

NEWS & COMMENTARY

ANALYSIS OF A CHANGING INDUSTRY

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FCC KICKS OFF CRUCIAL PROCEEDING IN LET'S MAKE A DEAL FASHION

Rural ILECs Asked to Pick One of Three Doors

In our last issue of *News & Commentary* (No. 0802), we attempted to set the stage behind the melodrama unfolding amidst the Federal Communications Commission's (FCC's) and Chairman Kevin Martin's attempts to bring closure to the continuing sagas of universal service and intercarrier compensation reform. In this follow-up edition, we summarize the Further Notice of Proposed Rulemaking (NPRM) issued by the FCC on November 5, addressing comprehensive reform for both. In our review, we highlight some key questions that, JSI believes, again give credence to the adage, "the devil is in the details."

It's Your Turn to Pick a Plan!

Harkening back to the days of the classic TV game show, "Let's Make a Deal," JSI can sense the presence of legendary host Monty Hall offering the audience mysterious prizes hidden behind three doors. Unfortunately, our prizes today include a couple of goats behind two of the doors, while behind the winning door is the grand prize: a brand new plan. Yes, the FCC has released three plans for comment: Chairman Martin's draft proposal, which he shared with the other commissioners in mid-October; a "narrow" universal service reform proposal; and, what's called the "Alternative Proposal," a modification of the chairman's draft plan that accommodates to a certain degree two *ex parte* presentations – one from a media/communications reform organization, Free Press, and the other from two telecom associations, OPASTCO and WTA.

JSI believes we don't need to spend much time on the "goats." Rather, the plan of interest – and our focus – is the "Alternative Proposal," or Appendix C of the NPRM. We note that the narrow universal service reform plan proposes to cap the overall size of the federal high-cost universal service fund and to adopt reverse auctions to distribute ILEC and CETC support within one year of the plan's adoption. Since JSI has long held that reverse auctions for all carriers is not in the public interest, we believe this goat of a proposal is merely a straw man designed to be knocked down with little effort. The fatal flaw would seem to be the FCC's proposal to use reverse auctions for all carriers within a year, which flies against overwhelming industry consensus that if the FCC were even to consider reverse auctions, it should explore their use and efficacy with wireless CETCs before considering their use for ILEC support. After all, this revolutionary concept *might not work* in preserving and advancing universal service – thereby, violating the clear direction given by Congress in the Telecommunications Act of 1996.

Door Number 3 – the Alternative Proposal

As noted, the Alternative Proposal is a modified version of Chairman Martin’s original plan that includes provisions advocated by Free Press and OPASTCO/WTA.

Purpose

One goal of comprehensive reform is to fix some of the problems in the current federal universal service program and intercarrier compensation regime. However, the purpose of the Alternative Proposal is to promote the deployment of broadband Internet access services to all areas of the nation. It is important to measure the details of the proposal against this purpose and ask whether this is the best way to achieve this goal.

Universal Service Reform

Broadband Internet Access Service Commitment

The first action proposed by the FCC is to have each ILEC decide whether it will commit to make broadband Internet access service available to all customers in its service area in five years. Not surprisingly, the first detail left undefined in the proposal is, “what is a customer?” Is the ILEC committing to serve all residents and businesses in five years – even those who are not the ILEC’s customers? Or, is the ILEC committing to serve all its current customers in five years? Or, perhaps, is the ILEC committing to serve all customers it may have in five years? The definition of “what a customer is” has significant implications for rural carriers.

While the FCC gives ILECs a choice, JSI would argue it’s really a Hobson’s choice; *i.e.*, no choice at all, for rate-of-return rural carriers. Not making this commitment triggers a reverse auction for the study area, and depending on the outcome of the auction, the ILEC may not receive high-cost universal service fund (USF) support from the existing federal program. Thus, we believe that many rate-of-return carriers will conclude they have no choice: They must make the broadband Internet access service commitment. Given the fact that failure to make this commitment will likely result in the loss of USF support that the FCC has proposed to be frozen at the study-area level (*see below*), one major issue not addressed in the Alternative Proposal is whether agreeing to the five-year broadband build-out commitment will result in future payments of frozen USF after the commitment period is over.

