

FCC NPRM on High-Cost Universal Service Support and Intercarrier Compensation Reform

March 3, 2011

On February 9, 2011, the FCC released a Notice of Proposed Rulemaking ("NPRM" or "Notice") on reform of intercarrier compensation ("ICC") and the high-cost support components of the universal service fund ("USF"). With the release of this 289-page Notice, the FCC signaled that it is ready to engage anew in its quest to reform these interrelated subsidy and compensation regimes that nearly all interested parties agree are unsustainable.

With roughly \$4.5 billion/year in play in high-cost USF support and approximately \$8 billion/year at stake in ICC, any rules or policies adopted in this proceeding will have a significant impact on many segments of the telecommunications industry. The NPRM sets staggered comment dates, as follows:

- April 1: initial comments on ICC for interconnected voice over Internet protocol ("VoIP") traffic, rules to address "phantom traffic," and rules to reduce access stimulation.
- April 18: reply comments on ICC for interconnected VoIP traffic, rules to address phantom traffic, and rules to reduce access stimulation.
- April 18: initial comments on all other sections of Notice.
- May 23: reply comments on all other sections of Notice.

Despite the rapid comment cycle, the timing of any action is unclear. The NPRM raises a broad range of complicated and controversial issues. On many matters, the Notice seeks comment on a wide variety of alternative proposals without advocating a specific option. On the major problems with ICC -- VoIP v. TDM traffic, intrastate/interstate arbitrage, or wireline/wireless issues -- the FCC punts, with no specific near or long-term proposals. Proposals for the reform of other interrelated programs such as USF contribution and Lifeline support have been left for other proceedings. As such, the process of adopting high-cost USF support and ICC reforms is likely to be difficult. At the same time, the FCC appears committed to implementing at least some high-cost support reforms in 2012.

In reforming high-cost USF support and ICC, the Commission states that it will be guided by four (4) principles. Most importantly, the FCC wants to modernize and refocus high-cost USF support and ICC to accelerate the transition from circuit-switched to IP networks and make affordable broadband available to all Americans. In addition, the Commission's actions are intended to promote fiscal responsibility, require accountability, and transition to market-driven and incentive-based policies. The Commission does not want to eliminate universal service support for communications services in high-cost areas; rather, the Commission wants to improve the efficiency and effectiveness of that

support.

The FCC proposes specific, near-term steps that it believes will accelerate broadband investment and set high-cost USF support and ICC on a path that is consistent with these principles. Alternatives for completing the reform process over the longer term are discussed in broader terms, but generally build on National Broadband Plan recommendations. The Commission commits in the Notice to work with state regulators to achieve "shared goals" and to avoid "flash-cut" changes to its policies.

ICC Reform: Near Term Proposals

The Notice recognizes four (4) fundamental problems with the existing ICC scheme, as follows:

- The system is based on outdated concepts and a per-minute rate structure from the 1980's that no longer matches industry reality.
- Rates vary based on the type of provider and where the call originated, even though the function of originating or terminating a call does not change.
- Because most ICC rates are set above incremental cost, they create incentives to retain old voice technologies and engage in regulatory arbitrage for profit.
- Technological advances, including the rise of new modes of communications such as texting, e-mail, and wireless substitution have caused local exchange carriers' compensable minutes to decline, resulting in additional pressures on the system and uncertainty for carriers.

In the near term (not defined), the Commission's reform efforts for ICC will focus on reducing inefficiencies and waste by curbing arbitrage opportunities. More specifically, the FCC proposes to establish an ICC framework for interconnected VoIP traffic; revise the FCC's rules to avoid phantom traffic; and reduce access stimulation.

ICC for Interconnected VoIP. In the Notice, the Commission makes no specific proposals regarding ICC for interconnected VoIP traffic. Rather, the FCC seeks comment on whether interconnected VoIP traffic should be subject to the same ICC charges - intrastate access, interstate access, reciprocal compensation - as voice telephone traffic; bill-and-keep; or a compensation scheme that is specific to interconnected VoIP. The Commission also asks commenters to address whether providers of interconnected VoIP should be obligated to pay ICC now or as part of a future glide path. The Commission makes no attempt to classify interconnected VoIP services as telecommunications services or information services.

Phantom Traffic. To remove the incentives to misidentify the source of traffic so as to avoid or reduce payments to the terminating service provider - so-called "phantom traffic" - the FCC proposes to require the inclusion of appropriate signaling information for all voice traffic, including interconnected VoIP. However, the proposed rules are not intended to affect existing agreements between service providers on how to "jurisdictionalize" traffic.

Access Stimulation. The FCC also proposes and seeks comment on rules to redress access stimulation - an arbitrage scheme to game ICC rates by inflating traffic volume to maximize revenue. Under the proposed rules, carriers that have entered into a revenue-sharing arrangement would be required to refile their interstate switched access tariffs to reflect a low rate that is consistent with their volume of traffic.

