John Staurulakis, Inc.

NEWS & COMMENTARY

ANALYSIS OF A CHANGING INDUSTRY

No. 0704
October 30, 2007

GLUTTONY, ONE OF THE SEVEN DEADLY SINS, RAISES ITS HEAD IN IOWA; COULD HAVE ALL ILECS REACHING FOR THE ALKA SELTZER

When Dante Alighieri penned his Italian classic *Commedia*, known to most of us as *The Divine Comedy*, he described the Third Circle of Hell as the place where gluttons could be found, guarded by Cerberus, a three-headed dog. Fortunately for the rural incumbent local exchange carrier (ILEC) industry, tales of economic gluttony are rare, mitigating the need for the posting of guards, whether by means of three-headed dogs or by increased regulatory scrutiny. Thus, it was shocking and embarrassing to pick up the *Wall Street Journal* on October 4 and read of certain goings-on in Iowa. The *Journal* described the now-notorious practice of "traffic pumping." In the interstate access arena, the alleged gluttony arises from a filing process for rate-of-return carriers with less than 50,000 access lines under Section 61.39 of the FCC's rules, known as "historic filing." In this edition of *JSI News & Commentary*, we take a look at the recent controversy – and its consequences on all rural ILECs.

Historic filers base their interstate access rates for the upcoming two-year period on costs and demand for the most recent, complete study year. Small ILECs using either cost or average schedules are allowed to use the historic filing process. Cost companies base their revenue requirement on their most recent annual interstate toll cost study. Average schedule companies base their revenue requirement on the average-schedule settlements either actually received from the National Exchange Carrier Association (NECA), in the case of carriers exiting a NECA pool, or on what they would have received in settlements had they been in the NECA pool, for carriers having previously exited a NECA pool. Carriers exiting the NECA pool with the apparent intention of traffic pumping file switched access rates using the historic filing process.

Rosebud: What Is Traffic Pumping?

With rates set on historic cost and demand, significant increases in volume *without* corresponding increases in costs generate earnings <u>significantly in excess of</u> what would be required to realize a *fair* rate-of-return. Moreover, historic filers essentially "bill-and-keep" their access revenues and have no prescribed duty to report or refund over-earnings. Thus, a potential economic feast is laid before those ILECs that would be tempted to gluttony. As Orson Welles said in his later, stouter life, "Gluttony is the sin you cannot hide."

As the *Wall Street Journal* recounted, the recent traffic-pumping activity was so markedly excessive that affected interexchange carriers complained to the Federal Communications Commission (FCC) and filed petitions against the June 30, 2007, annual tariff filings of all ILECs exiting the NECA Traffic Sensitive pool. In response, the FCC suspended, on its own motion, all such filings. To have the investigation lifted, these LECs had to either reenter the NECA pool (six carriers did so) or file regulations in their tariffs committing to revise their rates in the event that actual demand for any month more than doubled in comparison to the same month in the preceding year. At first glance, making allowance for a 100 percent increase in traffic might seem unusually generous of the FCC; however, the traffic pumping the FCC hoped to arrest has in some cases produced increases in demand as high as 1,000 percent over the historic period on which the rates are based.

It is JSI's view that the FCC's Section 61.39 historic filing process is a critically important option for ILECs. In the recent annual filings, the majority of average-schedule carriers exiting the NECA pool did so to avoid significant reductions in revenue that would have resulted from recent modifications NECA made to the average schedules. Moreover, in the case of average-schedule carriers making historic filings in JSI's FCC Tariff No. 5, their company-specific rates are for the most part less than the corresponding NECA rates, effective June 30, 2007.

Will the FCC Proscribes a Bitter Diet for All?