Since most, if not all, rate-of-return ILECs will likely make the commitment, it is important to understand what the responsibilities are – as well as the consequences if a company fails to satisfy this commitment. First, what it is: Broadband Internet access service is defined as 768 kbps download and 200 kbps upload speeds for all “customers within the study area.” If the cost to deliver this service is too high, ILECs may file a waiver with the FCC to request to provide this service *via* satellite technology. In addition, rate-of-return ILECs have a limited automatic waiver for *very* high-cost-loop customers; *i.e.*, customers whose additional cost to provide broadband service is greater than 150 percent of the study area average cost-per-loop can be automatically served by satellite. This limited waiver applies to only two percent, or less, of the ILEC’s total loops within a study area. Since the additional cost of providing broadband Internet

access service is compared with the total study area average cost-per-loop, we believe the “limited” automatic waiver is limited indeed: For example, if the carrier’s annual study area average cost-per-loop is \$450, the 150 percent threshold is \$675 additional cost-per-loop in order to receive the automatic waiver. This \$675 is in addition to the current cost-per-loop to provide voice-grade service. Thus, the loop must have a total cost of \$1,125 to receive the waiver. This example illustrates why we see this automatic waiver as *very* limited in the way it compares additional cost in providing the service to the study area average loop cost.

The FCC proposes “annual milestones” for ILECs during the five-year commitment. The FCC defines an “unserved customer” as either a residential or business customer located within the service area, again raising the issue of the definition of a customer, since it plays an integral role in the understanding of “customer locations.” The plan requires ILECs to be capable of providing broadband Internet access service to an additional 20 percent of their unserved customers by the end of each year of the five-year build-out. An ILEC that fails to achieve any one of these milestones will lose eligibility for support. The FCC will have the Office of Inspector General perform “milestone audits,” as necessary, to ensure its requirements are met. JSI notes the absence of any requirement to *repay* universal service funds in the event a milestone is not met. The loss of eligibility indicates a prospective, rather than retroactive, loss, yet this is little solace for ILECs facing the daunting challenge of meeting the milestones required under the commitment to be capable of providing broadband Internet access service to “customers” in a study area.

The FCC also details what happens in a study area where the ILEC will not commit to provide broadband Internet access service. In this case, the FCC would require a reverse auction to be held for the entire study area. If the auction failed to attract an ETC that will make the broadband service commitment, the ILEC would continue to receive frozen USF support pending the FCC’s evaluation, which could include raising the auction’s reserve price or dividing the study area into smaller segments. The auction winner, which must be an ETC, would be required to provide broadband Internet access service at specific tier levels and offer supported services at a retail price comparable to the retail price charged by the ILEC in that same study area for the same or equivalent service. Lastly, an auction winner has 10 years to build-out the milestones established by the FCC.

The broadband commitment scenarios lead to another unknown detail. Since there is no comparable price requirement for an ILEC’s broadband Internet access service, can the ILEC rate band its price for Internet access based on its cost to serve the customer? Since for most rural ILECs, this service is governed under an interstate tariff for rate-of-return carriers, will NECA offer rate-banded pricing based on the distance from the central office? The answer to this question may open an avenue in which ILECs may be able to offer broadband Internet access service to remote areas in a manner that accounts for the cost of serving remote areas of rural study areas.

Current Federal High-Cost Universal Service Support

The FCC proposes to freeze federal high-cost USF support on a lump-sum basis at the study-area level. This means there will be no need to identify support between the various high-cost

programs (*e.g.*, HCM, HCLS, IAS, ICLS, LSS). These programs will continue to exist for those jurisdictions exempt from this NPRM; *i.e.*, Alaska, Hawaii, and U.S. Commonwealths and Territories (*e.g.*, Puerto Rico, U.S. Virgin Islands, Guam, Northern Mariana Islands, and American Samoa). The study-area freeze for non-rate-of-return ILECs will be based on December 2008 annualized support amounts received. For rate-of-return ILECs, “all high-cost universal service mechanisms will continue to operate as they do today through 2010, and then will be frozen at that level.”

