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**Abolish Access Charges Now**

by

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Introduction

On August 3, 2011, the FCC issued a Public Notice soliciting still more comments on its ongoing proceeding to consider potential reforms of the Intercarrier Compensation and Universal Service programs. This follows the submission of a number of reform proposals, including the one put forward by six Price Cap Companies, which is called the "America's Broadband Connectivity Plan," or the "ABC Plan."<sup>1</sup> In the Public Notice, the Commission's earlier stated goal of facilitating the exchange of traffic on an IP-to-IP basis is overshadowed by requests for comment on detailed proposals to manage a slow transition away from access charges accompanied by regulatory structures designed to "maintain the predictable revenue stream associated with rate of return principles while also providing carriers with better incentives for efficient investment and operations."<sup>2</sup> The proposals are reminiscent of the debates of the 1980's with their concerns about protecting the revenue of local exchange companies and guaranteeing pass-through of access charge reductions to reduced long distance rates. There is little

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<sup>1</sup> Public Notice, Further Inquiry into Certain Issues in the Universal Service-Intercarrier Compensation Transformation Proceeding, DA – 1348, August 3, 2011.

<sup>2</sup> Public Notice, p. 14.

sense of the dominant role of wireless and IP-based communications except for a discussion of imposing new regulations on one-way interconnected VoIP services.<sup>3</sup>

In this *Perspectives* essay I suggest that proposed regulations to protect current revenue streams against competition and technological progress are counterproductive. Instead, access charges should be abolished immediately in favor of the continuation of both the regulated reciprocal compensation system and the unregulated private contracts.

My reasons for this recommendation are: (1) Wireless cellular carriers were exempted from the access charge system during the 1990's and they have prospered and pioneered important innovations such as distance insensitive rates; (2) The access charge system retards technological progress by creating incentives to maintain old technologies and rate structures and their associated revenues against new approaches that are more consistent with current technology; (3) The access charge system creates high transaction costs as companies seek ways to profit from access charge arbitrage, phantom traffic, and access stimulation while other seek to limit those activities with the associated lobbying and litigation costs; (4) Although early access charges were designed to provide subsidies, the identifiable subsidies have already been removed from access charges and the previous subsidy revenue incorporated into USF payments; (5) Because the same facilities can be used for regulated telephone service and unregulated services, the regulatory procedures used to compute access charges cause them to sometimes subsidize competitive services or provide windfall profits; and (6) Reciprocal compensation provides a clearer path to all-IP networks than access charges.

The access charge system will reach its thirtieth birthday in early 2014. That is a good target date for the complete abolition of the entire structure of access charges and the associated FCC rules and administrative procedures. The FCC has properly proposed ending access charges, but it envisions a long “glide path” to reduce the level of rates, accompanied by measures to protect current access revenue flows to individual companies, rather than a specific date for completely ending access charges. The seventeen year phase-out of identifiable subsidies was completed ten years ago. The next logical step after the 2001 elimination of identifiable subsidies was to abolish the rigid structure altogether and allow companies to negotiate arrangements under the reciprocal compensation framework. Instead, the system has remained intact while companies have found privately profitable but socially detrimental ways to “game” the complex combination of FCC rules.

## Background

Both the voice network and the Internet depend on cooperation among service providers to provide communications. The payments from one carrier to another for jointly providing communications services are known as Inter-carrier Compensation

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<sup>3</sup> The Public Notice at p. 17 defines one-way interconnected VoIP services as “those that allow users to terminate calls to the PSTN, but not receive calls from the PSTN, or vice versa.”

("ICC"). ICC is determined by a complex system that includes federal regulation, state regulation, and unregulated arrangements that vary with technology and the historical circumstances that shaped the particular arrangement. For many years, the FCC has proposed ideas to reform and rationalize the system but has not adopted any of the proposed major reforms.