Notwithstanding that the majority of historic filers are not associated with any traffic-pumping schemes, the gluttonous gorging of a few are risking both the erosion of tariff filing options and the addition of onerous burdens to those options. On October 2, the FCC issued a Notice of Proposed Rulemaking (*FCC 07-176*) regarding its existing access-charge rules and proposed changes designed to curb the excesses in the rural industry. To our thinking, it is lamentable that the FCC would propose such drastic and widespread action to curb what obviously are exceptions to the usual and customary practices of rural ILECs throughout the nation. Nevertheless, the Notice is out for public comment and some proposals, if adopted, will affect all rural carriers. Below we provide a brief review of the information the FCC has asked for in public comments. We hope it will serve to motivate clients to urge your associations and other representative groups to become active in this rulemaking process. Among the issues on which the FCC seeks comment are:

- how chat lines, conference bridges, help-desk provisioning, and other similar high call volume operations are provided and how compensation occurs between the involved parties – the FCC tentatively concluded that it must revise its rules to ensure that tariffed rates remain "just and reasonable even if a carrier experiences or induces significant increases in access demand";

- the cost recovery of investment and expenses – specifically, the FCC asked for response to the issue that charging an average rate beyond the level of demand used to determine the switching rate will cause profits (or return) to rise to the point of excess, or beyond a just and reasonable level;

- revenue sharing or other forms of compensation used by rural carriers to attract high-volume terminating customers to their service territory – the FCC focused particular attention on whether the revenue sharing "expenses" are included in the carrier's revenue requirements;

- modifying tariff language to ensure that if access demand exceeds the demand used to calculate the tariff rate by a certain percentage, the access carrier must file a revised tariff within a specific timeframe;

- whether NECA pool members have an incentive to engage in "traffic stimulation" – thus extending its request for comments to those carriers in the NECA Traffic-Sensitive pool;

- proposals to require Section 61.39 carriers to include a certification with their tariff filings – this certification would affirm that the carrier is not engaging in traffic stimulation and will not do so during the tariff period; and

- possible changes to Section 61.39 rules by requiring carriers to elect either to file indefinitely as an historic filer or to remain an historic tariff filer for a given number of tariff cycles (the latter option is perhaps the least onerous for existing historic 61.39 filers and would likely reduce or eliminate the traffic-pumping incentive because a carrier that stimulates traffic in the first tariff cycle would then be forced to adjust its rates for the later cycles using its then-historic high-volume traffic) – the FCC also suggested eliminating the 61.39 option from its rules and requiring all carriers to file under Section 61.38 rules under which a carrier files tariffed rates based on its projected costs and demand and targets its rates to earn an 11.25 percent return.

It appears to JSI that with its proposal to modify the filing of Section 61.39 carriers or requiring all carriers to file under Section 61.38 prospective filing procedures projections, the FCC is trying to mitigate the lack of prescriptive power over rates created by the adoption by Congress of the Section 204 streamlined tariff process. With that measure, interstate access rates are deemed lawful if filed on 15-day notice for increases and decreases and 7-day notice for decreases only.

Further Chipping Away at the Access Charge System

All these issues are weighty and require a thorough vetting. JSI will continue to participate in these deliberations and encourages clients to become actively involved in the process under way at the FCC regarding access tariffs. The decisions made by the FCC in the aftermath of the traffic-pumping controversy will have an impact on ILEC operations. Replying to the petitions for the suspension of this year's tariff filing, JSI explained, among other things, the history of JSI's FCC Tariff No. 1 and the benefits of the existing Section 61.39 historic filing process. (Clients that would like a copy of JSI's reply should contact Scott Duncan [sduncan@jsitel.com] in JSI's Maryland office, at 301-459-7590.)

To conclude this woeful tale, JSI observes that the whole debacle regarding access minutes and access charges further illustrates the weakness in the per-minute access charge regime. While

we are not suggesting an immediate change in the current regime – the Missoula Plan is far too fresh a memory to suggest such a sea change right now – JSI points out that the long-run thinking in the Missoula Plan, with its approach to access services based on capacity, rather than minutes, would go a long way to avoid the concerns raised by the FCC in its Notice.

JSI will continue to monitor this issue, and we will update clients in broadcast e-mails as well as upcoming issues of *News & Commentary*. If you have any questions or comments about the information in this article or would like assistance in filing comments with the FCC on the matter, please contact Manny Staurulakis (mstaurulakis@jsitel.com) or Scott Duncan (sduncan@jsitel.com) in JSI's Maryland office, or Douglas Meredith (dmeredith@jsitel.com) in Utah, at 801-294-4576.