Another unresolved detail, JSI notes, is what it means to “continue to operate as they do today through 2010.” Does it mean that consistent with non-price-cap ILECs, support for rate-of-return ILECs will be frozen based on December 2010 annualized receipts? Or, is rate-of-return ILEC support frozen at annual 2010 levels? This detail is critically important for ILECs seeking to recover costs for investments underway now that will not be completed by year-end 2008. In addition, as mentioned above, another important and missing detail is whether or not a rate-of-return ILEC committing to the broadband build-out will be eligible to receive its 2010 frozen USF payments at the conclusion of the five-year period and beyond.

One proposed mechanism is certain: The FCC is eliminating support for CETCs operating in the Continental United States. The FCC will phase-down CETC support by 20 percent each year; after five years, CETCs will receive no support. The specific mechanism proposed by the FCC is that a CETC will be capped at the total amount it has received in the past 12 months. This move effectively shuts down any attempts for new CETCs (in the Continental U.S.) to obtain support and eliminates the interim cost support exceptions established by the FCC last May. (These exceptions allowed for CETCs to file their own cost support and for automatic exceptions for tribal lands and Alaska native lands.) The FCC seeks comment on an appropriate universal service mechanism(s) targeted on the deployment and maintenance of advanced mobile wireless services in high-cost and rural areas.

Broadband for Lifeline/Link up Customers

We have not devoted much time to the provisions proposed by the FCC regarding low-income programs for broadband Internet access service. Suffice to say, the FCC has established a pilot program designed to assist qualifying low-income households to receive support for broadband service. An amount of \$300 million per year for three years will be allocated to such assistance.

Universal Service Contribution Reform

The FCC also has addressed the collection method for universal service fund contributions as part of this comprehensive reform proposal. The FCC proposes to base the charge on “Assessable Numbers,” under which contributors will pay a constant, flat-rate assessment on the number of telephone numbers they have assigned to residential end-users. An assessable number is a telephone number that is “actually in use by end users for services that traverse a public interstate network.” While there are many proposed details related to how to count these numbers, we do not think that discussion contributes to our analysis for this article.

The FCC has proposed a flat-rate assessment of \$1.00 per residential number per month. Concluding that business customers should contribute based on connections to the network, the FCC seeks comments on how this should be done. In the meantime, business customers, including single-line businesses, will continue to contribute based on the current system of assessing a contribution factor on interstate and international revenues. The change for residential customers will occur January 1, 2010, giving the FCC time to set up the rules and forms necessary to make the change.

Intercarrier Compensation Reform

The FCC's proposal addressing intercarrier compensation is nothing short of revolutionary. In order to shore up its decision in the *ISP Remand Order*, the FCC now proposes to subject all telecommunications traffic to reciprocal compensation and to migrate existing interstate and intrastate access to a reciprocal compensation regime in ten years. Similar to the universal service reform described above, the proposed access reform is only for carriers in the Continental United States.

One consequence of the FCC's decision that all telecommunications traffic is subject to Section 251(b)(5) reciprocal compensation is that originating access charges and their corresponding revenue will disappear after ten years. Another major determination made by the FCC is that IP-PSTN traffic is classified as "information service." However, the FCC maintained the *status quo* for this traffic during the ten-year transition period. Thereafter, this traffic is subject to a reciprocal compensation regime. We note that the *status quo* for this IP-PSTN traffic is that it is not classified as either information service or telecommunications service. Thus, we are left to limp along with an undefined and growing segment of traffic in rural ILEC operations. Needless to say, this is not an ideal situation.

