA knows of one national vendor that, in response to an RFP for hosted VOIP services, proposed the monthly price of interconnected VOIP that included bundled handsets at \$28/seat (or per line) for a three-year contract. The same service – interconnected VOIP -- was priced at \$22 per month without VOIP handsets for the same three-year contract. Multiple school districts were offered the identical bundled pricing by this vendor.

In one proposal to a small district representing approximately 5000 students and five school buildings, the district sought 601 lines, which resulted in a difference of \$3,606 between the monthly price of VOIP service without handsets and the monthly price with handsets. This calculates to an annual difference of \$43,272. Over the life of the three year contract, this applicant's pre-discount price would have been \$129,816 higher had they selected the service offering that included the costs of the bundled VOIP handsets – and this is just one small-

medium sized applicant with 5 school and two administrative buildings.¹ If just 200 similarly-sized applicants applied for E-rate discounts on such bundled services, Priority 1 demand would increase nearly \$26 million. Multiply that figure by the number of districts in the country in need of a new phone system and Priority 1 demand would be consumed by bundled VOIP service alone.

SECA anticipates that such pricing dichotomies will be difficult to obtain moving forward as vendors seek to aggressively market their bundled offerings. Instead, the end result will be for this vendor to charge applicants the higher \$28 per month fee and claim that the VOIP handsets are “free.” By offering the same price - \$28 per month – with or without bundled VOIP handsets, the vendor could claim that the handsets do not result in an increased monthly service fee, and E-rate applicants would have the incentive to buy the bundle. Indeed, there would be a disincentive to buy the unbundled service since they would be charged the same price as the bundled service. Even so, as this example illustrates, the monthly price of \$28 would include the amortized costs of the VOIP handsets even if the vendors claimed otherwise.

III. SECA’s Proposed Factors for Bundled Service with End-User Equipment Should Be Adopted.

SECA’s four factors are a workable solution that are straight-forward for the SLD to implement. Commenters had limited criticism of those factors, which the FCC can easily address with the further clarification that we offer here.

Our first factor is that the cost of any end-user equipment provided as a part of a bundled service must be considered “ancillary” relative to the cost of the bundle as a whole. The use of “ancillary” in this context meant financially modest or inconsequential. Jive Communications claimed that to the extent that this factor resembles the existing ancillary rule, there would be no need for cost allocation.² SECA disagrees. The existing ancillary rule, however, is available only when a price for the ineligible component cannot be determined separately and independently from the price of the eligible components. Such is not the case with respect to

¹ This pricing information is based on a proposal submitted in response to a RFP that had been issued prior to the release of the December 10, 2010 Clarification Order. The vendor’s proposal was submitted after the issuance of the Clarification Order but prior to the active marketing of bundled VOIP handsets.

² Jive comments at 10.

VOIP or other end user equipment. The price of these items is easily ascertainable as a separate cost element. Our point was that the equipment *costs* must be ancillary, that is, relatively modest and incidental compared to the overall cost of the service.

NetDiverse offers limited support for this factor only if the FCC clarifies exactly what is meant by “ancillary” cost. NetDiverse suggested a 20% figure to define ancillary in this context. In other words, if the cost of the handset was less than 20% of the pre-discount contract price (months of contract * monthly price), the handsets should be ancillary and not required to be cost-allocated. In the example above, this would mean that the bundled price of the service could be $\$22 / .8 = \27.50 per month per line. For 601 lines, the cost for the handsets included in the E-rate funding request would be $\$5.50 * 601 \text{ lines} = \3305.50 per month, $\$39,666$ per year and $\$118,998$ over a three year contract. If all E-rate applicants sought to sign up for such a service, the additional demand for funding would be overwhelming. We definitely do not agree that 20% equates to ancillary. There should be *no* price differential between the cost of E-rate eligible service with or without the bundled handset. Jive explained that its pricing meets this test because the unbundled offering without handsets is available to customers on a month to month basis whereas customers who agree to enter into a multi-year contract receive the same pricing including the handset.

Certain commenting parties also took issue with the second SECA proposed factor, that the bundled service offering must be deemed a commercially common practice within the industry, not a unique offering of an individual service provider. What we were addressing with this point is that such bundles created directly as a result of regulatory rules that were created specifically to address a widespread problem dealing with an entirely separate service offering, should not be permitted to be considered eligible, particularly because when FCC has not yet clarified the he ambiguity that was created by differing interpretations of Footnote 25 of its December 10, 2010 Clarification Order.

