Davis Wright Tremaine LLP

FCC Proposed Intercarrier Compensation Reforms

02.15.11

By Christopher W. Savage

In its Feb. 9 Notice of Proposed Rulemaking (NPRM), the FCC announced a variety of proposals to reform the existing system of intercarrier compensation (ICC). ICC includes both interstate and intrastate access charges (which are fees typically imposed by local exchange carriers (LECs) on interexchange carriers (IXCs) for originating and terminating long distance calls) as well as reciprocal compensation, which is the system under which LECs pay and receive compensation for terminating (but not originating) local traffic, ISP-bound traffic, and other traffic not subject to pre-1996-Act access charges or other specific payment arrangements.

Over the long run the FCC wants to eliminate all existing per-minute ICC payments and replace them either with a bill-and-keep (no payment) system, or a system in which payments are flat monthly amounts based on bandwidth, not minutes of use. In the short run, the FCC proposes certain steps to deal with some significant industry ICC problems, including resolving disputes regarding what rules apply to traffic to and from interconnected Voice-over-Internet-Protocol (VoIP) service providers, dealing with “phantom” traffic, and problems arising from so-called “access stimulation” arrangements. The FCC’s proposed long-run changes would be adopted in coordination with its adoption of a “Connect America Fund” (CAF) to replace the existing system of High-Cost universal service support.

Overview

The FCC correctly recognizes that ICC reform and Universal Service Fund (USF) reform are linked. The linkage is three-fold. First, to the extent that some carriers, particularly high-cost rural carriers, rely on ICC revenue to cover costs, the ICC system functions as a supplemental high-cost USF system. Second, to the extent that carriers derive significant revenues from ICC—whether “legitimately” based on cost, or as a result of access stimulation arrangements—those carriers will be reluctant to transition away from traditional circuit-switched network arrangements to broadband/IP-based networks. Third, as VoIP grows in prominence, the lack of clarity regarding the application of ICC obligations to interconnected VoIP traffic is producing controversy in the industry that may also detract from an orderly conversion to broadband/IP-based networks and their interconnection. As a result, the FCC proposes a variety of changes to the current ICC system, based on its desire to smooth the industry transition towards all-broadband, all-IP networks.

As the FCC recognizes, ICC rules, precedents, and physical networking arrangements are extremely complex, with very different payment obligations applying to nearly identical physical arrangements and services, depending on increasingly arbitrary regulatory classifications. For example, in some cases a carrier delivering a minute of traffic to another might be obliged to pay a high per-minute rate (e.g., a long distance carrier delivering an intrastate long distance call to a small rural local exchange carrier (LEC)); in other cases the carrier delivering a minute of traffic might be entitled to ***receive*** a high per-minute rate (e.g., a competitive local exchange carrier (CLEC), that matches a high rural rate, sending traffic outbound to a long distance carrier); in still other cases no money would change hands (e.g., a long distance carrier delivering traffic to a wireless carrier for termination). The wide range of possible monetary outcomes for the same physical activity—handing off traffic to another carrier—creates business and regulatory uncertainty, distorts competition and investment incentives, and allows various arbitrage arrangements.

The FCC proposes a number of specific steps to deal with these problems over the long term. At the same time, the FCC recognizes that some LECs receive so much money from ICC that a system for continuing to provide funding to such LECs will be needed, both as a transition and possibly on a permanent basis. (The FCC calls this funding a “recovery” mechanism.) The FCC requests comment on all its specific ICC-related suggestions, on suggestions that other entities have made over the last several years, and on any other ideas that commenters may have. Thus, while the FCC’s preferences in the NPRM are in many cases very clear, at least formally the FCC remains open to additional considerations and arguments from affected industry members.

We discuss below the highlights of the FCC’s proposals. Given the extreme complexity of existing rules and networking arrangements, however, we would urge clients who either pay or receive intercarrier compensation under today’s rules to contact us for a careful review of their existing situation in order to assess whether, and how, the FCC’s proposals would affect them.

Authority to Act

Perhaps the most radical aspect of the FCC's discussion of ICC reform is its suggestion that under existing law, the FCC has the authority to dictate the levels of ***intrastate*** access charges. As a general matter the Communications Act grants authority over purely intrastate communications (such as a long distance call between Philadelphia and Pittsburgh or San Francisco and Los Angeles) to state regulators, and the FCC has long respected that division of regulatory authority. The FCC recognizes, however, that a large portion of current problems with the ICC system relate to the high level of intrastate access charges, particularly (though not exclusively) for small rural LECs. To deal with this situation, the FCC proposes to rely on the broad language of Section 251(b)(5) of the Act—relating to LEC reciprocal compensation obligations—to regulate intrastate access rates. The FCC's logic is as follows. First, by its terms Section 251(b)(5) imposes reciprocal compensation obligations with respect to ***all*** "telecommunications" traffic that a LEC exchanges with another carrier. This obligation is not limited either to jurisdictions (inter- versus intrastate traffic) or to types of calls (local, intrastate toll, interstate toll). So, following on the logic of a broad interpretation of Section 251(b)(5) in 2008, this provision on its face extends to intrastate access charges along with the "local" and ISP-bound traffic to which it has been traditionally applied.