The latest effort began with the release of a Notice of Proposed Rulemaking and Further Notice in February 2011 that proposed overhauling ICC and the closely related Universal Service Fund ("USF").<sup>4</sup> In the ICC portion of the NPRM, the Commission proposed short-term changes to solve particular problems with the current ICC system and also sought comment on how to structure the ICC system to facilitate the expected transition to all-IP networks. Thus, the Commission stated: "Most fundamentally, the long-term approach to intercarrier compensation reform also must be consistent with the exchange of traffic on an IP-to-IP basis."<sup>5</sup>

In the current ICC system, the payment for a particular function depends on the technology used and on political boundaries. Consider a rural telephone company ("A") that terminates a voice call that was originated by a different company. If the incoming call was originated by a wireline company, A is entitled to a payment for each minute determined by its relevant access charge tariff, with different rates according to whether the call originated in the same state or a different state. If the incoming call was originated by a wireless company, reciprocal compensation applies and the payment (if any) is determined by the net traffic between the two companies, but will often be close to zero. If the incoming call was originated from a computer (Skype or similar service) and terminates on a broadband connection provided by A, A will pay for the connection to a major Internet provider (through a capacity charge, not a per-minute charge).

Thus, depending on the technology used for the call, the terminating telephone company could receive a payment, make a payment, or do neither. The differences create incentives for companies to adopt or avoid a particular technology in order to get a more favorable rate. These different rates also create incentives for companies to seek ways to stimulate access minutes in highly compensated categories in order to receive higher access payments. Or they create incentives to disguise traffic subject to one charge to make it appear subject to a more favorable charge. The existing process transfers money among various parties in a particularly inefficient way as the parties distort technology, lobby, and litigate in order to gain an advantage.

Access charges were first implemented in 1984, and they were designed to maintain a portion of the pre-divestiture subsidy from long distance to local service for a temporary period while the industry adjusted to early competition. Access charges were created through a rigid cost allocation system for companies subject to rate of return regulation with an expected industry structure of competitive long distance companies and monopoly local exchange companies. Price discrimination was a fundamental feature of

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<sup>4</sup> Connect America Fund; A National Broadband Plan for Our Future; Notice of Proposed Rulemaking and Further Notice of Proposed Rulemaking, 26 FCC Rcd 4554 (2011)

<sup>5</sup> NPRM, at para. 527.

access charges from the beginning and the system has generated a long series of disputes and innovative ways to arbitrage between higher and lower rates for essentially the same service.<sup>6</sup>

Even at the time of its creation, the FCC recognized that the access charge system was an awkward compromise between the conflicting goals of increasing competition and protecting the monopoly revenue flows from being eroded (too quickly) by competition. The FCC understood that the system created inefficiencies and arbitrage opportunities and sought to phase out the implicit subsidies embedded in access charges. The access charge subsidies were gradually replaced by explicit subsidies paid through the Universal Service Fund through a long series of orders over a 17-year period (1984-2001). During that time, average access charges per long distance conversation minute dropped by 90% from \$.17/minute to \$.017/minute<sup>7</sup>, but changes in technology and industry structure generated continuing problems from the access charge system. While average access charge rates have dropped dramatically, the small rural carriers that remain under rate-of-return regulation (instead of the price cap regulations that apply to large carriers) have much higher rates than the average. Furthermore, their rates have been increasing in recent years as the number of wireline access minutes has declined.

If current regulations remain in place, the increase in access charge rates for rate-of-return carriers is likely to continue as more consumers shift long distance communication from wireline to wireless and Internet. Direct competitive pressure on access charges is limited by the Commission's price averaging rules, but the current path creates increasing distortions and is unsustainable in the long run. The choice is between changing the rules to protect the current revenue flows or eliminating the access charge regulations.

For the reasons below, I recommend abolishing the structure of switched access without attempting to preserve the revenue flow currently created by that structure.<sup>8</sup>

### Six Reasons to Abolish Access Charges

#### 1. Achieve wireline-wireless equality

During the 1990's the FCC established interconnection rules between CMRS carriers (wireless cellular telephones) and wireline local telephone companies based on reciprocal compensation and prohibited CMRS carriers from filing access tariffs.<sup>9</sup> Those rules made it feasible for cellular carriers to eliminate the earlier sharp distinction between rates charged for local and for long distance calls and to begin the now

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<sup>6</sup> The initial access charges and their predecessor negotiated agreement were designed to charge a higher rate for a call to MCI's office that initiated a competitive long distance call than for a physically indistinguishable call to another local customer.