Rather, only longstanding widely available service offerings should be permitted to fit within this exception. Consequently the question we would ask is whether the bundled service offering was available prior to the issuance of the December 10, 2010 Clarification Order of the Sixth Report and Order. If not, the bundled service offering should continue to be subject to cost allocation requirements. This approach offers a bright line test for USAC/SLD to administer and

eliminates the subjective inquiry that Funds for Learning suggests as an alternative “wait and see” approach that would put all of the risk of subsequent ineligible determinations or denials on applicants’ shoulders.

The third factor, the arrangement must be currently available to the public and not just to a designated class of subscribers, attempts to offer a suggested clarification for the FCC to make that would eliminate the current ambiguity surrounding the definition of “designated class of subscribers.” USAC has specifically requested clarification on this question and we believe that a bright line test should be adopted here so as to minimize the administrative burden of implementing this procedure. If the “available to the public” standard is not sufficiently clear, we would support an alternative standard that considers whether similarly sized customers – commonly referred to as enterprise customers – are offered the same bundled service offering with handsets.

The last factor, that a package or packages of equivalent eligible services, without bundled end-user equipment, should not be available at a lower price, was generally agreed upon by the commenting parties.

IV. SECA Urges the FCC to Make A Decision Regarding the Pending Petition as Quickly as Possible and to Put Applicants on Notice about the Funding Risk Associated with Purchasing Services that Include Bundled End User Equipment.

As representatives of applicants across the nation, SECA wants to ensure that all applicants are informed of the E-rate program rules prior to entering into any arrangement with a service provider that may include bundled end user equipment. Applicants are entitled to know how much cost will be eligible for E-rate discounts and how much cost will be the responsibility of the applicants to pay. Applicants cannot risk entering into these arrangements, particularly for a multi-year period where they would incur additional charges for the handsets or for early termination of the contract if they later learned that the cost of the end user equipment was not eligible for E-rate discounts.

The current climate of uncertainty is fostering confusion and creating unnecessary and unfair risk to applicants. Some vendors have been actively marketing VOIP bundled service, claiming that they have received regulatory approval from either the FCC, SLD or both. Yet, in

correspondence sent to the FCC on August 5, 2011, USAC specifically requested guidance on the following questions:

USAC seeks guidance on what can be considered a “class of subscribers” and what constitutes “available to the public” for the purposes of the E-rate gift rules. For example, are all libraries and elementary and secondary schools considered a “class of subscribers” such that a special equipment discount or free equipment offered only to libraries and elementary and secondary schools would allow a school or library participating in the E-rate program to accept free or discounted equipment from a service provider?

USAC seeks guidance on when equipment (for example, netbooks, cell phones or distance learning equipment) received by a school or library participating in the E-rate program is considered an acceptable charitable donation and when it is considered free equipment in violation of the E-rate gift rules. Specifically, USAC seeks guidance on when the free equipment is subject to the Free Services Advisory requiring cost allocation. Alternatively, when might free equipment be considered an acceptable charitable donation versus when the free equipment is not allowed because it leads to an increase in the demand for service from the service provider?

Given that USAC has explicitly asked the FCC on the very question of when equipment is required to be cost allocated, it is impossible to reconcile the claim from vendors that USAC has approved of bundled VOIP services.

Applicants that enter into multi-year contracts, in reliance on vendors’ claims that these bundled offerings are fully eligible do not even realize that they are incurring a risk that the handset portion of the contract may be deemed ineligible. If the FCC later rules that the handsets are ineligible and must be cost allocated, the E-rate applicant would continue to be fully responsible for the total contract costs including the cost of the handsets. These applicants may not have the budgeted funds to pay for the handsets and may incur stiff termination fees to end the contract prior to its scheduled expiration. These consequences should be avoided at all costs and we implore the FCC to promptly issue a ruling on the SECA Petition.

If this is not possible, then at the very least, the FCC should include a prominent notation on the final approved version of the 2013 Eligible Services List that the eligibility status of bundled services that include the price of free end user equipment, other than cellular equipment, is under review and has not yet been determined. Such a caution will put applicants on notice

that they will incur a risk if they enter into a contract for a bundled service that includes end user equipment.

V. Conclusion

For the reasons stated above and in our Petition, SECA respectfully requests the FCC to enter an Order that clarifies the narrow circumstances in which eligible service bundled with end user equipment may be fully eligible without requiring cost allocation of the end user equipment costs.

Respectfully Submitted by:

/s/ Gary Rawson

Gary Rawson, Chair
State E-Rate Coordinators' Alliance

Mississippi Department for Information Technology Services
3771 Eastwood Drive
Jackson, Mississippi 39211
601-432-8113
Gary.Rawson@its.ms.gov
September 24, 2012