Second, the FCC believes that this conclusion is bolstered by Section 251(g). This is a "grandfather" provision that preserves LEC access obligations and the right to receive access charges that existed under the 1982 decree breaking up the old Bell System, in effect at the time the 1996 Act passed, until the FCC issues rules that supersede those obligations. The FCC correctly points out that the old decree obligation to provide (and the right to get paid for) access services to long distance carriers applied to ***both*** interstate and intrastate access arrangements. It follows, according to the FCC, that when Congress authorized it to supersede those historical arrangements following passage of the 1996 Act, it necessarily granted the authority to set new rules for intrastate access charges.

State regulators are likely to strongly object to this broad view of the FCC's authority. The FCC's position, however—while indeed representing a radical departure from the past—is at least facially and reasonably grounded in the statutory language and the FCC's own recent precedent regarding the scope of Section 251(b)(5).

That said, the FCC also proposes an alternative approach under which it would work cooperatively with states to reform ICC arrangements, including intrastate access charges, with the states and the FCC operating within their own traditional jurisdictional spheres. Further splitting the difference on this issue, as part of its discussion of transitioning from the existing system, the FCC suggests an arrangement under which the states would be given some period of time (perhaps 4 years) to use their own authority to reform intrastate access charges, with the FCC standing ready to apply its more robust view of its own authority, described above, if the states do not act.

Proposed Long-Term Goal of ICC Reform

The FCC's high-level focus in this NPRM is reforming both the USF and ICC regimes to accommodate and encourage the transition to broadband, IP-based networks, within which traditional per-minute-rated voice traffic is but a small feature. Given this, the FCC believes that the preferred long-term goal for ICC is a bill-and-keep system, under which interconnecting carriers do not pay each other anything for the exchange of traffic. At a minimum, the FCC disfavors continued long-term reliance on per-minute charging arrangements. It notes that IP-based network interconnection is either bill-and-keep or based on flat monthly charges for a given amount of internetwork bandwidth. Significantly, if the FCC achieves its long-term goal of no per-minute charges, a wide array of existing problems and disputes—discussed below—will simply disappear.

As noted above, the FCC recognizes that some carriers may require long-term, continued support from the USF to reflect the loss of ICC payments. The FCC seeks comment on how such continued support should be structured. The key issues are (a) whether the support amounts should be based on some analysis of the affected carriers' ***costs***, or instead based on the amount of ***revenues*** those carries would lose as a result of the transition to the FCC's long-term plan; and (b) whether the payment of such "recovery" amounts to the affected LECs should be conditioned on the LECs taking certain actions, such as actually deploying broadband networks to serve customers.

Dealing with Current Controversy—Exchange of VoIP Traffic

The FCC notes that there is growing controversy about what compensation rules apply when carriers exchange traffic that originates or terminates with an interconnected VoIP service provider. It believes that such arguments are counterproductive and urges carriers not to engage in "self-help" while the NPRM is under consideration. At the same time, the FCC takes no firm stand regarding what to do about interconnected VoIP traffic during the transition to the

ultimate bill-and-keep system of interconnected broadband networks. Instead, it seeks comment on four major alternatives: (a) immediately impose a bill-and-keep system for VoIP traffic; (b) create an immediate obligation to pay some newly-crafted rate for VoIP traffic; (c) establish an obligation to pay some rate for VoIP traffic, but only as of some future time; or (d) immediately treat VoIP traffic under existing intercarrier compensation rules. Different industry participants will obviously have differing views as to which of these alternatives is the best solution.

- ***Dealing with Current Controversy—Access Stimulation***

Access stimulation occurs when a carrier with above-cost access charges offers services, or enters into a business arrangement with someone who offers services, that generate a lot of incoming traffic from end users. Typically the carrier shares incoming access revenues with the service provider. Examples include "free" conference calling, chat lines, and adult services. The problem with these arrangements, from an ICC perspective, is that the end users who call these "free" services create large payment obligations for the carriers who deliver their calls, without realizing (through per-minute charges or other end-user price signals) that the costs are being incurred.