<sup>7</sup> "Trends in Telephone Service," Industry Analysis and Technology Division, Wireline Competition Bureau, FCC, September 2010, Table 1.2.

<sup>8</sup> "Special access" has different considerations than switched access and is outside the scope of this essay.

<sup>9</sup> The regulatory history of this provision is summarized in the NPRM, footnote 700.

standard practice of distance insensitive rates for calls that begin on a wireless telephone. The routine use of wireless phones for long distance calls illustrates the feasibility of reciprocal compensation as a substitute for access charges. If access charges were abolished, intercarrier compensation for the declining set of wireline phones could conform to the system used for the increasing set of wireless phones.

## 2. Decrease barriers to technological progress

The access charge system creates incentives to retain lucrative access charge structures even when other methods of interconnection would be more efficient. Access charges have slowed the movement toward distance insensitive rates in wireline phones and have increased real costs by discouraging IP-based data transfer methods. Access charges are based on old legacy costs and rate structures and create incentives to maintain the old structures and their associated revenues against new approaches that are more consistent with current technology.

## 3. Reduce transaction costs

The access charge system creates substantial transaction costs that ultimately adversely impact consumers. The direct transaction costs include the accounting, filing, review, and payment costs. The indirect transaction costs are much larger than the direct costs as companies seek ways to profit from access charge arbitrage, phantom traffic, and access stimulation while others seek to limit those activities. The indirect transaction costs include the additional costs of routing conference calls to sparsely populated rural areas with high costs in order to generate highly compensated access minutes, the costs of bargaining and litigation over questionable access charge bills, and lobbying over ways to maintain or change the current system. All payment methods incur some transaction costs. But the complex price discrimination scheme embodied in access charges creates unusually high transaction costs. The FCC's proposals in the NPRM regarding phantom traffic and access stimulation<sup>10</sup> are an example of the detailed regulatory oversight required to preserve the access charge structure and rates at levels far different than competitive market levels would dictate.

## 4. Identifiable subsidies have already been removed and replaced with USF funds.

The FCC first removed identifiable subsidies from the access charges imposed by price-cap carriers and later for rate-of-return carriers. The final step was the Commission's adoption of the Multi-Association Group (MAG) plan in 2001 which reformed access for the small rural carriers that continued under rate-of-return regulation after the major companies had switched to price cap regulation. The Commission created a new universal service element to replace identifiable subsidies contained in the small telephone company access charges. At the same time, it stated: "As the new, uncapped support mechanism that we create will provide certainty and stability by ensuring that the rate structure modifications we adopt do not affect overall recovery of interstate access costs. . . . we are adopting a cautious approach which rationalizes the access

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<sup>10</sup> NPRM, at paras. 620-677.

rate structure and converts identifiable implicit subsidies to explicit support, without endangering this important revenue stream for rate-of-return carriers.”<sup>11</sup>

Payments to companies for the new USF element of Interstate Common Line Support increased rapidly from \$173 million in 2002 to \$1.5 billion in 2009, while total High-Cost Support increased from \$2.9 billion to \$4.5 billion during those years.<sup>12</sup> Although some telephone companies claim that their revenue from the post-2001 access charges is higher than their costs associated with providing the service, the policy rationale for access charges over the past ten years has been to cover the costs of service while identifiable subsidies previously embedded in access charges are paid to companies as explicit universal service payments.

#### 5. Access charges sometimes subsidize competitive services or provide windfall profits

There is a statutory prohibition on cross-subsidy<sup>13</sup> but enforcement of cross subsidy prohibitions is difficult and dependent upon detailed cost allocation rules. For price cap carriers, cost allocation has become of minimal importance because their allowable prices are determined by the price cap formulas largely independent of their current accounting costs. For rate-of-return carriers, cost allocation remains important but because most of them are small and exempted from keeping the detailed accounts required of larger carriers, cost allocation rules are particularly difficult to enforce.