ICC Reform: Long-Term Framework

Per the Notice, the Commission's long-term approach to ICC will be consistent with the exchange of traffic on an IP-to-IP basis. Since the FCC believes that per-minute charges are inconsistent with peering and transport arrangements for IP networks (where traffic is not measured in minutes), the FCC's preferred long-term solution is to move away from per-minute rates. But beyond that, the Notice is short on specific proposals for long-term rate reform. Instead, the Commission seeks comment on different alternatives for various rate-related aspects of the ICC framework, *e.g.*:

- *Compensation methodology*: should the end-point for comprehensive reform be bill-and-keep, flat-rate charges, or something else?
- *Federal/state role*: should the Commission and the states act within their existing roles in regulating ICC (i.e., FCC restructures interstate access charges, while the states restructure intrastate access charges), or should the FCC unify all intercarrier rates, including rates for intrastate calls, under the reciprocal compensation framework in sections 251 and 252 of the 1996 Act?
- *Cost-based v. revenue-based recovery*: should the mechanism (if any) whereby carriers can recover reduced ICC be cost-based, revenue-based, or some combination thereof?
- *Recovery benchmarks*: what tools (e.g., rate benchmarks, imputation of benchmark revenues) should be used to ensure that recovery from end users is reasonable?
- *Interstate subscriber line charges*: what is the role (if any) of the interstate subscriber line charge - a flat rate end user charge for the interstate portion of the local loop -in ICC going forward?
- *Recovery from USF*: what criteria should be applied to determine whether a provider qualifies for explicit universal service support for ICC cost or revenue recovery?
- *Recovery considerations for rate-of-return carriers*: what specific recovery considerations should apply to rate-of-return carriers?

The Commission also seeks comment on certain technical issues related to ICC reform, including the legal and technical framework for IP-to-IP interconnection arrangements for the exchange of VoIP traffic; points of interconnection ("POI") and network edge issues; transiting; disputes regarding the rating and routing of traffic; and the appropriate ICC regime applicable to virtual central office code calls to distant ISPs. Finally, the FCC asks for comment on the effect of its proposed reforms on existing interconnection agreements, commercial agreements, and tariffs.

Reform of High-Cost USF Support: Near Term Proposals

The FCC proposes four (4) specific priorities for the federal universal service high-cost program:

- Preserve and advance voice service.
- Ensure universal deployment of modern networks capable of supporting necessary broadband applications as well as voice service.
- Ensure that rates for broadband service are reasonably comparable in all regions of the nation

and that rates for voice service are reasonably comparable in all regions of the nation.

- Limit the contribution burden on individuals.

As an initial matter, the FCC seeks comment on several overarching topics concerning high-cost support for universal service, including the role of the states in reforming the high-cost components of USF; whether eligibility requirements for carriers who receive high-cost support ("eligible telecommunications carriers" or "ETCs") should be modified or eliminated; and the public interest obligations that should be imposed on ETCs. Most notably, the Commission proposes that all ETCs be required to provide "voice telephony service" as well as broadband service that meets or exceeds minimum metrics prescribed by the FCC (not specified). With respect to broadband service obligations, the Commission asks whether ETCs should be subject to service, coverage, and deployment requirements, as well as requirements to offer service in rural areas at rates that are affordable and reasonably comparable to rates in urban areas. All public interest obligations on ETCs would be technology-neutral.

With respect to current high-cost funding mechanisms, the FCC identifies several major flaws:

- Carrier subsidy programs institutionalize outdated support strategies and fail to incentivize recipients to invest and operate efficiently.
- Funding supports operations in areas that are already adequately served.
- High-cost support may be provided to multiple providers in a given service area where other unsubsidized facilities-based carriers are currently providing service.
- Current funding strategies fail to transition American households to broadband.

In the near term - with target dates beginning in 2012 - the FCC proposes to reformulate specific high-cost support elements, and transition certain support components into a new Connect America Fund ("CAF"). Current high-cost support programs will continue (albeit revised) and run concurrently with this "Phase I" of CAF.

Rationalize existing high-cost support programs. In the Notice, the Commission proposes to reduce or eliminate certain existing high-cost support funding elements, as follows.

- Reduce high-cost support rates; cap support on an interim per-line basis (barring exceptional circumstances); and set benchmarks for reasonable reimbursement. It is proposed that local switching support ("LSS") either be phased out entirely or combined with high-cost loop support ("HCLS") into a new local high cost support fund.
- Eliminate or limit support for corporate overhead expenses and "safety-net" funding.
- Eliminate the identical support rule and rationalize support for competitive eligible telecommunications carriers ("ETCs") so that the Fund supports provider commitments over a larger unserved area rather than multiple providers in fewer unserved areas.
- Establish benchmarks for reimbursable operating expenses ("opex") and capital expenditures ("capex") to encourage efficient carrier spending.
- Phase out Interstate Access Support ("IAS").

- Revise study area protocols to encourage consolidation and rationalized operating territories; streamline the study area waiver process.