The FCC proposes a three-stage reform process:

Stage 1: Intrastate Terminating Access Rates Are Reduced to Interstate Terminating Access Rates

One year from the effective date of the order, all ILECs are required to reduce terminating intrastate switched access rates by 50 percent of the difference between their intrastate and interstate switched access rates. JSI notes that this directive assumes that the rate structures for both intrastate and interstate terminating access are the same. This is not the case for many ILECs, so the FCC will need to clarify how to accommodate differing rate structures.

Two years from the effective date of the order, all ILECs are required to reduce intrastate terminating switched access rates to match their interstate terminating access rates. ILECs must meet all state tariff requirements and other applicable state laws in making these changes. If an ILEC has intrastate rates lower than its interstate rates, it does not raise its rates to the interstate rate. In fact, this downward-ratchet approach is applied in every reform stage.

Within two years of the effective date of the order, states must adopt a statewide interim, uniform reciprocal compensation rate applicable to all carriers (except for those whose rates are already below this interim uniform reciprocal compensation rate).

Stage 2: Uniform Terminating Access Rates Are Reduced to an Interim Uniform Termination Rate Established by State Commissions

Upon reaching the three-year anniversary of the effective date of the order, all ILECs will reduce their terminating rates by 50 percent of the difference between their current terminating rates and the interim, uniform reciprocal compensation rate established by the state.

By now, you can probably guess what happens next. At four years from the order's effective date, all ILECs will reduce their terminating rates by the remaining amount to match the uniform interim reciprocal compensation rate. This interim rate is the starting point for the next stage.

Stage 3: Terminating Access Rates Are Reduced to End of Transition Rates

This stage sees a gradual downward transition to a final uniform reciprocal compensation rate, which will be set by the states according to a new additional cost standard called multiproduct incremental cost (MIC). MIC is designed to capture only the additional traffic-sensitive cost for termination. By its design, this rate will be very low and will not have any allocation of shared or common costs that are allowed under the now familiar TELRIC-based pricing methodology. States will have discretion to determine the downward glide path required to reach their final uniform reciprocal compensation rate.

Transition's End

At the end of the ten-year transition, all non-exempt ILECs will have terminating reciprocal compensation rates set by the states according to the MIC pricing methodology. The FCC seeks comment on how best to reduce and then eliminate originating access rates. The FCC has determined that at the end of the transition stages, all originating access rates and corresponding revenues will cease and reciprocal compensation shall apply to all telecommunications traffic, including IP-PSTN traffic.

Subscriber Line Charge Increases

With the reductions in intrastate and interstate access rates and corresponding revenues, the FCC proposes that federal Subscriber Line Charge (SLC) caps increase to help offset revenue losses ILECs will face. SLC caps for residential and single-line business customers increase to \$8.00 from \$6.50 per month. The cap for non-primary-residential lines (a price-cap rate) increases to \$8.50 from \$7.00. And the multi-line business SLC cap increases to \$11.50 from \$9.20.

Limitations on Suspension and Modification of Reform Measures

The FCC has placed limits on the ability of carriers to seek suspension or modification of its Section 251(b)(5) reciprocal compensation rules put in place by the FCC's comprehensive reform efforts.

Supplemental Federal Universal Service Support for Interstate Rate-of-Return ILECs

Interstate rate-of-return ILECs are faced with a special situation because of the nature of how they are regulated. Acknowledging that, the FCC has agreed with a provision proposed by OPASTCO/WTA to provide supplemental universal service support only for those ILECs under rate-of-return regulation in the interstate jurisdiction. The supplemental program consists of two components: First, the FCC will provide compensation for "revenues lost as a result of the mandated reductions in intercarrier compensation rates that are not otherwise recoverable through increases in SLCs." This provision includes lost terminating access revenue and recovery of originating access revenues lost due to the FCC-mandated elimination of these rates. JSI fears that despite this language, the FCC may not be able to guarantee that ILECs will receive dollar-for-dollar support for all access revenues lost due to the mandated reductions in switched access rates.

The second component of the supplemental support is available only to those carriers making the commitment to the five-year broadband build-out and is intended to ensure that those rural rate-of-return ILECs continue to have an opportunity to earn their authorized interstate return, subject to an escalating funding cap. This component is designed to recover revenue losses resulting from declines in access lines and interstate and intrastate minutes of use and is scheduled to last five years. The FCC also notes that it will review this component of supplemental support to ensure that it works as intended.