In 2001, the Commission adopted the “no barriers to advanced services” policy for small telephone companies. The Commission stated: “The public switched telephone network is not a single-use network. Modern network infrastructure can provide access not only to voice services, but also to data, graphics, video, and other services. . . . Thus, although the high-cost loop support mechanism does not support the provision of advanced services, our policies do not impede the deployment of modern plant capable of providing access to advanced services. Rural carriers may consider both their present and future needs in determining what plant to deploy, knowing that prudent investment will be eligible for support.”<sup>14</sup> This policy allowed small carriers to install plant capable of providing both regulated and unregulated services while, at the same time, defraying much of the cost of the plant through USF and access charges with no regard to the revenue received from unregulated services such as video and broadband Internet access.

As the Commission stated in the USF NPRM: “Under our 'no barriers' policy, a significant portion of rate-of-return carriers' costs, including costs of upgrading the network with fiber for broadband, is allocated to regulated services, even though non-regulated services increasingly have been provided using that same network, and have accounted for an increasing percentage of revenue. As a policy matter, when evaluating

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<sup>11</sup> MAG Order, 16 FCC Rcd 19613 (2001) at 19620.

<sup>12</sup> Universal Service Monitoring Report 2010, Industry Analysis and Technology Division, Wireline Competition Bureau, FCC, Table 3.1.

<sup>13</sup> 47 U.S.C. 254(k).

<sup>14</sup> Rural Task Force Order, 16 FCC Rcd 11244 (2001) at 11322.

recovery in the context of intercarrier compensation reform, it is unclear why the Commission would simply ignore all revenues earned from such services."<sup>15</sup> The "no barriers" policy together with weak and/or rarely enforced cost allocation rules allows rate-of-return companies to assign assets that are used jointly for regulated and unregulated services to the regulated category and to recover a portion of their costs twice: first from regulated services including access charges and USF payments and then from selling unregulated services derived from the same plant. This anomaly could be corrected by more extensive regulation such as bringing more services under the regulatory boundary or imposing strict accounting and cost allocation rules. However, it would be better to decrease regulation by abolishing the rigid structure of access charges and recognizing that new sources of revenue (such as providing unregulated Internet access service) can compensate for declining historical sources of revenue (such as regulated access charges) in order to cover the cost of assets used for both regulated and unregulated services.

#### 6. Reciprocal compensation provides a clearer path to all-IP networks than access charges

Because of concerns about discrimination and competitive fairness at the time of the AT&T divestiture, the structure of access charges was prescribed in the FCC rules with no flexibility for parties to negotiate alternative arrangements. Consequently, the technology of that time continues to shape the structure of access charges and there is no easy way for companies subject to access charges to convert from charges based on minutes of voice conversation to the exchange of packets. The reciprocal compensation framework initiated by the Telecommunications Act of 1996 provides a much more flexible structure that can easily accommodate IP technology. The starting point is negotiation among the relevant carriers, and if they reach a voluntary agreement, they are exempt from the statutory guidelines. Even if they fail to reach a voluntary agreement and seek binding arbitration from the state commission, the requirement for "mutual and reciprocal recovery by each carrier of costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier"<sup>16</sup> is general enough to be applied to IP networks.

#### Conclusion

The access charge system will reach its thirtieth birthday in early 2014. That is a good target date for the complete abolition of the entire structure of access charges and the associated FCC rules and administrative procedures. The FCC has properly proposed ending access charges, but it envisions a long "glide path" to reduce the level of rates rather than a specific date for completely ending access charges. The seventeen year phase-out of identifiable subsidies was completed ten years ago. The next logical step after the 2001 elimination of identifiable subsidies was to abolish the rigid structure altogether and allow companies to negotiate arrangements under the reciprocal

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<sup>15</sup> NPRM, at para. 569)

<sup>16</sup> 47 U.S.C. 252(d).

compensation framework. Instead, the system has remained intact while companies have found privately profitable but socially detrimental ways to “game” the complex combination of FCC rules.

While some time is needed for companies to arrange reciprocal compensation agreements as a replacement for access charges, there is no need for a further slow phase-out of access charge revenue. It is now time for the FCC to specify a date certain for the elimination of the obsolete system and to conform the wireline ICC regime to that already successfully used for wireless and wireless-wireline combinations.

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