The FCC does not expressly ban, or even necessarily condemn, all arrangements where the LEC receiving traffic shares its revenue with a service provider. However, the FCC proposes a variety of specific reforms to make it much more difficult to extract excessive interstate access revenue from long distance or other carriers by means of such an arrangement. The FCC's key idea is that whenever a LEC enters into a revenue-sharing arrangement based on its access charges, it will "trigger" a number of requirements determined by the LEC's specific regulatory situation:

- LECs that participate in the NECA pool (where access charges are set at an industry average level rather than based on a carrier's individual costs) must withdraw from it and set their own specific access rates. This will require carriers to acknowledge the expected high volumes of traffic and correspondingly lower per-minute costs of providing access.
- For a LEC that sets rates based on its own costs, payments to the underlying provider of the "stimulating" service would not count as costs.
- Carriers that already set their rates based on their own projected costs and revenues must refile their rates, taking account of the anticipated higher level of traffic (and thus, lower per-minute rates).
- Carriers that have set rates based on historical levels of cost and demand will have to change over to using projected costs and demand.
- CLECs that have set their access rates using a small (and high-cost) rural LEC's rates as a benchmark will be required to re-set their rates based on those of the former Bell company in their state or, if there is none (e.g., in Hawaii), based on the rates of the largest other telephone company in the state.
- LECs that have revenue-sharing deals in place will have to file tariffs with a longer pre-effectiveness notice period (no less than 16 days), which will signal to the FCC and the industry that particular scrutiny is warranted. Failure to meet this obligation would be treated as an unfair practice and subject the carrier to refund obligations.

The question of reforms to handle access stimulation is particularly affected by the question, noted above, regarding whether the FCC can assert authority to set intrastate access rates. Thus, while the FCC's specific proposals on this topic do not seek to displace state authority on this specific issue, the FCC's broad view of its own authority certainly applies here. It may well be that the idea of FCC preemption of states on this issue will become more prominent as the proceeding continues.

- ***Dealing with Current Controversy—Phantom Traffic***

"Phantom traffic" refers to traffic that a terminating LEC receives that does not contain enough data to allow it to be accurately billed. The typical problems are (a) lack of "CPN" (calling party number) in the signaling information received by the terminating carrier; and (b) a fictitious "CN" (charge number) that overrides the CPN data provided. The FCC proposes to require all carriers to include, preserve, and pass on this information to other carriers, regardless of the particular signaling method (SS7, old-style "multi-frequency," or IP-based) used.

While this proposal appears straightforward and sensible—and is, in our view, likely to be adopted—we expect implementation to be challenging for calls that traverse many carriers' networks from start to finish. It will likely be administratively or operationally challenging to trace back particular calls to determine at what point in the call path the required signaling information was dropped or altered. Thus, this proposal might actually lead to increases in the number of disputes between carriers regarding appropriate intercarrier compensation for these calls. That said, by establishing a clear rule requiring the handling of this information, those disputes may be subject to more prompt resolution than exists today.

Davis Wright Tremaine LLP

Dealing with Miscellaneous Current Controversies

The FCC notes that there are certain “open” issues that are logically affected by the overall ICC reform the FCC is discussing, and seeks further comment on them. These are: (a) potential FCC regulation of “transiting” arrangements and rates (that is, situations where a call “transits” one or more carriers between the originating and terminating carriers); (b) the application of the FCC’s “intraMTA” rule, under which traffic that originates or terminates with a wireless carrier is deemed “local” for ICC purposes if it stays within a Major Trading Area; and (c) the appropriate ICC treatment of “virtual” NXX arrangements, particularly relating to calls to ISPs.

Finally, the FCC notes that in the past it has considered establishing explicit regulations that would define the “edge” of a given network (for example, an incumbent local exchange carrier’s (ILEC) tandem switch) and requiring interconnectors to bear all their own costs in getting their traffic to that “edge.” The FCC seeks comment on how, and whether, that concept might apply in the case of interconnected IP networks.

The discussion above reflects a review of the portions of the NPRM that relate to ICC issues and that appear most significant. Two points bear emphasis. First, the FCC has made a variety of detailed suggestions and comments that are not included in the discussion above, but which may be monetarily significant to different entities depending on their particular situation. Second, the FCC has made clear that it is interested in hearing comments not only on its own specific proposals, but also on any other proposals that are relevant to these topics. Therefore, we emphasize that this proceeding can have potentially large monetary impacts on ***any*** party that either pays or receives significant amounts of intercarrier compensation. We stand ready to assist such parties in evaluating how the FCC’s proposals might affect them, and how and whether to participate in the proceedings on the NPRM.

Return to Executive Summary

This advisory is a publication of Davis Wright Tremaine LLP. Our purpose in publishing this advisory is to inform our clients and friends of recent legal developments. It is not intended, nor should it be used, as a substitute for specific legal advice as legal counsel may only be given in response to inquiries regarding particular situations.