WHEN IS A RULE NOT A RULE?
THE FCC'S USE OF REGULATORY FORBEARANCE TO ESTABLISH POLICY

We are familiar with the saying, "It is easier to ask forgiveness than it is to get permission," widely attributed to an otherwise little-known naval officer, Rear Admiral Grace Murray Hopper. From our vantage point, JSI might assert that it is perhaps fitting to use a quote from a relatively "obscure" author to introduce the heretofore relatively "obscure" regulatory practice of forbearance. However, given the recent spike in requests from carriers that the FCC "forbear" from its rules, JSI notes the increased reliance on asking for permission in regulation is motivated more by self interest than any attempts at being polite.

The Communications Act allows the FCC to forbear from applying "any regulation or any provision of the Act to a telecommunications carrier" if it makes certain threshold determinations. Under forbearance, the FCC agrees to suspend application of a requirement of its rules; a good example is when there are sufficient alternatives provided by other technologies that rate regulation is no longer necessary, and a carrier may need greater flexibility in the rates, terms, or conditions applicable to individual customers. In such a case, the FCC would forebear from applying its rate development rules and tariff filing rules. With such forbearance, the carrier has total freedom to set rates, terms, and conditions under individual or generally available service agreements and prices. In turn, the carrier can respond better and more quickly to competitive pressures. Without explaining the details of the FCC's forbearance authority, we note there are several areas in which forbearance petitions have surfaced recently. In this article, we review these areas briefly and attempt to draw a conclusion about use of these petitions by the FCC to regulate in a dynamic telecom environment.

IP Services Petition

In an October 23 filing, a group of VoIP and Internet service/application providers requested that the FCC forbear from requiring them to pay access charges for VoIP services, so-called voice-embedded Internet communications, when these services are carried, and most likely terminated, on the public switched telephone network (PSTN). Further, the petitioners asked the FCC to refrain from setting any automatic triggers that would require a change in the $0.007 per-minute-of-use rate established by the FCC in its April 2001 ISP remand order. In the crux of its

argument, the group claimed immediate, but minimal, action, is necessary to ensure unfettered use by consumers of existing voice-embedded Internet-based communications services and to promote the unhampered expansion of applications employing new Internet-based technologies.

Thus, the petitioners sought FCC agreement that "all IP-PSTN and incidental PSTN-PSTN traffic exchanged by a LEC and [providers of IP services] within the same LATA as the PSTN end-user would be exchanged on a 'minute-is-a-minute' basis" over local interconnection trunks, rather than access trunks. Further, the group asked that the triggers established in the ISP remand order be set aside for this type of traffic. One possible implication of this petition is that rural ILECs may not be able to charge access to the members of the petitioners' group for intra-LATA calls they terminate. Naturally, this would have serious consequences for rural ILECs' access revenues as voice traffic increasingly relies on new technology for call completion. JSI reminds clients that the FCC indicated it would address the applicability of access charges to VoIP traffic in its IP-enabled services NPRM released in 2004 – an issue that is still pending before the FCC.

Verizon and AT&T Petition

In 2004, Verizon filed a petition for the FCC to forbear from applying Title II and *Computer Inquiry* rules to certain broadband services, and it was deemed granted on March 20, 2006 by operation of law, without discussion by the FCC. The Verizon request was "deemed" granted because the FCC failed to act within a specific time limit. Subsequently, congressional hearings recently revealed that the FCC did vote on the Verizon petition, and it resulted in a 2-2 tie. The affected parties are now arguing the case in the U.S. Court of Appeals, contending that under a common law interpretation, a tie retains the *status quo* and, thus, the petition should have been deemed denied by failing to achieve the majority required to change the *status quo*.