Initial CAF Funding. During Phase I, funding for CAF support would come from the savings that would result from revisions to existing high-cost support components. It is proposed that initial total CAF funding be set at a specific amount (\$500 million - \$1 billion). The FCC seeks comment whether to (a) transfer all savings from high-cost fund modifications into CAF or (b) use some part of the savings to reduce the overall Fund size and lighten the burden on consumers.

CAF Support Recipients. During Phase I, funding would be available for wireline or wireless carriers, which may partner with other carriers, including satellite broadband providers, to cover gaps. It is proposed that satellite providers not be permitted to submit bids for funding except in a supplemental partnering capacity, to focus limited satellite broadband resources on the most expensive areas to serve. For each area, there will be a single CAF recipient, which could but need not be an incumbent provider. A variant proposal would grant the voice carrier of last resort a right of first refusal to serve as the broadband provider of last resort.

CAF Funding Award Methodology. The FCC proposes to award initial CAF funding via use of "reverse" auctions. The auctions would occur in 2012 and possibly again in 2014. Funding would be technology neutral (including voice-over-internet-protocol services) and awarded to the lowest bid for coverage of an area. Recognizing that funds will be insufficient to target all unserved areas, the recipient selection would target areas which can be served at the lowest cost, resulting in maximum coverage of unserved housing units (rather than coverage of the most expensive and difficult-to-serve units). Additional elements include required disaggregation of support within study areas starting in 2012 and adoption of methods to incentivize states to collaborate.

CAF Distribution and Implementation Issues. The FCC proposes that the Universal Service Administrative Company ("USAC") administer the CAF. It is proposed that a speed of 4 Mb/1 Mb be required and that supported carriers commit to a 3-year build-out with continuing operations for five (5) years in each area for which they are funded.

In connection with its proposals, the FCC seeks comment on the appropriate pace at which to proceed with each element; whether proposed support levels should be higher or lower; and whether there are alternative approaches which would better serve overarching Fund goals. In addition, the Commission requests comment on the following issues:

- The appropriate basis for calculating support, and workable criteria for carriers to demonstrate exceptional need.
- Criteria for awarding support, including whether exceptions should be adopted for tribal lands (and other traditionally set-apart areas), and how to integrate these exceptions into the mainstream funding process.
- Technical requirements and parameters for proposed broadband services; build-out timeframes; post-completion service obligations; enforcement strategies and liability for carriers failing to complete a funded build-out.
- Estimated impact of the proposed reforms on carrier operations, in particular on the ability of rate-of-return carriers to achieve their authorized return; whether the Commission should revisit the currently authorized return rate.

- Wireless carriers' assertion that the proposed restriction of support to at most one mobile provider in each area will result in technical incompatibility problems for roaming.
- Strategies to motivate states to collaborate in the implementation of this program; whether funding should be steered towards states which have already been proactive in access rate reform and broadband expansion; whether in the near-term funding should be restricted to states that undertake such participatory action.

Finally, the FCC proposes a variety of measures to increase accountability and better track performance of the Fund as a whole. The Commission's proposals include performance goals and measures; reporting requirements for Fund recipients; certification requirements; and audit processes.

Reform of High-Cost USF Support: Long-Term Framework

In the long term, the Commission proposes to transition all remaining high-cost funding to the CAF. The CAF would provide support for broadband, with voice provided as an application over broadband networks. The Notice solicits comment on various longer-term options for providing support to rural areas. Under one option, all support would be awarded through a competitive, technology-neutral bidding mechanism. Under a second option, the Commission would award support via competitive bidding in a particular region only if the current voice carrier of last resort refuses to serve as the broadband provider of last resort for an ongoing amount of support based on a cost model. Under these approaches, all ongoing support for carriers operating in high-cost areas would come from the CAF; CAF funding would replace all explicit high-cost support as well as all implicit subsidies from ICC. In the alternative, the FCC asks whether right-of-first refusal or auction-based support should be limited to a subset of geographic areas, such as those served by price cap companies, while continuing to provide ongoing support based on reasonable actual investment to smaller, rate-of-return companies.

Issues Presented

The proposals made by the Commission in the Notice present many controversial issues that are likely to be hotly debated in the comments, such as:

- Does the Communications Act give the FCC sufficient authority to preempt the states and unify all intercarrier rates, including rates for intrastate calls, under the reciprocal compensation framework in sections 251 and 252?
- If the FCC does not assert control over ICC for intrastate calls, how can the FCC incentivize the states to restructure intrastate access charges, and what should the FCC do where states refuse to adopt the federal model?
- For high-cost areas, with low prospects for unfunded service providers, does the single funded provider model protect consumers against rate leveraging?
- What is the legal basis for giving a right of first refusal to an incumbent carrier and how does the Commission reconcile this position with theories of competition?
- How can the Commission limit the eligibility of satellite service providers for high-cost funding consistent with its position that high-cost support should be technology neutral?

For further information on the NPRM, please contact your usual Kelley Drye [Communications](#) attorney.