Transport Rules

After the ten-year transition period, the FCC proposes to establish a set of default rules regarding network "edges." These rules largely arise from AT&T's edge proposal that was discussed at length and parts of which were included in the Missoula Plan. The rules are designed to establish rural ILECs' responsibilities to deliver originating traffic to their network edge.

Proper Billing Reforms

To provide mechanisms for proper billing, the FCC has proposed measures to ensure correct billing information is being provided to the terminating carrier. Especially notable is the provision that a transit carrier (tandem provider) which passes along traffic that is not identified or "lacks any of the signaling information required by [the FCC's rules as amended by this order], or that does not otherwise provide the required call information, for example by providing an industry standard billing record, to the recipient, must pay the terminating service provider's highest termination rate in effect at the time the traffic is delivered to the terminating service provider." With this clear statement, the FCC has signaled a significant victory for rural carriers contending with phantom traffic. This also suggests to JSI that the transit/tandem carrier is obligated to provide this information and should not be able to charge for this information.

Do We Want What's Behind Door Number 3?

We realize this article is lengthy and detailed. However, we believe that this information is necessary for you to make an informed decision about the FCC's proposed actions and how it will affect your business. The Alternative Proposal includes no shortage of issues of significant consequence for rural ILECs. We urge caution and detailed examination of the proposal to make sure what's behind Door Number 3 does not turn out to be a goat!

In the end, what should you make of this proposal? According to Chairman Martin, there is almost no chance that it will come up for a vote in December, and he is the one who sets the agenda! There is a possibility that the proposal could come to a vote in January, but still the likelihood for this is less than half. At this time, the best prospect for this proposal is that it sets the table for further discussions in 2009. We encourage you to participate fully in this process, contacting your associations and explaining your particular concerns.

For more information about this article or if you have questions about the FCC's NPRM or its provisions, contact Manny Staurulakis (mstaurulakis@jsitel.com) in JSI's Maryland office, at 301-459-7590, or Douglas Meredith (dmeredith@jsitel.com) in Utah, at 801-294-4576.

MANAGEMENT CHANGES IN JSI'S MINNESOTA OFFICE GORDON DAUCHY ASSUMES RESPONSIBILITY AS JIM HOWARD RETIRES

With thoughts of both looking back in fond remembrance and looking forward with confidence and assurance, JSI calls clients' attention to a management change in our Minnesota office and notes a significant milestone in the company's history. After almost 30 years of dedicated service, Jim Howard has announced his retirement at year-end. Jim served JSI clients honestly and faithfully, distinguishing himself by the insightful counsel and assistance he provided to all with whom he worked. While Jim's role will be changing, he will be retired but not forgotten. We are pleased to add that Jim will continue to serve JSI and clients in an advisory capacity.

Wishing to take advantage of Jim Howard's experience and effect a seamless transition, Gordon Dauchy has assumed the leadership responsibilities in the Minnesota office. A key member of the JSI team for more than 20 years, Gordon is well known in industry circles in the Midwest, working closely with clients, state and regional associations, and other groups. In addition, he has worked with and contributed to the activities of regulatory agencies, NECA offices, and state PUC staff on such critical issues as access and USF reform, rate rebalancing, switching and network planning, and pricing. Under Gordon's leadership, JSI is confident that the Minnesota staff will maintain its focus on each of our client relationships.

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As this issue of our newsletter indicates, events are reaching a boil for JSI clients. Thus, it's critical for you and other key staff to stay abreast of developments. Are there others at your company that should be getting the *JSI News & Commentary*? Has your e-mail address changed since our last issue? We try to keep our database accurate, but things change. If we do not have your correct e-mail address, or if others at your company may also like to receive our newsletter *via* e-mail, please complete the following information and fax it back to us, at 301-577-5575, or simply use the e-mail link to provide the information directly.

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