The court drama aside, on October 11, 2007, the FCC granted a "me-too" petition filed by AT&T. The FCC held that AT&T would no longer have to comply with dominant carrier tariff-filing, cost-support, discontinuance, and domestic transfer-of-control regulations. In addition, AT&T would be relieved of certain *Computer Inquiry* requirements, with respect to the company's non-TDM-based, packet-switched services capable of transmitting 200 kilobits per second or more in each direction, and its non-TDM-based, optical transmission services. AT&T's forbearance applies only to current service offerings and to those services listed in the petition; AT&T remains subject to the *Computer Inquiry* regulation imposed on non-incumbent, facilities-based, wireline LECs. AT&T must also continue to comply with Title II public policy obligations, such as those related to E-911 service, emergency preparedness, customer privacy, and universal service. Further, the FCC-imposed conditions approving the AT&T-BellSouth merger remain in effect. To no one's surprise, the FCC's grant of the AT&T forbearance petition has already been appealed and is currently under federal appeals court review.

ACS of Anchorage

Verizon and AT&T are price-cap carriers subject to an already reduced level of economic regulation. The FCC awarded its first major grant of forbearance to a rate-of-return carrier to ACS of Anchorage on August 20, 2007. The FCC granted only in part the petition for

forbearance from regulation for certain interstate access services, as well Title II regulation for its enterprise broadband services. In recognition of the greater challenges in granting forbearance to rate-of-return carriers, the FCC stated that "regulatory relief from pricing regulations presents difficult challenges in the rate-of-return context. These challenges must be addressed regardless of whether such relief from pricing regulation is adopted in the rulemaking or forbearance context to ensure that the relief does not have harmful consequences for ratepayers, as well as for universal service."

The partial grant of forbearance, with conditions, to ACS of Anchorage represents an interesting development in the regulation of rate-of-return carriers, JSI observes. It is the first time the FCC has applied forbearance on price regulation for a rate-of-return carrier in a comprehensive manner. In getting forbearance, ACS will be subject to both voluntary commitments advanced in its petition and additional conditions imposed by the FCC. JSI believes that some of these conditions are not appropriate for other rate-of-return carriers; for example, conditions such as removing the study area from the NECA Common Line pool, capping switched access rates indefinitely, and capping federal universal service support on a per-line basis. The extent to which this case can serve as a template for other rate-of-return carriers remains uncertain. Three parties, including ACS of Anchorage, have requested that the FCC's reconsider its order. Until this reconsideration is complete, we will not know exactly how the FCC will deal with rate-of-return-carrier issues with respect to forbearance. JSI is following closely the reconsideration of this case to determine how the FCC's actions may affect other rate-of-return carriers. Until the FCC's concern about properly accounting for costs is met, we will likely see conditions imposed on rate-of-return carriers seeking forbearance from price regulation directed at stopping any potential cost shifting to services remaining under rate regulation.

Inferences and Implications

These forbearance examples, JSI believes, also suggest a broader trend in federal regulation as well. For price-cap regulated carriers, the forbearance provision in the Act appears to be a useful tool to extract changes in regulatory policy from the FCC. However, recent congressional actions also suggest the forbearance process is either broken or severely damaged. Several members of Congress are seeking to remove the "deemed granted" provision from the Communications Act, motivated by the political concern that the "deemed granted" status of a petition has little if any foothold for Congress to conduct oversight and for the courts to review an FCC decision made by inaction.

The FCC's response to ACS of Anchorage leaves the distinct impression that at least for the time being, the consequence of recent forbearance actions on rate-of-return carriers remains uncertain. What is certain is that the unique challenges identified by the FCC regarding regulation for rate-of-return carriers will require conditions on rate-of-return ILECs that seek forbearance. If you have any questions on forbearance or the implications this may have on your tariff filings, please contact your JSI representative or John Kuykendall (jkuykendall@jsitel.com) or Scott Duncan (sduncan@jsitel.com) in JSI's Maryland office, at 301-459-7590.

700 MHz Auction Provides Opportunity for Some; Quandary for Others

The FCC has announced that the much-anticipated 700 MHz auction will begin on January 24, 2008. The licenses offered in this auction have been touted by the FCC as being "the finest crown jewels the FCC has to put up for auction" and "particularly well-suited for wireless broadband services." In addition, for JSI clients and other rural carriers awarded licenses in the previous 700 MHz bidding, the January auction offers the opportunity to increase the amount of continuous spectrum, since the FCC is once again auctioning the 700 MHz spectrum in CMA-size blocks.

With the deadline, December 3, for filing auction applications just over a month away, a number of companies appear excited about participating and are already preparing their applications. Some JSI clients, however, have sought advice and recommendations about whether participating in this auction is an appropriate step, especially given the unique characteristics associated with this auction.

Assessing the Requirements

The most noteworthy of these characteristics, as far as JSI clients and other rural providers are concerned, are the *stringent build-out requirements*. According to FCC Chairman Kevin Martin, the build-out requirements are "the toughest ever imposed by the Commission." Not since the days when cellular licenses were first offered in the 1980s has there been such valuable spectrum up for bid with *geographic* coverage benchmarks. PCS, AWS, and the previously auctioned 700 MHz spectrum all had population benchmarks, with many of the licenses carrying the vague "substantial service" coverage requirement. In the upcoming auction, licensees winning the smaller and medium-size licenses that will be available, the CMAs and EAs, must provide signal coverage and offer service to at least 35 percent of the licensed geographic area by February 17, 2013, and to at least 70 percent of the licensed geographic area at the end of the license term.

The penalties for missing these benchmarks are severe. If the first benchmark is missed, licensees will have their license terms reduced from ten to eight years, thus requiring these licensees to meet the end-of-term benchmark two years sooner. If the end-of-term benchmark is missed, the unused portion of the license *will terminate automatically* and become available for FCC reassignment. The FCC warned that in addition to these measures, licensees may also be subject to potential enforcement action, including possible license forfeitures or cancellation. (Accordingly, an auction winner will not be able to plan to build out the areas in which it makes the most financial sense and then just "lose" those areas where it did not plan to construct.) Further, the FCC warned that licensees would be granted waivers only if they could show that construction was delayed due to "unavoidable circumstances beyond the licensee's control."

Chairman Martin justified these tough build-out requirements by stating that they "will ensure that this spectrum is put to use quickly in both urban and rural areas" and that they are in line with his goal for this auction to yield the "next phase of wireless broadband innovation." Consequently, if these goals are met and winners of CMA licenses in this auction cover at least 70 percent of their areas by the end of the license term ten years from now, many companies that

decide not to participate in the auction, or participate but are not able to win spectrum in their service area, will likely have at least one wireless broadband provider serving a significant portion of their territory.

Companies that do participate in the auction, however, and win one or more CMAs will face a short timeframe in which to construct a wireless network covering large portions of sometimes very difficult terrain. One way rural companies may be able to accomplish this is to divide the CMA into "partitions" to reduce the geographic area that the licensee must cover. On the other hand, we may see cases in which there may not be individuals residing in parts of the 70 percent of the CMA or partitioned area that must be covered, meaning that companies would have to build out in areas where no one lives just to meet the requirements. Thus, JSI cautions, the upcoming auction may not be a good business fit for clients that do not already have some form of wireless infrastructure to help them meet the build-out requirements in a short period of time.

We will continue to monitor developments as the 700 MHz auction approaches and report our findings in *JSI News & Commentary* and/or our broadcast e-mails. If you have questions or comments about the auctions or the information in this article, please contact John Kuykendall (jkuykendall@jsitel.com) in our Greenbelt, Md., office, at 301-459-7590, or Douglas Meredith (dmeredith@jsitel.com) in Utah, at 801-294-4576.

ADD A NAME TO THE JSI NEWSLETTER E-MAIL LIST

Should others at your company get 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 there are others at your company who would also like to get our newsletter *via* e-mail, please complete the following information and fax it back to us, at 301-577-5575, or use the e-mail link to provide the information directly.

☐ I would like to receive JSI's newsletter via e-mail at the following address:

Name**:** ______________________________
Email Address______________________________
Company: ______________________________

☐ Please add the following individuals to the JSI e-mail newsletter list:

Name: ______________________________
Email Address:______________________________
Company: ______________________________

Name: ______________________________
Email Address:______________________________
Company: ______________________________

Please fax the completed form to Leah Yoakum in JSI's Maryland office, at 301-577-5575, or e-mail, lyoakum@jsitel.com.